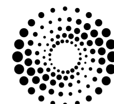
RETT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Small Employer Retirement Plans



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Interactive Self-study CPE

Companion to PPC's Guide to Small Employer Retirement Plans

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INTRODUCTION

Companion to PPC's Guide to Small Employer Retirement Plans consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Small Employer Retirement Plans* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **August 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S GUIDE TO SMALL EMPLOYER RETIREMENT PLANS

COURSE 1

Understanding Eligibility and Vesting Rules, and Testing for Minimum Coverage and Participation (RETTG101)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides an overview of employer retirement plan eligibility and vesting as well as the requirements to maintain favorable tax status. Lesson 1 explains the eligibility, benefit accrual, and vesting standards applicable to most employee pension benefit plans (i.e., defined contribution and defined benefit plans) using a step-by-step approach, and Lesson 2 provides an overview of the minimum participation and coverage rules.
PUBLICATION/REVISION DATE:	August 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Small Employer Retirement Plans*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of qualified retirement plans
CPE CREDIT:	8 QAS Hours, 8 Registry Hours 8 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **August 31, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Understanding Eligibility and Vesting Rules

Completion of this lesson will enable you to:
- Describe the steps in determining eligibility and vesting rules, and summarize the plan document and minimum age and service requirements.
- Determine how a year of service is determined including service computation periods and measuring and crediting service.
- Determine the employees' participation date, and how to handle breaks in service.
- Describe how benefits are accrued under the defined contribution, defined benefit, and cash plans; and vesting standards.

Lesson 2—Testing for Minimum Coverage and Participation

Completion of this lesson will enable you to:
- Determine how the plan document affects coverage and if the plan should be tested.

- Summarize how to identify plans to be tested for minimum coverage and identify controlled groups.
- Determine nonexcludable, active employees and highly compensated employees.
- Describe the average benefit test, and the consequences of failing the minimum coverage testing; and the minimum participation rules for defined benefit plans.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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See the test instructions included with the course materials for more information.

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Lesson 1: Understanding Eligibility and Vesting Rules

INTRODUCTION

What Are the Eligibility Rules?

Both the Internal Revenue Code and ERISA contain standards regarding the minimum age and length of service requirements an employer may impose on employees before allowing them to participate in the employer's qualified plan. While a plan may set minimum age and service requirements, it may not set maximum requirements. Also, certain employees are allowed to be excluded even though they satisfy the minimum age and service requirements.

ERISA does not preclude an employer from setting plan participation standards unrelated to age and service. For example, an employer can establish a pension plan for employees of Division A but not Division B, or for hourly employees but not for salaried employees. In setting such standards, the plan must be able to meet coverage requirements that are designed to ensure that a plan covers a broad base of nonhighly compensated employees. However, the Internal Revenue Code, unlike ERISA, also contains coverage requirements that may restrict an employer's ability to provide a plan for some groups of employees, but not for others. Thus, the employer with Divisions A and B may have to maintain a plan for employees of both divisions in order to meet Internal Revenue Code requirements.

What Are the Vesting Rules?

Both the Internal Revenue Code and ERISA regulate benefit accrual and the length of time within which an employee must vest in benefits accrued under the plan. Vesting generally refers to when a participant's accrued benefit becomes nonforfeitable. As with the participation standards, the Code and ERISA standards are minimum standards; a plan can always provide for faster benefit accrual and vesting than the statutory minimums.

What Does This Course Cover?

This course explains the eligibility, benefit accrual, and vesting standards applicable to most employee pension benefit plans (i.e., defined contribution and defined benefit plans) using a step-by-step approach.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the steps in determining eligibility and vesting rules, and summarize the plan document and minimum age and service requirements.
- Determine how a year of service is determined including service computation periods and measuring and crediting service.
- Determine the employees' participation date, and how to handle breaks in service.
- Describe how benefits are accrued under the defined contribution, defined benefit, and cash plans; and vesting standards.

STEPS IN DETERMINING ELIGIBILITY AND VESTING

The following outline provides an easy step-by-step process for determining eligibility and vesting. Refer to the plan document to determine the plan's specific provisions.

Step 1 Determine who is eligible to participate:

- What are the eligibility requirements for participation?

- Is the employee a member of an excluded group?
- What method does the plan use to credit service?
  - Actual hours?
  - An hour equivalence method?
  - Elapsed time method?
- How is the service period determined?
- What are the time periods for measuring service for participation?
- Must service with a previous employer be included in credited service?
- Are there rehired employees?
- Has an employee been on leave or incurred a break-in-service?
- What are the plan entry dates for new participants?

Step 2 Determine if eligible participants completed the service requirement to accrue a benefit for the current plan year.

Step 3 Determine each participant's vesting percentage:

- Does the same vesting schedule apply to all types of employer contributions?
- Is the employee fully vested?
- Did the employee complete a year of service for vesting purposes?
- Did the employee reach normal retirement age?
- Did the employee retire early?
- Was the plan terminated?
- Determine the employee's vested interest in his benefits.

THE PLAN DOCUMENT

The plan document must be reviewed as part of determining the eligibility and vesting requirements for the plan. The Internal Revenue Code and ERISA specify the statutory rules that must be followed, but there are different options available in fulfilling these requirements. A plan is allowed to have more liberal eligibility conditions than the statutory requirements, but the plan document must specify these conditions. The plan document sets forth the specific requirements that are to be completed by an employee to meet the eligibility, vesting, and benefit accrual rules. In each step of determining the eligibility, benefit accrual, and vesting requirements, the provisions of the plan document must be consulted.

Failure to operate a plan in accordance with the written terms is a disqualifying event under the Internal Revenue Code and a violation of ERISA. However, if a plan has erroneously covered an employee that is ineligible under the terms of the document, it can generally be corrected with an Employee Plans Compliance Resolution System (EPCRS) correction method for operational failures.

MINIMUM AGE AND SERVICE REQUIREMENTS

Eligibility for participation in a qualified plan is limited to individuals who are employees of the sponsoring employer. *Employee*, for this purpose, refers to common law employees; however, certain leased employees and full-time life insurance salespersons are treated as employees eligible to participate in a qualified plan.

An employer may require that an employee be employed for a certain length of time before being eligible to participate in the employer's qualified plan. This is commonly referred to as a *service requirement*. In addition, an employer may require that employees attain a minimum age before allowing them to participate in a qualified plan. However, both the Code and ERISA restrict the minimum age and service requirements that an employer may impose for plan participation. These restrictions are discussed in this lesson.

Complying with the One-year-of-service/Age 21 Rule

A plan can have minimum age and/or service requirements. However, in general, a plan cannot require an employee who is otherwise eligible to participate in the plan to complete a period of service extending beyond the later of:

a. the date on which the employee reaches age 21, or

b. the date on which the employee completes one year of service.

Any minimum age and/or service conditions must be specifically stated in the plan document. The plan document will also state the date an eligible employee who has satisfied the age and service requirements may join or enter the plan. Governmental plans and nonelecting church plans are exempt from the minimum age and service requirements,.

Two-year Service Requirement

As an exception to the one-year-of-service rule, a plan may require an employee to complete two years of service before becoming eligible to participate in the plan if the employee will be 100% vested after completing the service requirement.

Special Rules for 401(k) Plans. The two-year rule cannot be used to determine eligibility for participation in the salary deferral feature of a 401(k) plan. However, a 401(k) plan having elective deferrals, matching contributions, and discretionary employer contributions could have two eligibility requirements. Participation in elective deferrals could require one year of service, while participation in the matching and discretionary contributions could require two years of service.

Example 1-1: When employees are eligible to defer salary in a 401(k) plan.

An employer maintains a profit-sharing plan with a 401(k) salary deferral feature. The employer also makes discretionary contributions to the plan. The employer contributions are fully vested after the participant completes two years of service.

When must employees be allowed to participate in making salary deferral contributions to the plan? Otherwise eligible employees must be eligible to make salary deferral contributions after one year of service, but the plan may require that an employee complete two years of service before becoming eligible to share in employer contributions (including employer matching contributions) as long as the employee is immediately vested in those contributions.

Considering Top-heavy 401(k) Plans

If the plan is top-heavy, it may not be desirable to have differing eligibility requirements because an individual eligible to participate in any portion of the plan must be included in top-heavy testing. Employees participating in the 401(k) feature but not yet eligible for the employer discretionary contributions are included in determining whether a plan is top-heavy and in calculating the top-heavy minimum contribution. Accordingly, in making the

top-heavy minimum contributions, the employer may be required to make such contributions for employees who otherwise would not have been included. In such a case, it is best to have the same eligibility requirements for both the 401(k) and non-401(k) portions of the plan.

The top-heavy rules do not apply to SIMPLE 401(k) plans or qualified automatic contribution arrangements (QACAs). Safe harbor 401(k) plans that consist of only 401(k) safe harbor deferrals and 401(m) safe harbor matching contributions are also exempt from the top-heavy requirements. Thus, if such plan had an employer match of 3% (or more) of pay for 401(k) participants, the employer would not have to put in additional money for them due to the top-heavy rules, but would have to contribute 3% of pay for non-key employees who are eligible but not participating in the 401(k) plan by making elective deferrals if the safe harbor method chosen was the non-elective 3% contribution.

Avoiding Maximum Age Restrictions

A plan may not exclude an employee from participation on the basis of having reached a *maximum* age.

Adopting More Liberal Plan Provisions

The age and service rules are *minimum* requirements for a qualified plan to maintain its status. A plan may always provide for more liberal entry criteria. For example, a plan may provide that all employees are eligible to begin participation six months after they are employed. However, in testing whether the plan satisfies the minimum coverage requirements, a plan with more liberal age and/or service requirements may, at the employer's option, be tested as two plans (i.e., one plan consisting of all employees who meet the statutory one-year and age 21 requirement, and the second plan consisting of all employees whose age and/or service is below the statutory minimum).

Using a more liberal service condition such as six months allows part-time employees to enter the plan. Part-time employees will be able to participate because a minimum hours of service requirement cannot be used. The minimum hours of service requirement is used only with eligibility periods of 12 or 24 months..

Excluding Employees from Participating

Generally, an employee who has satisfied a plan's minimum age and service requirements must be allowed to participate in the plan. However, certain employees may be excluded from participation as long as the exclusion is not related to age or service. A plan may exclude employees based on their employment classification, job description, work location, or company division and not be considered discriminatory. If a plan chooses to exclude a class of employees, the exclusion must be specified in the plan document. Employees who are currently excluded from participation in a plan because of another eligibility condition will continue to accrue vesting and eligibility service. If such employees subsequently become eligible, they cannot be excluded based on service and would have accrued vesting service.

Election Not to Participate

Generally, once an employee has satisfied the plan's eligibility requirements and the entry date is reached, the employee is automatically treated as a plan participant. However, a plan may provide for eligible employees to elect not to participate in the plan by voluntarily making a written statement declining participation. The election should be in a form acceptable to the plan administrator and state that the employee has been informed about the advantages of participation. Employees who elect not to participate for a plan year are considered eligible employees for purposes of coverage testing, but not as an employee benefiting under the plan. This can create difficulty in passing the coverage tests if the employee is highly compensated.

Employees Not Allowed to Be Excluded

Employees cannot be excluded from participation because of disguised service or age conditions. Any age or service condition that has the effect of requiring more than the greatest age or service condition allowable is treated as imposing an age or service condition, even if the plan provisions do not specifically refer to age or service.

Example 1-2: Employees not excludable because of *disguised* service condition.

Corporation A is divided into two divisions. In order to work in Division 2, an employee must first have been employed in Division 1 for five years. A plan provision that requires Division 2 employment for participation will

be treated as a service requirement because such a provision has the effect of requiring five years of service. This service requirement exceeds the greatest service condition allowable (i.e., one year) and the plan would not meet the qualification requirements.

Part-time or Seasonal Employees. Part-time or seasonal employees may not be excluded from plan participation if it is possible for such employees to meet the Section 410(a) year-of-service requirement (i.e., to have at least 1,000 hours of service) (IRS Field Directive on Exclusion of Part-time Employees from Plan Participation Under IRC Sec. 410, on November 22, 1994, and Employee Plan Determinations Quality Assurance Bulletin, FY-2006 No. 3, February 14, 2006). Excluding such employees, in effect, imposes an impermissible indirect service requirement on plan participation that could exceed one year of service. Accordingly, plans that exclude such employees are in violation of the IRC Sec. 410(a) year-of-service requirement.

Example 1-3: Part-time employees not excludable.

Company B has a profit-sharing plan that requires one year of service. The plan also excludes part-time or seasonal employees if their customary employment is for no more than 20 hours per week or five months in any plan year. The plan is not a qualified plan because the provision imposes a minimum service requirement that could result in the exclusion of an employee who has completed a year of service. The plan would not qualify even though, after excluding all such employees, the plan satisfied the minimum coverage requirements.

However, the IRS will accept an eligibility provision providing that "an employee whose customary employment is for at least 20 hours per week shall be eligible to participate as of the first of the month following date of hire, and an employee whose customary employment is for fewer than 20 hours per week shall be eligible to participate as of the first of the month following the date on which such employee has earned a year of service." Under such a provision, Company B's part-time employees will participate in the plan if they do in fact earn at least 1,000 hours of service in an eligibility computation period.

Other Special Rules

Tax-exempt Educational Institutions. In the case of plans maintained by certain tax-exempt educational institutions, the plan may substitute a minimum age requirement of 26 years for 21 years if the plan provides that an employee with one year of service is 100% vested in any accrued benefit and does not use more than a one-year service requirement for eligibility.

Governmental and Church Plans. The age and length-of-service requirements do not apply to governmental plans or to church plans not electing under IRC Sec. 410(d) to be treated as nonchurch plans. Nonelecting church plans are subject only to pre-ERISA eligibility standards under IRC Sec. 401(a)(3), with the exception of certain Indian Tribe plans covering employees not providing essential government services after 2006. Governmental plans maintained by a state or local government or a political subdivision are exempt from both ERISA and pre-ERISA age and service eligibility standards.

403(b) Plans. The age and length-of-service requirements pertain to Section 403(b) plans that are subject to Title I of ERISA. However, voluntary Section 403(b) plans that have only salary deferrals and the employer's only involvement in the arrangement is the withholding of salary deferrals and their remittance to the annuity contractor or custodial account holder, provided that other conditions required by DOL Reg. 2510.3-2(f) are satisfied, are exempt from these rules. In addition, under final regulations effective for taxable years beginning after 2008, 403(b) plans may allow only elective deferrals to satisfy a universal availability requirement.

Universal availability requires that generally all eligible employees [which would not include any excludable employees under the plan terms such as nonresident aliens; employees eligible to make deferrals to a 457(b), 401(k), or another 403(b) plan; students; and employees who normally work fewer than 20 hours per week] of the employer be permitted to make elective deferrals immediately (without a one-year wait) if any employee of the employer may make elective deferrals. Universal availability also requires that employees have an effective opportunity to defer at least annually and are provided notice of the availability of the right to defer and the period of time during which elections can be made. Church plans are not subject to universal availability.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Determining plan entry dates for new employees is a part of which of the following steps?

   a. Determine eligible participants.

   b. Determine if eligible participants can accrue benefits for the current plan year.

   c. Deciding vesting percentage.

2. When considering top-heavy 401(k) plans, which of the following is correct?

   a. Employers are encouraged not to have varying eligibility requirements.

   b. Only employees who are eligible for the employer discretionary contributions can determine the top-heavy minimum contribution.

   c. Top-heavy rules apply to qualified automatic contribution arrangements (QACAs), 401(k) plans, and SIMPLE 401(k) plans.

3. There are situations when specific employees who meet the plan's minimum age and service requirements are excluded from participation in a plan. Which of the following employees could be considered ineligible to participate?

   a. Adam is an employee at Flash Foto Photography (FFP). He has been employed at FFP for five years. FFP's minimum service policy is two years according to their service agreement.

   b. Barbara is employed at The Best of Nature (TBN) Vitamin Shoppe. Although TBN's home office in Delaware; Barbara spends most of her time in Kaduna, Nigeria searching for native herbs.

   c. Cory is 24-years old and is employed at the Marine Coastal Geology Program. According to the Marine Costal Geology Program's (MCGP) plan agreement, the minimum age is 19.

4. Which of the following statements pertaining to other special rules regarding minimum age and service requirements is most accurate?

   a. Any plans maintained by education institutions must always use the 21-year age requirement.

   b. Church plans that do elect to be treated as nonchurch plans must adhere to the age and length-of service requirements.

   c. State-maintained governmental plans generally are exempt from ERISA age and service eligibility requirements.

   d. Church plans are subject to universal availability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Determining plan entry dates for new employees is a part of which of the following steps? **(Page 3)**

   a. Determine eligible participants. [This answer is correct. Determining plan entry dates for new participants as well as determining rehired employees is a part of step 1 of determining eligibility and vesting. Then, the service requirements and vesting percentages are determined.]

   b. Determine if eligible participants can accrue benefits for the current plan year. [This answer is incorrect. Determining if eligible participants have completed the service requirement to accrue a benefit for the current plan year is step 2 of determining eligibility and vesting.]

   c. Deciding vesting percentage. [This answer is incorrect. Determining each participant's vesting percentage is step 3 of determining eligibility and vesting.]

2. When considering top-heavy 401(k) plans, which of the following is correct? **(Page 5)**

   a. Employers are encouraged not to have varying eligibility requirements. [This answer is correct. If a plan is top-heavy, it may not be desirable to have differing eligibility requirements because an individual eligible to participate in any portion of the plan must be included in top-heavy testing. In making the top-heavy minimum contributions, the employer may be required to make contributions for employees who otherwise would not have been included.]

   b. Only employees who are eligible for the employer discretionary contributions can determine the top-heavy minimum contribution. [This answer is incorrect. Employees participating in the 401(k) feature but not yet eligible for the employer discretionary contributions are included in determining if a plan is top-heavy and in calculating the top-heavy minimum contributions.]

   c. Top-heavy rules apply to qualified automatic contribution arrangements (QACAs), 401(k) plans, and SIMPLE 401(k) plans. [This answer is incorrect. The top-heavy rules do not apply to SIMPLE 401(k) plans or QACAs. Also, Safe harbor 401(k) plans that consist of only 401(k) safe harbor deferrals and 401(m) safe harbor matching contributions are also exempt from the top-heavy requirements per the Internal Revenue Code.]

3. There are situations when specific employees who meet the plan's minimum age and service requirements are excluded from participation in a plan. Which of the following employees could be considered ineligible to participate? **(Page 6)**

   a. Adam is an employee at Flash Foto Photography (FFP). He has been employed at FFP for five years. FFP's minimum service policy is two years according to their service agreement. [This answer is incorrect. According to IRS regulations, an employee who has satisfied a plan's service requirements generally is allowed to participate in the plan. Adam has been employed at FFP for five years and FFP's service agreement states that the minimum service is two years. Therefore, he cannot be excluded for the service requirement.]

   b. Barbara is employed at The Best of Nature (TBN) Vitamin Shoppe. Although TBN's home office in Delaware; Barbara spends most of her time in Kaduna, Nigeria searching for native herbs. [This answer is correct. Because TBN's home office is in Delaware and Barbara spends most of her time in Nigeria, she could be ineligible to participate in the plan. IRS regulations state that an employee may be excluded from the plan based on their work location.]

   c. Cory is 24-years old and is employed at the Marine Coastal Geology Program. According to the Marine Costal Geology Program's (MCGP) plan agreement, the minimum age is 19. [This answer is incorrect. Cory is eligible to participate in the company's plan because he meets the minimum age requirement as stated

in MCGP's plan agreement. An employee who has satisfied a plan's minimum age requirement cannot be excluded from participation based on his age.]

4. Which of the following statements pertaining to other special rules regarding minimum age and service requirements is most accurate? **(Page 7)**

   a. Any plans maintained by education institutions must always use the 21-year age requirement. [This answer is incorrect. According to IRC Sec. 410(a)(1)(B)(ii), in the case of plans maintained by certain tax-exempt educational institutions, the plan may substitute a minimum age requirement of 26 years for 21 years if the plan provides that an employee with one year of service is 100% vested in any accrued benefit and does not use more than a one-year service requirement for eligibility.]

   b. Church plans that do elect to be treated as nonchurch plans must adhere to the age and length-of service requirements. [This answer is incorrect. The age and length-of-service requirements do not apply to church plans not electing under IRC Sec. 410(d) to be treated as nonchurch plans per IRC Sec. 410(c).]

   c. State-maintained governmental plans generally are exempt from ERISA age and service eligibility requirements. [This answer is correct. Governmental plans maintained by a state or local government or a political subdivision are exempt from both ERISA and pre-ERISA age and service eligibility standards per the Internal Revenue Code.]

   d. Church plans are subject to universal availability. [This answer is incorrect. According to Reg. 1.403(b)-5, universal availability requires that employees in 403(b) plans have an effective opportunity to defer at least annually and are provided notice of the availability of the right to defer and the period of time during which elections can be made. Church plans are not subject to universal availability.]

CREDITING SERVICE METHOD

A Year of Service

The concept of a year of service is used to determine when an eligible employee can participate in the plan, when the employee can accrue benefits, and when vesting occurs. There are generally two methods for crediting service: the hours method or the elapsed time method.

Methods for Measuring Service

Hours Method. The hours method for crediting service is used by most plans. The number of hours worked in a 12 month period is equated to years of service for determining eligibility for participation, vesting, and benefit accruals. An employee generally earns an hour of service for each hour the employee is paid or entitled to compensation. This method either uses the actual hours of service earned by employees or one of the simplified methods of determining service equivalences.

Elapsed Time Method. The elapsed time method for crediting service is based on a period of service, rather than determining the hours credited toward a year of service. Under the elapsed time method, the plan disregards actual hours worked and instead bases credit for participation and vesting on the total period of time an employee works for the employer, beginning with the date employment begins and ending when employment is severed.

DETERMINING A YEAR OF SERVICE

The 1,000 Hours Standard

A *year of service* is defined as a 12-consecutive-month period during which the employee completes at least 1,000 hours of service. When the plan's eligibility computation period is less than 12 months, hours must be disregarded and the elapsed time method must be used, or an alternative eligibility computation period of twelve months must be provided for those employees who do not satisfy the shorter eligibility computation period with prorated hours. Special care must be taken to ensure that the plan maintains compliance with the minimum statutory standard of *a year of service* when an eligibility period of less than 12 months applies. The same rule applies when the service requirement is less than two years but more than one year (e.g., 18 months).

> **Example 1-4: Service requirement of less than 12 months.**
>
> Samantha is employed by Big Boats Inc. on October 1. The Big Boats 401(k) plan provides for a six-month eligibility period and defines a month of service as at least 120 hours in a calendar month. The initial computation period for Samantha is measured from her employment commencement date of October 1 through the next September 30, during which time she is credited with 100 hours per month, for a total of 1200 hours. The plan's eligibility criterion of six months of service has not been met because Samantha did not work 120 hours in six different months. However, failure to allow Samantha to participate in the plan would be a violation of the statutory minimum service standards because she has worked over 1,000 hours in a 12-month period.

The plan document must specify whether an employee completes a year of service by earning at least 1,000 hours of service, or whether the employee must both (a) earn 1,000 hours of service, and (b) complete twelve consecutive months of service (although the employee need not have been employed in each of the twelve months, as long as the employee is employed at the end of the period).

Excluding Terminated Employees. A plan may provide that employees who terminate employment before their plan entry date but after completing at least 1,000 hours of service are deemed not to have begun participation in the plan.

PERIODS OF SERVICE COMPUTATION

Computation of Service for Eligibility, Vesting, and Benefit Accrual

Computation periods must be defined by the plan document for (a) determining eligibility to participate in the plan, (b) crediting of service for vesting, and (c) benefit accrual.

In general, an eligibility computation period determines whether an employee has met the service requirements for admission into the plan. It can also determine whether an employee or participant with no vested interest in employer-derived accrued benefits remains eligible for plan participation under the rule of parity. The plan document must contain the eligibility computation periods.

Eligibility Period Based on Employment Anniversary or Plan Year

Initial Eligibility Period. An employee's initial eligibility period must begin with the employment commencement date (the first day of which the employee is credited with an hour of service) and end with the date that is one year after the date of employment.

Subsequent Eligibility Periods. Eligibility computation periods subsequent to the initial eligibility period may be based on the plan year or the employment anniversary date for employees not meeting the service requirements in the initial period. Plans with a two-year service requirement also may "shift" eligibility requirements from the employment anniversary to the plan year, although such a shift may substantially reduce the actual time requirement for entry.

> **Example 1-5: Eligibility based on employment date.**
>
> Malott Enterprises maintains a defined benefit plan with a calendar year-end. The plan requires that an employee complete one year of service to be eligible to participate in the plan. A year of service is defined by the plan as the annual period beginning on the employee's date of employment. Bruce, an employee, began work on May 1, 2009. Bruce had completed only 900 hours of service as of April 30, 2010, the end of his initial eligibility period. Since Bruce did not meet the service requirement in the initial period, his subsequent eligibility period begins May 1, 2010, and ends April 30, 2011, in determining whether he has attained 1,000 hours of service during that period.
>
> Variation 1: If Malott Enterprises' eligibility requirement had been two years, the eligibility computation period shifted, and Bruce had completed 1,100 hours of service as of April 30, 2010, his second eligibility computation period would begin on January 1, 2010, and he would become eligible to participate on January 1, 2011.
>
> Variation 2: If the plan had retained the anniversary date for the second eligibility computation period and there were semi-annual entry dates, Bruce would not have become a participant until July 1, 2011.

Keeping track of each employment anniversary date to determine service can be burdensome. The plan document may provide for shifting the computation period to the plan year after the first anniversary of an employee's hire date. If a plan shifts eligibility periods to the plan year, the first eligibility period using the plan year must include the first employment anniversary date. In this case, an employee credited with 1,000 hours during the initial period and the plan year that includes the first employment anniversary date must be credited with two years of service for participation purposes. As a result, these two eligibility periods overlap and some hours of service will be credited twice.

> **Example 1-6: Subsequent eligibility periods shifted to plan year.**
>
> Assume the same facts as in Example 1-5. However, instead of measuring subsequent eligibility periods based on the employment date, the plan specifies that the period shifts to the plan year. Bruce's initial eligibility period remains the same. However, his subsequent eligibility period begins January 1, 2010, and ends December 31, 2010. If Bruce has 1,000 hours during this period, he must be allowed to participate in the

plan as of December 31, 2010. This occurs even if he has hours of service from January 1–April 30 that are counted in both eligibility periods.

MEASURING AND CREDITING SERVICE

When Must an Hour of Service Be Credited to an Employee?

An hour of service is generally one for which the employee is paid or entitled to compensation, either with respect to the performance of duties or the non-performance of duties, such as vacation, sick leave, holiday, jury duty, military duty, etc. However, an employer is not required to credit more than 501 hours in any year during which the employee performs no duties (i.e., for an extended leave of absence). Any hour for which the employee receives back pay is an hour of service, and that hour is credited to the eligibility period to which the back pay pertains, as long as the same hours have not already been credited to the employee (i.e., credited at a lower pay rate)—no double credit is allowed. It does not matter if the employment relationship has terminated. Hours are taken into account for periods during which "no duties are performed (irrespective of whether the employment relationship has terminated)." Under this rule, payment for unused vacation must be credited as hours of service.

An hour of service is not required to be credited for compensation received under a plan maintained solely for the purpose of complying with workman's compensation, unemployment compensation, or disability insurance laws.

An hour of service is not required to be credited for payments to the employee solely for reimbursement of medical expenses.

Determining Hours of Service for Reasons Other Than Performing Duties

Special rules apply in calculating the hours of service when an employee is entitled to compensation where no duties have been performed. When payment is based on a unit of time (e.g., hours, days, weeks, or months), the hours that must 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 workday, or any reasonable basis. To be reasonable, the method used must be consistently applied and reflect the average hours worked by the employee, or by other employees in the same job classification, over a representative period of time. For example, if a plan uses a 40-hour workweek to calculate the number of hours of service credited for periods of paid absences for one employee, it cannot use a different method for such calculation for another, similarly situated employee.

Example 1-7: Payment based on units of time for a regular work schedule.

Joan, an employee, was paid her normal weekly salary for two weeks of vacation. The payment was therefore calculated on the basis of units of time (weeks). Joan is scheduled to work 37½ hours per week (although from time to time she works overtime). Joan must be credited with 75 hours of service for the vacation (37½ hours per week multiplied by two weeks).

Example 1-8: Payment based on units of time for no regular work schedule.

Ginny, an employee, spent three weeks on a paid vacation. Ginny's salary is set at an annual rate but is paid on a biweekly basis. The amount of salary payments for paid vacation is calculated on the basis of units of time (weeks). Ginny has no regular work schedule but works at least 50 hours per week. The plan provides for the calculation of hours of service to be credited for periods of paid absences on the basis of a 40-hour workweek. Ginny must be credited with 120 hours of service for the vacation (three weeks multiplied by 40 hours per week).

Example 1-9: Payment made for amounts less than normal compensation.

Brandon, an employee, is regularly scheduled to work a 40-hour week. During a computation period, Brandon is incapacitated for 11 weeks because of a skiing injury. Under his employer's sick leave policy, Brandon is paid his normal weekly salary for the first eight weeks of his incapacity. After eight weeks, the

employer ceases to pay Brandon's normal salary, but, under a disability insurance program maintained by his employer, he receives payments equal to 65% of his normal weekly salary for the remaining three weeks during which he is incapacitated. For the period during which he was incapacitated, Brandon must receive credit for 440 hours of service (11 weeks multiplied by 40 hours per week), even though his payments for the last three weeks he was incapacitated were less than his normal compensation and paid by an insurance company.

Variation: If Brandon is incapacitated for 16 weeks, the same calculation would credit him with 640 hours of service (16 weeks multiplied by 40 hours per week). However, because this is a *continuous period during which no duties or services are performed* by Brandon, DOL regulations allow the plan to limit the hours of service credited to 501 hours for the 16-week period. The plan document must specify this provision for the plan to apply the limit.

When payment is made in a lump sum (i.e., not based on units of time), the hours to be credited are calculated by dividing the lump sum payment by the employee's most recent hourly rate of compensation prior to the period during which no duties were performed. For an employee whose compensation is not based on a fixed rate over a specified period of time, the hourly rate of compensation is determined as the lowest hourly rate paid to employees in the same job classification. If there are no other employees in the same job classification that have an hourly rate, then the current minimum wage should be used. Note that no more than 501 hours must be credited in a period where no duties are performed.

Example 1-10: Calculating hours of service for lump sum payment to hourly employee.

As a result of an injury, Martha, an employee, is incapacitated for five weeks. Martha receives a lump sum payment of $2,000 with respect to the injury under a disability insurance plan maintained by her employer. At the time of the injury, Martha's rate of pay was $10.00 per hour. Martha must be credited with 200 hours of service ($2,000 divided by $10.00 per hour).

Example 1-11: Calculating hours of service for lump sum payment to employee paid weekly.

Assume the same facts as in Example 1-10, except that, at the time of the injury, Martha has a rate of pay of $500 per week and a regular work schedule of 40 hours per week. Martha's hourly rate of compensation is, therefore, $12.50 per hour ($500 per week divided by 40 hours per week) and she must be credited with 160 hours of service for the period of absence ($2,000 divided by $12.50 per hour).

Example 1-12: Calculating hours of service for lump sum payment to employee when 501 maximum hours are reached.

Elizabeth, an employee, is paid $12.00 per hour and works a regular schedule of 40 hours per week. She is disabled for 26 weeks during a computation period. For the first 12 weeks of disability, Elizabeth is paid $480 per week (her normal earnings) by her employer. Thereupon, she receives a lump sum disability payment of $2,000 from her employer's disability insurance plan. Elizabeth must be credited with 501 hours of service for her period of disability (the lesser of the maximum number of hours required to be credited for a period of absence, i.e., 501 hours, 647 hours, or the sum of 12 weeks multiplied by 40 hours per week plus $2,000 divided by $12.00 per hour).

Using Simplified Methods of Determining Service-equivalencies

Because of the difficulty inherent in keeping track of actual hours, DOL regulations permit the use of simplified methods of determining service, known as equivalencies. Equivalencies are often used for salaried employees where hours are not usually tracked. The regulations approve a number of equivalencies and contain details of how these are to be applied. The equivalency method used must be specified in the plan document. These methods are discussed in the following paragraphs.

A plan may use different methods of crediting service (including equivalencies) for various purposes, including different classifications of employees covered under the plan, as long as the classifications are reasonable and consistently applied. The classifications must not discriminate in favor of highly compensated employees. For

example, a plan may provide for the crediting of service for part-time employees using actual hours and full-time employees using an equivalency. However, if a classification keeps employees from their statutory right of participating, vesting, or accruing benefits, it will not be deemed to be reasonable or consistently applied. Because many employers do not track hours for exempt employees, a common plan design uses an equivalency for exempt employees, and "actual hours" methodology for non-exempt employees, who do track their hours.

Hours Worked Method. This equivalency method takes into account only *hours worked*; it does not take into account hours for which the employee did not perform any duties, such as vacation time or sick leave. It is not necessary to keep track of actual hours worked under this method. However, because the hours during which no duties are performed are excluded, employees would be given credit for fewer hours than under the actual hours method. Accordingly, fewer hours of service are needed to complete a year of service. Thus, an employee needs only 870 hours to be credited with 1,000 hours of service, and 435 hours to be credited with 500 hours of service . Therefore, attaining at least 436 hours avoids a one-year break in service.

Regular Time Hours Method. As in the *hours worked* method, the *regular time hours* method excludes any hours for which the employee did not perform any duties. Only regular time hours are taken into account; thus, any overtime hours are ignored. This method also takes fewer hours into account, so fewer hours of service are needed to complete a year of service. Thus, an employee needs only 750 regular time hours to be credited with 1,000 hours of service, and only 375 regular time hours to be credited with 500 hours of service. Therefore, attaining at least 376 hours avoids a one-year break in service.

Example 1-13: Using the regular time hours method.

A defined benefit plan uses the equivalency method based on regular time hours. During a computation period, a participant works 370 regular time hours and 20 overtime hours. The participant incurs a one-year break in service for the computation period because the participant has not been credited with 376 regular time hours in the computation period.

Equivalencies Based on Periods of Employment. This method determines the number of hours of service to be credited to employees based on the following periods for which the employee would receive credit for at least one hour of service:

a. 10 hours for each day,

b. 45 hours for each week,

c. 95 hours for each semimonthly period, or

d. 190 hours for each month.

Planning Tip: The period in item b (45 hours for each week) is the easiest of the four to use and generally credits employees with the least number of hours.

Example 1-14: Calculating hours of service for payment for cashed-out vacation time upon termination of employment.

Malott Enterprise terminated Bruce's employment on May 31, 2010, when he had two weeks of unused vacation time accrued. Bruce was an exempt employee, and was paid on the weekly equivalency method under which he was credited with 45 hours of service for each week. Because Bruce worked 21 full weeks, and one partial week, he is credited with 22 weeks at 45 hours per week for 990 hours of service. Because he receives an additional 90 hours of service for his two weeks of vacation, he has 1,080 hours of service (and has earned a year of service).

A plan that uses a period of employment method does not take into consideration the employee's actual hours that *would have been credited*, even if the actual hours were more than or less than the hours credited under the period of employment equivalency method.

Example 1-15: Participating under the period of employment equivalency method.

Phil is a sales representative for Mobile Madness Inc., a nationwide distributor. Because of the tedious work involved to count each employee's actual hours worked toward reaching eligibility for participation in the company's 401(k) plan, Mobile's plan document calls for use of an equivalency method that deems that an employee who works at least one hour in a week to be credited with 45 hours for the total week. In his first 4 weeks of employment, Phil worked 50 hours each week to fulfill training requirements. However, under the equivalency method, his actual hours (i.e., 50 hours times 4 weeks equals 200 hours) are disregarded and he will be credited with a total of 180 hours (4 weeks multiplied by 45 hours per week) for this time period.

Equivalencies Based on Earnings. This method determines the hours of service credited to employees based on the employee's compensation under the rules in DOL Reg. 2530.200b-3(f). This rule converts an employee's compensation into hours of service. After dividing an hourly employee's compensation by the employee's hourly rate, an employee needs only 870 hours to be credited with 1,000 hours of service, and only 435 hours to be credited with 500 hours of service. Therefore, attaining at least 436 hours avoids a one-year break in service. All other employees (i.e., nonhourly employees) also apply the regulations by converting an employee's earnings to arrive at an hourly rate to calculate hours of service. As this is a more generous method of measuring hours of service, a nonhourly employee needs only 750 hours to be credited with 1,000 hours of service, and 375 hours to be credited with 500 hours of service. Therefore, attaining at least 376 hours avoids a one-year break in service.

Using the Elapsed Time Method

The elapsed time method is another means of measuring an employee's service. This method determines service based on a period of service, rather than determining the hours credited towards a year of service (as when using actual hours or an equivalency method). Under the elapsed time method, the plan disregards an employee's actual hours. Service is credited based on the total period of employment (i.e., period of service), beginning with the date employment begins and ending when employment is severed.

The employment commencement date is the date on which the employee first performs an hour of service for the employer. Employment is severed on the earlier of (a) the date the employee quits, dies, retires, or is discharged, or (b) 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. Thus, if an employee separates for any reason other than quitting, retiring, or discharge, and returns to work within 12 months, there is no severance period.

If the separated employee returns after a severance period of less than one year, and that period includes an entry date applicable to the employee, the employer must cover the employee no later than the date on which the employee returns.

Example 1-16: Participating under the elapsed time rules.

Plan ABC provides for a minimum age requirement of 21 and a minimum service requirement of one year with semiannual entry dates of January 1 and July 1. Employee X met the minimum age and service requirements on March 20, 2010. X quit work on April 5, 2010, and then returned to work on December 1, 2010 (before incurring a one-year period of severance but after the semiannual entry date of July 1, 2010).

When must the plan allow X to participate? Employee X is entitled to become a participant immediately upon returning to service on December 1, 2010.

Transferring or Changing Methods. A plan may allow for an employee's service period for eligibility, vesting, or benefit accrual to be determined under an hour equivalency method, but determined under the elapsed time method for a different class of employees. When an employee transfers from one class of employee to another class using a different method of crediting service, special rules outlined in the regulations must be followed. An amendment can also be made to the plan document to change the service crediting method from use of a computation period to the elapsed time method, or vice versa. A change in method resulting from a plan amendment will follow the same procedure outlined in Reg. 1.410(a)-7(f)(1) for a transfer from one class of employees to another.

Crediting Service with Other Employers

Service with another employer must sometimes be included when crediting service toward an employer's eligibility requirement. Employees of certain related organizations are treated as if they are employed by a single employer for purposes of the *year of service* and *hour of service* rules. Service credited toward one related employer in a group will be regarded as service credited to all employers in the group. Related organizations include the following:

a. Members of a controlled group of corporations under IRC Sec. 1563; i.e., two or more corporations connected through common ownership described in IRC Sec. 1563(a)(1), (2), or (3), regardless of whether a corporation is a component member of a controlled group within the meaning of IRC Sec. 1563(b). Controlled groups include parent-subsidiary, brother-sister, and combined groups.

b. Commonly controlled trades or businesses. Under this rule, the principle of common ownership found in IRC Sec. 1563 is applicable to partnerships, proprietorships, and other businesses under common control. Reg. 1.414(c)-1 through -4 explains the application of this rule.

c. Members of an affiliated service group.

If an existing plan is continued by a successor employer, service with the predecessor employer must be counted when crediting service toward eligibility of the successor employer's plan. The plan of the predecessor employer, or previous employer of employees now employed by the current employer, will be considered to be maintained by the successor employer if the plan is formally adopted or merged into the successor's plan. The plan document must specify that prior employers will be included in crediting service and must identify the prior employers. The granting of such past service credit must also meet the nondiscrimination requirements under IRC Sec. 401(a)(4) based on a facts and circumstances test and a safe harbor test.

If a successor employer does not maintain the predecessor's plan, IRC Sec. 414(a)(2) requires that service for the predecessor be credited according to the regulations. However, no regulations have been issued at this time. In the absence of regulations, the IRS has allowed successor employers to count service with the predecessor, even with unrelated employers, so long as the crediting is nondiscriminatory and the plan document specifies such provisions. There appears to be no obligation to provide such credit until regulations are released.

Treatment of Leased Employees. Certain leased employees must be treated as employees for purposes of crediting service. To obtain leased employee status, a person must have performed services pursuant to an agreement with the recipient on a substantially full-time basis for at least one year, and such services are performed under the primary direction or control of the recipient. A leased employee's years of service with the recipient employer (the employer for whom the employee renders services) count in the same way as the years of service of a common law employee of that employer after the one-year qualifying period has been met. However, IRS Notice 84-11, Q&A 15 affirmatively states that leased employees may be excluded as a class from participation under a recipient employer's retirement plan if the nondiscriminatory coverage requirements of IRC Sec. 410(b) are satisfied. See section for a discussion of leased employees.

USERRA Requirements. Uniformed service must be credited toward the employee's satisfaction of eligibility requirements. Under the Uniformed Services Employment and Reemployment Rights Act of 1994, if a service member is reemployed by an employer, the eligible period of military service is treated as if it were continuous service with the employer for purposes of determining the service member's right to accrue benefits under a qualified plan. A plan should determine service on the basis of the employee's regular work schedule at the time the qualified military service began or on the basis of the employee's hours of service in the last 12 (or fewer) months preceding the military service if the employee did not have a regular work schedule.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Which of the following methods should be used when a plan's eligibility computation period is less than 12 months?

   a. Elapsed time.

   b. Safe harbor.

   c. Hours worked.

   d. Regular time.

6. What is the least amount of hours an employee must work to be credited with 1,000 hours of service under the hours worked method?

   a. 501.

   b. 750.

   c. 870.

   d. 1,000.

7. Which of the following statements regarding the equivalencies based on earnings is most accurate?

   a. The equivalencies based on earnings determine service according to a period of service.

   b. The equivalencies based on earnings converts an employee's compensation into hours of service.

   c. The equivalencies based on earnings ignores an employee's actual hours worked.

   d. When using the equivalencies based on earnings, the date on which the employee performs an hour of service is considered the commencement date.

8. What happens when an existing plan is continued by a successor employer?

   a. The plan must ensure that the employees are 100% vested after completing a maximum of three years.

   b. The plan must use the 12-consecutive-month period beginning on the date the employee returned to work.

   c. The employee's service with the predecessor employer is included when crediting service toward the successor employer's plan.

9. Which of the following is most accurate regarding the treatment of leased employees?

   a. An individual must have performed services for at least two years to obtain leased employee status.

   b. A leased employee may be excluded as a class from participation under a recipient employer's retirement plan.

   c. The years of service for a common law employee are different from that of a leased employee.

10. According to the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), how should a plan determine service to be applied to eligibility requirements when service member was away on qualified military service?

    a. Based on the one-year holdout rule.

    b. Based on work schedule.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Which of the following methods should be used when a plan's eligibility computation period is less than 12 months? **(Page 12)**

   a. Elapsed time. [This answer is correct. A year of service is defined as a 12-consecutive-month period during which the employee completes at least 1,000 hours of service. When the plan's eligibility computation period is less than 12 months, hours must be disregarded and the elapsed time method must be used, or an alternative eligibility computation period of twelve months must be provided for those employees who do not satisfy the shorter eligibility computation period with prorated hours.]

   b. Safe harbor. [This answer is incorrect. A plan can use a safe harbor method to comply with the requirements relating to maternity and paternity absences. This does not specifically apply to computation periods of less than 12 months.]

   c. Hours worked. [This answer is incorrect. This method takes into account only *hours worked*; it does not take into account hours for which the employee did not perform any duties, such as vacation time or sick leave. This method does not assist in determining service in periods less than 12 months.]

   d. Regular time. [This answer is incorrect. The *regular time hours* method excludes any hours for which the employee did not perform any duties. Only regular time hours are taken into account; thus, any overtime hours are ignored. This method is not used to calculate service for periods of less than 12 months.]

6. What is the least amount of hours an employee must work to be credited with 1,000 hours of service under the hours worked method? **(Page 16)**

   a. 501. [This answer is incorrect. According to the Department of Labor (DOL), no more than 501 hours is required to be credited in a period where no duties are performed. This is a limit applied to extended leave of absence situations.]

   b. 750. [This answer is incorrect. Under the regular time hours method, an employee needs only 750 regular time hours to be credited with 1,000 hours of service. Overtime hours and hours not performing duties are ignored.]

   c. 870. [This answer is correct. According to the DOL, an employee needs only 870 hours to be credited with 1,000 hours of service, and 435 hours to be credited with 500 hours of service. Since vacation, sick leave, etc. are excluded; employees would be given credit for fewer hours of service than under the actual hours method.]

   d. 1,000. [This answer is incorrect. Since vacation and sick time are ignored, the hours worked method requires less than 1,000 hours.]

7. Which of the following statements regarding the equivalencies based on earnings is most accurate? **(Page 17)**

   a. The equivalencies based on earnings determine service according to a period of service. [This answer is incorrect. The elapsed time method is another means of measuring an employee's service. This method determines service based on a period of service.]

   b. The equivalencies based on earnings converts an employee's compensation into hours of service. [This answer is correct. This rule converts an employee's compensation into hours of service based on the employee's compensation under the rules in DOL Reg. 2530.200b-3(f). After dividing an hourly employee's compensation by the employee's hourly rate, an employee needs only 870 hours to be credited with 1,000 hours of service, and only 435 hours to be credited with 500 hours of service. Therefore, attaining at least 436 hours avoids a one-year break in service.]

c. The equivalencies based on earnings ignores an employees' actual hours worked. [This answer is incorrect. This rule converts an employee's compensation into hours of service. Under the elapsed time method, the plan disregards an employee's actual hours. Service is credited based on the total period of employment beginning with the date employment begins and ending when employment is severed.]

d. When using the equivalencies based on earnings, the date on which the employee performs an hour of service is considered the commencement date. [This answer is incorrect. This method does not use periods of service. Therefore, the commencement date is not applicable. When using the elapsed time method, the employment commencement date is the date on which the employee first performs an hour of service for the employer. Employment is severed on the earlier of (a) the date the employee quits, dies, retires, or is discharged, or (b) 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.]

8. What happens when an existing plan is continued by a successor employer? **(Page 18)**

a. The plan must ensure that the employees are 100% vested after completing a maximum of three years. [This answer is incorrect. This addresses hybrid defined benefit plans, not plans continued by a successor employer. For plan years beginning after December 31, 2009, certain employers may maintain combined defined benefit/401(k) plans, providing both a defined benefit and a 401(k) component. The defined benefit portion of the plan must provide that employees are 100% vested after completing no more than three years of service according to IRC Sec. 414(x)(2)(D)(i).]

b. The plan must use the 12-consecutive-month period beginning on the date the employee returned to work. [This answer is incorrect. This rule applies to a break in service, not crediting service with other employers. If a plan measures subsequent eligibility periods based on the anniversary of the date an employee begins work, the plan must use the 12-consecutive-month period beginning on the date the employee returned to work and, when necessary, subsequent anniversaries of that date per DOL Reg. 2530.200b-4(b)(1)(i).]

c. The employee's service with the predecessor employer is included when crediting service toward the successor employer's plan. [This answer is correct. According to IRC Sec. 414(a)(1), If an existing plan is continued by a successor employer, service with the predecessor employer must be counted when crediting service toward eligibility of the successor employer's plan. The plan of the predecessor employer, or previous employer of employees now employed by the current employer, will be considered to be maintained by the successor employer if the plan is formally adopted or merged into the successor's plan.]

9. Which of the following is most accurate regarding the treatment of leased employees? **(Page 18)**

a. An individual must have performed services for at least two years to obtain leased employee status. [This answer is incorrect. Certain leased employees must be treated as employees for purposes of crediting service. To obtain leased employee status, a person must have performed services pursuant to an agreement with the recipient on a substantially full-time basis for at least one year per IRC Sec. 414(n).]

b. A leased employee may be excluded as a class from participation under a recipient employer's retirement plan. [This answer is correct. IRS Notice 84-11, Q&A 15 affirmatively states that leased employees may be excluded as a class from participation under a recipient employer's retirement plan if the nondiscriminatory coverage requirements of IRC Sec. 410(b) are satisfied.]

c. The years of service for a common law employee are different from that of a leased employee. [This answer is incorrect. A leased employee's years of service with the recipient employer (the employer for whom the employee renders services) count in the same way as the years of service of a common law employee of that employer after the one-year qualifying period has been met according to IRC Sec. 414(n)(4).]

10. According to the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), how should a plan determine service to be applied to eligibility requirements when a service member was away on qualified military service? **(Page 18)**

    a. Based on the one-year holdout rule. [This answer is incorrect. The one-year holdout rule does not apply to returning service members. Therefore, service members do not have to complete one year of service after returning to work before the plan will count pre-break service.]

    b. Based on work schedule. [This answer is correct. Per USERRA a plan should determine service on the basis of the employee's regular work schedule at the time the qualified military service began or on the basis of the employee's hours of service in the last 12 (or fewer) months preceding the military service if the employee did not have a regular work schedule.]

BREAKS IN SERVICE AND REHIRED EMPLOYEES

In general, all years of service with the employer are counted when determining an employee's eligibility. However, years in which the employee incurs a break in service may be an exception to this general rule. A one-year break in service under the counting hours method is a calendar year, plan year, or other 12-month consecutive period designated in the plan during which the employee is credited with fewer than 501 hours of service. When using the elapsed time method, a break in service occurs at the end of a one-year period of severance (i.e., 12 consecutive months beginning on the date the employee severed service and ending on the first anniversary of such date if the employee did not perform an hour of service during this 12-month period).

Rehired employees present a challenge to determine the rightful place on the vesting schedule and when they are entitled to begin participation. The plan document should contain provisions for handling the participation of rehired employees and address whether or not a break in service rule applies. It is important that rehires be identified and the appropriate information regarding their employment history be made available to the plan administrator as soon as possible after rehire, especially if the plan has a 401(k) feature. Under the IRS's Employee Plans Compliance Resolution System (EPCRS), the correction can be very expensive for a plan that has an operational failure by failing to notify a rehired employee of his or her right to make a deferral election in a timely manner.

Understanding the One-year Holdout Rule

In determining an employee's eligibility to participate, a plan may provide that an employee who has a one-year break in service must complete a year of service after returning to work before the plan will count pre-break service. This is known as the *one-year holdout rule*. Upon readmission to the plan, the employee must be given credit for benefit accrual and vesting for prior service, as though readmitted upon returning to work. Thus, an employee terminating with 1,000 or more hours of service will be eligible to participate upon being rehired or, if later, on the original entry date. If the plan uses the two-year 100% vesting rule for participation, it may provide that the pre-break service of a participant who terminates without meeting the two-year requirement will be disregarded.

Example 1-17: Recognizing pre-break service after returning to work.

Employer Y maintains a calendar year defined benefit plan that requires terminated employees to complete one year of service upon returning to employment after a one-year break in service before resuming participation. Employee Jane Smith begins participation in 2007. She terminates employment in February 2009, having worked 90 hours during 2009. She returns to employment on March 1, 2010. She must complete a year of service before being readmitted to the plan in 2011. However, when she is readmitted, she must be given benefit accrual and vesting credit as though she had been admitted upon her return to work on March 1, 2010.

When to Avoid the One-year Holdout Rule. The option for a plan to require the completion of a year of service before readmitting an employee who returns to employment after a one-year break in service does not work well with profit-sharing plans. This is because the crediting of a contribution and/or forfeiture allocation is retroactive and allocations for the plan year are made before the results of the one-year holdout rule are known. Also, this option cannot be used with a 401(k) or a 403(b) plan, as rehired participants cannot make up contributions missed during the holdout period. A defined contribution plan subject to minimum funding standards (e.g., money purchase pension plan) should not include a one-year holdout rule because it creates questions concerning the timing of the funding requirement for a participant being held out. Best practices indicate that this option should be avoided in a defined contribution plan due to the lack of guidance concerning the retroactive accrual feature (e.g., how to apply the feature in a profit-sharing plan and how discrimination testing is affected).

Understanding the Parity Break in Service Rule

A special break in service rule for determining participation, known as the *rule of parity*, applies if a participant is zero percent vested in his or her accrued benefits at the time the break in service begins. Under this rule, the plan may permanently disregard pre-break service if the employee's number of consecutive one-year breaks equals or exceeds the greater of five or the total years of pre-break service. However, practically speaking, a participant in a

single employer plan is either partially or fully vested with at least five years of service. Thus, the rule of parity cannot apply for such a plan when the pre-break service is at least five years.

Example 1-18: Disregarding pre-break service.

Bob Jones has participated for two years in the ABC, Inc., profit-sharing plan, which uses the rule of parity. He is not vested in any of ABC's contributions allocated to his account. Bob terminates employment and incurs six consecutive one-year breaks in service. He then returns to ABC's employment. The plan may disregard his pre-break service.

Example 1-19: Fewer than five consecutive pre-break service years.

Sally Davis participates in the XYZ, Inc., profit-sharing plan. XYZ's plan uses the rule of parity. She has participated for four years and is not vested in any of XYZ's contributions allocated to her account. Sally terminates employment and incurs three consecutive one-year breaks in service. She then returns to XYZ's employment. The plan may not disregard her pre-break service because the number of consecutive one-year breaks is fewer than five. However, she may be required to wait one year before beginning participation if the plan specifies use of the one-year holdout rule.

The rule of parity is not available for a plan with a two-year eligibility requirement because all participants are fully vested upon participation. However, a plan that requires an eligibility requirement of two years of service may permanently ignore any prior service earned if the employee incurs a one-year break in service before satisfying the two-year requirement.

Dealing with Maternity or Paternity Absences

Special rules apply to determine if an employee (a mother or father) has a break in service while on unpaid leave from work because of—

a. the employee's pregnancy,

b. the birth or adoption of the employee's child, and/or

c. the caring for the child immediately after birth or adoption.

During such periods of absence, the plan must treat the following hours as hours of service:

a. the number of hours with which the individual would normally have been credited except for the absence, or

b. if the plan cannot determine the hours in item a, eight hours per normal workday during the absence.

The total number of hours credited under this rule cannot exceed 501. The rule is meant solely to determine whether the employee incurred a break in service and *not to obtain* a year of service. The rules in the previous paragraph apply only in the year the absence begins (if the application of the rule would prevent the participant from incurring a break in service), or (in any other case) in the following year. In other words, if the leave spanned two computation years, all the hours are credited to the first year if the participant would otherwise incur a break in service that year. Otherwise, the hours of service of the absence are credited in the second year.

Example 1-20: Crediting service for maternity leave covering two computation years.

Mary, an employee, takes maternity leave on March 1, 2009, of a calendar year computation period after earning 300 hours of service. She returns on March 1, 2010. The profit-sharing plan in which Mary participates defines a year of service as a computation period in which an employee earns 1,000 hours. The employer provides paid maternity leave for a period not to exceed 300 hours.

Which computation period are the hours of service for *unpaid* maternity leave credited to, 2009 or 2010? Mary separated from service with 300 hours. In addition, she is paid for 300 hours of maternity leave, for a total of

600 hours of service. As a result, Mary does not incur a break in service for 2009. Since no hours of service are needed in 2009 to prevent Mary from incurring a break in service, the hours of service due to her unpaid maternity leave will be credited to 2010.

The plan may provide that the participant has the burden of proving that the absence was by reason of one of the covered causes.

Safe Harbor Method. The plan can use a safe harbor method to comply with the requirements relating to maternity and paternity absences. If the plan's break in service rules require a minimum of six consecutive one-year breaks in service for service to be disregarded (versus the statutory minimum of five), then the plan will not have to include any special rules relating to maternity and paternity absence. This simplified method is available only if the plan computes years of service on the basis of hours of service or permitted equivalencies. It does not apply to plans using the elapsed time method.

For a plan using the elapsed time method of crediting service, a break in service does not occur until the second anniversary of the first day of the maternity or paternity-related leave.

Family Medical Leave Act. For purposes of determining whether an employee has incurred a break in service, any period of unpaid leave under the Family Medical Leave Act (FMLA) is ignored and is not counted towards a break in service. Under the FMLA, covered employers (i.e., employers with at least 50 employees) must provide up to 12 weeks of unpaid leave during any 12-month period for eligible employees for the birth or adoption of a child or a family member's serious health problem. In addition, under the National Defense Authorization Act of 2008, employees who are spouses, children, parents, or next of kin of a covered service member are permitted to take up to 26 weeks of leave during a 12 month period to care for that service member. Further, eligible employees are entitled up to twelve weeks of leave because of any "qualifying emergency" arising out of the fact that the spouse, son, daughter, or parent of the employee is on active duty, or has been notified of an impending call to active duty status, in support of a contingency operation. While such leave does not count towards a break in service, it will not be counted as *credit* toward a year of service in determining benefit accrual, vesting, and eligibility to participate. However, in certain circumstances, employers are allowed to require employees to use paid leave as part of their FMLA leave. In that circumstance or any other where the employee receives paid FMLA leave, the paid leave must be considered for purposes of calculating hours of service to prevent a break.

If the plan provisions require an employee to be employed on a specific date and credited with a year of service for vesting, contributions or participation purposes, an employee on paid or unpaid FMLA leave shall be deemed to have been employed on that date.

Employees on paid or unpaid FMLA leave are to be treated as if they continued to work for purposes of changes to benefit plans. They are entitled to changes in benefit plans, except those which are dependent upon seniority or accrual during the leave, immediately upon return from leave or to the same extent they would have qualified if no leave had been taken. For example, if the benefit plan is predicated on a preestablished number of hours worked each year and the employee does not have sufficient hours as a result of taking paid or unpaid FMLA leave, the benefit does not accrue.

Dealing with Uniformed Service

The Department of Labor issued final regulations on the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), effective January 18, 2006. Individuals incurring a break in service due to absence for qualified military service must be re-employed as though not having incurred a break in service for eligibility, vesting, or benefit accrual purposes. Vesting and benefit credit must be given for the time the rehired employee was absent due to qualified military service as if it were continuous service with the employer.

Qualified military service is defined as any service in the uniformed services by an individual entitled to reemployment upon the end of the service. Uniformed services include services in the following military branches: (a) Army, Navy, Air Force, Marine Corps, or Coast Guard; (b) the reserve for any of the military branches listed in item a; (c) Army National Guard or Air National Guard; (d) Commissioned corps of the Public Health Service; and (e) any other category of persons designated by the President of the United States in time of war or emergency.

Service in the uniformed services is the voluntary or involuntary performance of duty in a uniformed service under competent authority and includes active duty, active duty for training, inactive duty training, full-time federal National Guard duty, time away from work for examination to determine if a person is fit for such duty, and time away for performing funeral honors duty.

Defined Contribution Plans. For defined contribution plans, rehired military personnel subject to USERRA are entitled to employer contributions (but not earnings and forfeitures) that they would have enjoyed had they not been absent due to uniformed service. Contribution rates are based on the wages employees would have received had they remained at work. If that rate cannot be reasonably determined, the rate is based on the employee's wages for the 12-month period before the military absence. The employer must make contributions that are contingent on employee contributions [such as employer matching contributions based on a percentage of salary deferrals under a 401(k) plan] if the rehired employee makes up the missed amounts of salary deferral within the statutory time period. The statutory time period begins with the date of re-employment and extends to the lesser of three times the length of the employee's uniformed service or five years.

A contribution made up by the employer or the employee and required by USERRA (for this purpose, elective deferrals are treated as required even though they are voluntary) is not subject to limits such as the elective deferral limit, contribution and benefit limit, or contribution deduction limit for the year in which the contribution in made. However, the contribution is subject to these limitations for the year to which the contribution relates. In addition, by making the contribution, the plan will not be treated as failing any nondiscrimination, minimum participation, minimum coverage, minimum funding, or top-heavy requirements, including those applicable to 401(k), 403(b), SEPs, or SIMPLE IRA plans.

The maximum elective deferral make-up contribution for nonhighly compensated employees (NHCEs) is easy to compute—it is the smaller of the amount allowed under IRC Sec. 402(g) or the plan provisions. However, the maximum amount of the elective deferrals for an HCE is not clear.

Example 1-21: Maximum elective deferral for HCE.

Kevin begins a period of qualified military service on January 1, 2008, and completes the service on June 30, 2011. He is re-employed on July 15, 2011. Kevin is a 5% owner and there are two other HCEs in the plan. For the plan year 2009, the average deferral percentage for the HCEs was 8% and the individual deferrals were 10% and 6%. What is the maximum Kevin can defer for 2009?

The answer to this question is not clear. Some possibilities include: 10%, as that is the highest amount deferred by one of the other HCEs; 9%, on the assumption that, had Kevin been included in the original nondiscrimination test, he and the HCE deferring 10% would be limited to 9%; or 8%, as that was the ADP for the HCEs. The make-up contribution may be a dollar amount.

The definition of *compensation* used to determine the contribution rate apparently applies for purposes of (a) testing for nondiscrimination, (b) determining HCE and key employee status, (c) calculating the maximum employer deduction, and (d) calculating contributions to SIMPLE-IRAs.

Defined Benefit Plans. For defined benefit plans, service for rehired military personnel counts not only for vested rights, but also for benefit accruals. Therefore, rehired employees are effectively restored to the same accrued benefit level they would have received had they not been absent due to uniformed service.

As to a defined benefit plan, the rehired military personnel must have service counted not only with regard to vested rights, but also with respect to benefit accruals. Therefore, rehired employees are effectively restored to the same accrued benefit level they would have received had they not been absent due to military service. Employer contributions to restore the required benefit are deductible in the year the contribution is made. They are subject to the deduction limit for the year to which the contribution relates.

Veterans are required to be notified of their rights, benefits, and obligations under USERRA. This notice should be posted where employee notices are customarily placed. The model notice is located at **www.dol.gov/vets/programs/userra/USERRA_Private.pdf#non-Federal**.

Survivor Benefits for Military Personnel. If a qualified retirement plan participant dies while performing qualified military service, his or her survivors are entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would have been provided had he or she resumed employment and then terminated employment on account of death. Similar rules apply to 403(b) annuities and 457(b) plans. This rule is effective for deaths occurring after 2006. Plans must generally be amended to comply with this rule the last day of their plan year beginning after 2008.

For benefit accrual purposes, retirement plans may permit individuals who leave for qualified military service and cannot be reemployed due to death or disability to be treated as if they had resumed employment in accordance with their reemployment rights under USERRA as of the day before death or disability and then terminated employment on the date of death or disability. This provision is effective for deaths or disabilities occurring after 2006.

Measuring a Break in Service

Whether an employee is credited with a year of service after returning to work depends on how the plan measures eligibility periods after an employee's initial eligibility period.

If a plan measures subsequent eligibility periods based on the anniversary of the date an employee begins work, the plan must use the 12-consecutive-month period beginning on the date the employee returned to work and, when necessary, subsequent anniversaries of that date.

If a plan measures subsequent eligibility periods based on plan years, the plan must first use the 12-consecutive-month period beginning on the date the employee returned to work and, when necessary, subsequent periods beginning with the plan year that includes the first anniversary of the date the employee returned to work.

WHEN MUST AN EMPLOYEE BEGIN PARTICIPATING?

Entry into the Plan to Begin Participation

Once the minimum age and service requirements are met, the employee must be allowed to begin participating by the earlier of (a) six months after satisfying the requirements or (b) the first day of the first plan year beginning after the requirements are met. An exception to this rule occurs if an employee separates from service and does not return before the applicable entry date. If the employee returns after either date without incurring a break in service, the employer must cover the employee upon return.

Because of this entry date rule, most plans will need to have at least two entry dates (the beginning of the year and the middle of the year). However, when a plan's service requirements are more generous than the statute requires, the plan can have a single annual entry date and still meet this rule because the total waiting period is less than the statutory minimums. For example, in a plan with no age or service requirement, a new, otherwise eligible employee may be excluded until the next entry date of the plan after commencing employment. This provision will not disqualify the plan because no employee can be required to wait longer than a 12-month period under the terms of the plan. A single entry date can also be used if the plan allows retroactive entry for certain employees.

Participation under the Elapsed Time Method. Special rules apply if the plan uses the elapsed time method of crediting service. The plan must provide that an eligible employee who satisfies the statutory age and service requirements must be covered on the earlier of (a) the first day of the plan year after the employee has met the statutory requirements, or (b) six months after the date the requirements are satisfied. If the employee separates from service before the applicable entry date, the employee may be deemed as not participating.

Using a Single Entry Date

The plan must allow employees to begin participating according to the rules described in the previous paragraph. The plan may provide for a single entry date for employees who have completed the minimum age and service requirements, as long as no employee has to wait longer than the maximum permissible period. In general, a plan

with a single entry date will use the first day of each plan year as the sole entry date. The following provisions will allow for an acceptable entry date:

a. The plan may adopt eligibility requirements more lenient than the minimum age and service requirements. (See Example 1-22.)

b. The plan may adopt the entry date nearest to the satisfaction of the age and service eligibility requirements. Employees completing the minimum age and service requirements prior to the plan's midpoint enter the plan as of the first day of the plan year prior to the date the requirements are met. Those completing the requirements on or after the plan's midpoint enter the plan as of the first day of the plan year occurring on or after the date the minimum age and service requirements are met. (See Examples 1-23 and 1-24.)

Example 1-22: Eligibility requirements eased to allow for single entry date.

A profit-sharing plan having a calendar year-end allows employees to begin participating on the first day of the plan year beginning after the employee's employment commencement date. No other eligibility requirements must be satisfied. This provision ensures that no employee will have to wait longer than six months after completing a year of service, as all employees are eligible to participate within 12 months of the employee's employment commencement date.

Example 1-23: Retroactive entry into the plan.

A profit-sharing plan having a calendar year-end requires an employee to be at least 21 years of age and to complete one year of service to participate in the plan. The plan's entry date is January 1. All employees age 21 or older who begin work before July 1 and have 1,000 hours of service will enter the plan retroactively to January 1. Employees meeting such requirements who begin work July 1 or after will enter the plan the following January 1.

Example 1-24: Meeting the minimum age and service requirements.

ABC Company sponsors a profit-sharing plan with a calendar year-end. The plan requires an employee to complete one year of service and attain age 21 to be eligible for participation. Dorothy starts employment with ABC Company in December 2007, when she is 19 years old. In November 2009, she reaches age 21 and is still employed with ABC.

When must Dorothy be allowed to participate in the plan? She must be allowed to begin participating in the plan on January 1, 2010; i.e., the earlier of six months after meeting the age and service requirements (May 2010) or the first day of the plan year that begins after meeting the age and service requirements (January 1, 2010).

Using Multiple Entry Dates

To comply with the rule discussed earlier, many plans have two entry dates allowing employees to enter the plan: the earlier of (a) the first day of the plan year and (b) the first day of the seventh month of the plan year, Example 1]. Employees can be allowed to enter the plan more often (e.g., quarterly or monthly). However, dual entry dates makes recordkeeping easier because there are only two standard entry dates instead of a different entry date for each employee.

Example 1-25: Using dual entry dates.

Big D maintains a calendar year profit-sharing plan requiring employees to complete one year of service for entry into the plan. The plan does not have a minimum age requirement. The eligibility period is based on an employee's date of hire and each anniversary thereafter. Eligible employees enter the plan on the earliest of the first day of the plan year or the first day of the seventh month following completion of the service requirement. Lisa begins work on February 5, 2009. Rick begins work on August 10, 2009.

When are Lisa and Rick eligible to enter the plan? Lisa's first eligibility period begins February 5, 2009, and ends February 4, 2010, during which she has at least 1,000 hours of service. She is eligible to enter the plan

on July 1, 2010. Rick's first eligibility period begins August 10, 2009, and ends August 9, 2010, during which he has at least 1,000 hours of service. Rick is eligible to enter the plan January 1, 2011.

401(k) Plans. Using multiple entry dates is generally the only workable approach for 401(k) plans with both a year of service and an age 21 requirement. A retroactive entry date cannot be used, as the employee is unable to make up the contributions for the retroactive period. Also, employees should not be allowed to contribute until they meet the minimum requirements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. The one-year holdout rule should be avoided when using certain plans. Why should employers avoid this option in regards to defined contribution plans?

    a. Absence of guidance regarding the retroactive accrual feature.

    b. Contributions are required to be made up during the holdout period.

    c. Contribution credits are not retroactive.

12. Which of the following statements regarding the Family Medical Leave Act (FMLA) is most accurate?

    a. Only spouses of covered service members can take leave to care for that service member.

    b. Employers can require employees to use paid leave as part of their FMLA leave.

    c. Employers must provide eligible employees with up to 10 weeks of unpaid leave during any 12-month period for a family member's serious health problem.

    d. Employees on unpaid FMLA do not qualify for changes to benefit plans.

13. If the plan measures subsequent eligibility periods based on the employee's anniversary date she began work, what happens when she has a break in service?

    a. The plan uses the 12-consecutive-month period starting on the date the employee returns to work and then succeeding anniversaries of that date.

    b. The plan will use the 12-consecutive-month period starting on the date the employee returned to work and then succeeding periods starting with the plan year that includes the first anniversary of the date the employee returned to work.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. The one-year holdout rule should be avoided when using certain plans. Why should employers avoid this option in regards to defined contribution plans? **(Page 23)**

    a. **Absence of guidance regarding the retroactive accrual feature. [This answer is correct. A defined contribution plan subject to minimum funding standards should not include a one-year holdout rule because it creates questions concerning the timing of the funding requirement for a participant being held out. Best practices indicate that this option should be avoided in a defined contribution plan due to the lack of guidance concerning the retroactive accrual feature.]**

    b. Contributions are required to be made up during the holdout period. [This answer is incorrect. This option cannot be used with a 401(k) or a 403(b) plan, as rehired participants cannot make up contributions missed during the holdout period.]

    c. Contribution credits are not retroactive. [This answer is incorrect. The option for a plan to require the completion of a year of service before readmitting an employee who returns to employment after a one-year break in service does not work well with profit-sharing plans. This is because the crediting of a contribution and/or forfeiture allocation is retroactive and allocations for the plan year are made before the results of the one-year holdout rule are known.]

12. Which of the following statements regarding the Family Medical Leave Act (FMLA) is most accurate? **(Page 25)**

    a. Only spouses of covered service members can take leave to care for that service member. [This answer is incorrect. Under the National Defense Authorization Act of 2008, employees who are spouses, children, parents, or next of kin of a covered service member are permitted to take up to 26 weeks of leave during a 12 month period to care for that service member.]

    b. **Employers can require employees to use paid leave as part of their FMLA leave. [This answer is correct. In certain circumstances, employers are allowed to require employees to use paid leave as part of their FMLA leave per DOL regulations. In that circumstance or any other where the employee receives paid FMLA leave, the paid leave must be considered for purposes of calculating hours of service to prevent a break.]**

    c. Employers must provide eligible employees with up to 10 weeks of unpaid leave during any 12-month period for a family member's serious health problem. [This answer is incorrect. Under the FMLA, covered employers (i.e., employers with at least 50 employees) must provide up to 12 weeks of unpaid leave during any 12-month period for eligible employees for the birth or adoption of a child or a family member's serious health problem.]

    d. Employees on unpaid FMLA do not qualify for changes to benefit plans. [This answer is incorrect. According to the FMLA, employees on paid or unpaid FMLA leave are to be treated as if they continued to work for purposes of changes to benefit plans. They are entitled to changes in benefit plans, except those which are dependent upon seniority or accrual during the leave, immediately upon return from leave or to the same extent they would have qualified if no leave had been taken.]

13. If the plan measures subsequent eligibility periods based on the employee's anniversary date she began work, what happens when she has a break in service? **(Page 27)**

    a. **The plan uses the 12-consecutive-month period starting on the date the employee returns to work and then succeeding anniversaries of that date. [This answer is correct. According to DOL Reg. 2530.200b-4(b)(1)(i), if a plan measures subsequent eligibility periods based on the anniversary of the date an employee begins work, the plan must use the 12-consecutive-month period beginning on the date the employee returned to work and, when necessary, subsequent anniversaries of that date.]**

b. The plan will use the 12-consecutive-month period starting on the date the employee returned to work and then succeeding periods starting with the plan year that includes the first anniversary of the date the employee returned to work. [This answer is incorrect. According to DOL Reg. 2530.200b-4(b)(1)(ii), if a plan measures subsequent eligibility periods based on plan years, the plan must first use the 12-consecutive-month period beginning on the date the employee returned to work and, when necessary, subsequent periods beginning with the plan year that includes the first anniversary of the date the employee returned to work.]

BENEFIT ACCRUAL

The benefit accrual is the rate at which a plan participant earns benefits under the plan. The method of benefit accrual depends on whether the plan is a defined contribution plan or defined benefit plan.

Defined Contribution Plan

In the case of a defined contribution plan, the benefit accrual is the amount of contributions, forfeitures, expenses, earnings, gains, and losses allocated to the participant's account (i.e., the participant's account balance). In general, the benefit accrual rule can require both a minimum number of hours of service (of no more than 1,000 hours) and employment at the end of the plan year (often referred to as the *last day rule*). The partial accrual concept applies only to defined benefit plans. However, a benefit accrual requiring more than 501 hours of service may be considered discriminatory under IRC Sec. 410(b).

Most employers adopt a prototype document rather than having their own individually designed plan. A standardized prototype cannot have a last day rule or 1,000-hour rule. Many will have a 500-hour rule, which is allowed for terminated employees. These standards ensure the plan is *safe harbor* in that there is no way to exclude anyone from the minimum benefit accrual rules and potentially fail a nondiscrimination test.

An employer who wants to use the 1,000 hours or last day rule for the benefit accrual needs to adopt a nonstandardized, volume submitter, or an individually designed plan. The plan will need to meet the nondiscrimination tests.

Defined Benefit Plan

For a defined benefit plan, the accrued benefit is determined by the plan's benefit accrual formula as the periodic pension payable as of the normal retirement date. For example, a defined benefit plan may provide that the participant will earn a benefit equal to ½% of the average of the highest five consecutive years of compensation, times the number of years of service with the employer, limited to a maximum of 30 years. Both the Internal Revenue Code and ERISA contain similar rules restricting a plan's ability to *backload* defined benefit accruals. Backloading refers to the practice, commonly used prior to ERISA, of weighting the benefit formula so that a participant accrues proportionately greater benefits in later years of service. The rules relating to benefit accruals, found in IRC Sec. 411(b), generally result in ratable benefit accruals over the employee's period of service. However, a small degree of backloading is permissible under IRC Sec. 411(b) and its related regulations.

A defined benefit plan will fail to satisfy the benefit accrual provisions of IRC Sec. 411(b)(1)(H) if the rate of benefit accrual is reduced, either directly or indirectly, when participants reach a specific age. There has been considerable concern in this area for cash balance plans, particularly those adopted to replace traditional defined benefit plans.

In general, any participant in a defined benefit plan having 1,000 hours of service during the year must accrue a benefit. However, a participant may receive a partial year's accrual on a pro rata basis if the plan requires up to 2,000 hours for a full year's accrual. If the participant does not work full-time, the benefit accrued may be a proportionate part of the benefit accrued by a full-time employee. The partial accrual rule does not apply to the top-heavy minimum contribution. The maximum hourly requirement for the top-heavy minimum is 1,000 hours.

Cash Balance Plan

A cash balance plan falls under the defined benefit category, yet benefits are expressed as a cash account rather than as an accrued pension payable at normal retirement (i.e., rather than the traditionally defined, normal retirement benefit). The annual accrual under a cash balance plan is a stated contribution and a prescribed interest rate (irrespective of actual plan investment earnings). The rate of benefit accruals under this plan design may tend to decrease with age as compared to the traditional defined benefit accrual.

VESTING STANDARDS

Vesting is the process by which the right to a participant's accrued benefit becomes nonforfeitable. The Internal Revenue Code and ERISA contain similar rules that govern vesting. The concepts of years of service and hours of

service, which apply to eligibility and benefit accrual, also apply to vesting. In determining service for vesting, a plan may use the calendar year, plan year, or any other consecutive 12-month period designated by the plan.

By establishing a service period that must be met for participants to become vested in their accrued benefit, an employer is encouraging loyalty and longevity among its employees.

Fully Vested, Partially Vested, and Nonvested Participants

A fully vested participant is one whose right to an accrued benefit derived from employer contributions is 100% nonforfeitable. A participant who has no such vested right is nonvested. A participant whose nonforfeitable right is between 0% and 100% is partially vested.

Rollover Accounts. When a participant has a rollover from another plan and that is the only item credited to the participant, the participant should be considered nonvested in regard to employer contributions because the participant has not been credited with any employer contributions. Likewise, a participant should be considered nonvested when the only contributions made by a participant are those not considered to be elective deferrals (e.g., after-tax contributions).

401(k) Plans. If a participant in a 401(k) plan has no account balance because no elective contributions have been made (which precluded any credit of employer matching contributions), and the employer has not made any other contributions to the plan, the participant should be considered nonvested.

Vesting in Employee Contributions

A participant must always be fully vested in the participant's own contributions and associated earnings, regardless of the length of the employee's service. The determination of employee contributions depends on whether the plan is a defined contribution plan or a defined benefit plan. Although elective deferrals are treated for many tax purposes as employer contributions, for vesting purposes, they are treated as employee contributions.

Defined Contribution Plans. If separate accounts for employee contributions are maintained, an employee's contributions on any determination date consists of the balance of the employee's contributions, along with the income, expenses, gains, and losses attributable to such contributions. If separate accounts are not maintained, the following allocation must be made to separate the employee contributions:

$$\text{Employee's total account balance} \times \frac{\text{Total amount of employee contributions} - \text{withdrawals}}{\begin{array}{c}(\text{Total amount of employee contributions} - \text{withdrawals}) \\ + \text{ total amount of employer contributions} \\ (\text{including allocated forfeitures}) - \text{withdrawals}\end{array}}$$

Defined Benefit Plans. In the case of a defined benefit plan, the accrued benefit derived from contributions made by an employee on any given determination date depends on whether the contributions are mandatory or voluntary. If employee contributions are voluntary, they are treated as contributions to a defined contribution plan. Regulations require a separate account be maintained for such contributions.

If employee contributions are mandatory, the accrued benefit at any determination date is an annual benefit that is nondecreasing for the life of the participant. The annual benefit equals the amount of the employee's accumulated contributions [including interest as provided in Prop. Reg. 1.411(c)-1(c)(3)] divided by the appropriate conversion factor for the form of benefit chosen. The conversion factor is the present value of the annuity in the form of the annual benefit beginning at normal retirement age at a rate of $1 a year, computed using an appropriate interest rate and mortality table as provided in IRC Sec. 417(e)(3). This regulation may be relied upon pending issuance of the final regulations.

401(k) Plans. Salary deferrals under a 401(k) plan are considered employee contributions for the purposes of determining deductions under IRC Sec. 404. However, a participant must always be fully vested in salary deferrals.

Vesting at Normal Retirement Age

Upon reaching normal retirement age participants must always be fully vested in their accrued benefit derived from employer contributions. For this purpose, *normal retirement age* is the earlier of:

a. normal retirement age under the plan, or

b. the later of age 65 or the fifth anniversary of the date plan participation began.

The accrued benefit required to be vested is the *normal retirement benefit* . The normal retirement benefit is the greater of (a) the plan's early retirement benefit, if any, or (b) the benefit that begins at the normal retirement age. In order to compare the two values, each is presumed to be payable as a periodic benefit.

Example 1-26: Determination of normal retirement benefit.

To encourage early retirement, a plan provides benefits of $400 a month for life at normal retirement age 65 and $500 a month for life at early retirement age 60. The normal retirement benefit must be $500 a month, the greater of the benefit payable at normal retirement ($400) or early retirement ($500).

For this purpose, the early retirement benefit is determined without regard to any Social Security supplement. The early retirement benefit begins before the Social Security benefits become payable, as long as such early benefit does not exceed the Social Security benefits and the early benefit ceases when Social Security benefits begin.

The normal retirement benefit is determined without regard to any medical benefits and disability benefits in excess of the *qualified disability benefit*. For this purpose, a qualified disability benefit is that provided by the plan which does not exceed the benefit that would be provided for the participant upon separation from service at normal retirement age.

Vesting of Early Retirement Benefits

A plan may provide for early retirement benefits as well as benefits at normal retirement age. A special rule applies that does not fall under vesting requirements but deals with the right of the participant to receive the early retirement benefit. The rule comes into play when a plan provides for the early benefit based upon both age and service conditions. A participant terminating after satisfying the service requirement, but prior to completing the age requirement, will become eligible to receive an early retirement benefit upon completion of the age requirement. Such benefit must be at least the amount that the participant is entitled to at normal retirement age, reduced in accordance with regulations.

Vesting upon Plan Termination or upon Complete Discontinuance of Employer Contributions

Participants must be fully vested in accrued benefits derived from employer contributions if:

a. The plan terminates.

b. In the case of a defined contribution plan not subject to the minimum funding requirements of IRC Sec. 412 (e.g., a profit-sharing plan or a stock bonus plan), there is a complete discontinuance of employer contributions.

c. An event occurs that is considered a partial plan termination, but only for participants affected by the partial termination.

Partial Terminations. A partial termination of a plan is not a termination. Accordingly, the freezing of accruals under a qualified retirement plan that results in a partial plan termination, does not constitute a plan termination for purposes of determining whether service may be disregarded toward vesting if accruals resume under the plan. All years of service after the plan was initially established (including those during which accruals were frozen) must be taken into account for purposes of vesting. Under Rev. Rul. 2007-43, there is a presumption that there has been a partial termination of the plan if at least 20% of participating employees have had an employer-initiated severance

from employment. The revenue ruling provides that if a partial termination occurs on account of turnover, all participating employees who had a severance from employment during the period must be fully vested in their accrued benefits, to the extent funded on that date, or in the amounts accredited to their accounts. That is, under the revenue ruling, *affected participants* are all participants with a severance from employment and not only those whose severance was employer-initiated.

Example 1-27: Vesting when accruals are frozen.

Kansas Service Co. maintains a defined benefit plan that was established in 1995. Benefit accruals under the plan were frozen as of December 31, 2004, causing a partial termination in 2005. At that time, all participants became fully vested in their accrued benefits. Prior to 2005, a participant received a specified percentage of his or her highest average pay times the participant's total years of service. Each participant becomes fully vested after five years of service. Kansas Service Co. subsequently amended the plan to provide that, as of January 1, 2011, participants would begin accruing benefits under a different formula.

Can years of service during the time accruals were frozen be disregarded in determining vesting? No, the partial termination does not constitute a termination and all years of service since the plan's establishment in 1995 must be taken into account in determining vesting.

Vesting in Employer Contributions

Non-top-heavy Plan Vesting Schedule for Defined Benefit Plans. A non-top-heavy defined benefit plan (other than a cash balance or other hybrid defined benefit plan) must provide a vesting schedule at least as liberal as one of the two following statutory schedules (see Exhibit 1-1):

a. *Five-year Cliff Vesting.* A plan satisfies this schedule if a participant who has completed five years of service has a nonforfeitable right to 100% of the accrued benefit derived from employer contributions.

b. *Seven-year Graded Vesting.* A plan satisfies this schedule if a participant has a nonforfeitable right to a percentage of the accrued benefit derived from employer contributions under the following schedule:

Exhibit 1-1

Non-top-heavy Vesting Schedule for Defined Benefit Plans

	Percentages		
	1 yr. Service Requirement		
Years of Service	5 yr. Cliff	7 yr. Graded	2 yr. Service Requirement
1	0%	0%	0%
2	0%	0%	100%
3	0%	20%	100%
4	0%	40%	100%
5	100%	60%	100%
6	100%	80%	100%
7	100%	100%	100%

* * *

Defined Contribution Plan and Top-heavy Defined Benefit Plan Vesting Schedules Require Faster Vesting. Special rules apply for determining the vesting schedule for employer contributions or benefits for all defined contribution plans and top-heavy defined benefit plans (other than a cash balance or other hybrid defined benefit

plan). The employer must follow one of the following schedules with respect to the accrued benefit derived from employer contributions (see Exhibit 1-2):

a. *Three-year Cliff Vesting.* A plan satisfies this schedule if a participant who has completed three years of service has a nonforfeitable right to 100% of the accrued benefit derived from employer matching contributions.

b. *Six-year Graded Vesting.* A plan satisfies this schedule if a participant has a nonforfeitable right to a percentage of the accrued benefit derived from employer matching contributions under the following schedule:

Exhibit 1-2

Defined Contribution and Top-heavy Defined Benefit Plans Vesting Schedule

Years of Service	Percentages		
	1 yr. Service Requirement		2 yr. Service Requirement
	3 yr. Cliff	6 yr. Graded	
1	0%	0%	0%
2	0%	20%	100%
3	100%	40%	100%
4	100%	60%	100%
5	100%	80%	100%
6	100%	100%	100%

* * *

Vesting Schedule for Cash Balance and Other Hybrid Defined Benefit Plans

The Pension Protection Act of 2006 added new IRC Sec. 411(a)(13), providing that cash balance and other hybrid defined benefit plans must fully vest an employee who has earned at least 3 years of service. This applies to plan years beginning after 2007 for plans in existence on June 29, 2005, and immediately for other plans.

For plan years beginning after December 31, 2009, certain employers may maintain combined defined benefit/401(k) plans, providing both a defined benefit and a 401(k) component. The defined benefit portion of the plan must provide that employees are 100% vested after completing no more than three years of service.

Comparison of Vesting Schedules

Using cliff vesting under either the top-heavy or non-top-heavy schedules is most beneficial when the employer experiences high turnover of employees during the first three to five years. For example, an employer using a non-top-heavy five-year cliff vesting schedule would benefit if experiencing high turnover of employees before their fifth year of employment. Employees leaving before they are fully vested will forfeit their nonvested percentage. In defined contribution plans, employers may reduce contribution costs by applying the forfeitures to future contributions, or may increase benefits by reallocating the forfeitures. Defined benefit plans must reduce future contributions in applying forfeitures. If high turnover is not common for an employer, the employer may wish to adopt a graded vesting schedule. See Exhibit 1-3 for a comparison of vesting schedules.

Exhibit 1-3

Comparison of Vesting Schedules

Years of Service	Cumulative Contribution	Non-top-heavy DB Plans: 5 yr. cliff		Non-top-heavy DB Plans: 7 yr. graded		DC or Top-heavy DB Plans: 3 yr. cliff		DC or Top-heavy DB Plans: 6 yr. graded		2 yr. service requirement	
1	$ 0	0%	$ 0	0%	$ 0	0%	$ 0	0%	$ 0	0%	$ 0
2	$ 2,000	0%	$ 0	0%	$ 0	0%	$ 0	20%	$ 400	100%	$ 2,000
3	$ 4,000	0%	$ 0	20%	$ 800	100%	$ 4,000	40%	$ 1,600	100%	$ 4,000
4	$ 6,000	0%	$ 0	40%	$ 2,400	100%	$ 6,000	60%	$ 3,600	100%	$ 6,000
5	$ 8,000	100%	$ 8,000	60%	$ 4,800	100%	$ 8,000	80%	$ 6,400	100%	$ 8,000
6	$ 10,000	100%	$ 10,000	80%	$ 8,000	100%	$ 10,000	100%	$ 10,000	100%	$ 10,000
7	$ 12,000	100%	$ 12,000	100%	$ 12,000	100%	$ 12,000	100%	$ 12,000	100%	$ 12,000

* * *

Changes in the Vesting Schedule

A plan is not required to keep the same vesting schedule it originally adopts. The plan may change the vesting schedule as long as it does not decrease the vested percentage of the participants. Further, if a plan amendment changes a schedule, a participant who has at least three years of service must be given the right to elect to continue to vest under the former schedule, unless the participant's vested percent under the new vesting schedule is always at least equal to the prior vesting schedule. The plan may require that such election is irrevocable.

Determining the Participant's Vesting Percentage

When determining an employee's vesting percentage, years of service (not years of plan participation) with the employer are counted. In making this determination, generally all years of service must be counted to the extent stated in the plan, except for the following:

a. Years of service before age 18.

b. Years of service when an employee declined to make mandatory contributions (unless the employer contributes any part of the mandatory contributions during a period when the employee is eligible to make contributions).

c. Years of service during which the employer did not maintain the plan or a predecessor plan. A plan is a predecessor plan if within the five year period immediately preceding or following the date the employer terminates a plan the employer establishes another qualified plan.

d. Years of service before January 1, 1971, unless the employee has at least three years of service after December 31, 1970.

e. Years of service before the minimum vesting standards of IRC Sec. 411 applied to the plan (generally, prior to 1976), when such service would have been disregarded under the terms of the plan then in effect with regard to service breaks that occurred prior to 1976.

f. Years of service that may be disregarded under the break in service rules. These rules are summarized in Exhibit 1-4. A break in service for this purpose is the same as for the eligibility rules. However, a plan may use a different rule (e.g., hourly vs. elapsed time method) in measuring service for vesting than it uses for eligibility purposes.

Exhibit 1-4

Break in Service Rules for Vesting

1. In a rule similar to the one-year holdout rule for eligibility, a plan is not required to count years of pre-break service of a participant who incurs a one-year break in service until the participant has completed a year of service on returning to work.

2. A rule of parity identical to that which applies for determining years of service for eligibility also applies in determining vesting.

3. Rules identical to those for eligibility apply to maternity, paternity, or family medical leave act absences for determining whether a break in service has occurred.

4. The plan may disregard service when a terminated employee receives a cash-out of his vested accrued benefit. A plan that disregards such service must also offer a participant the right to buy back the service by repaying the cashed-out amount (plus interest, in the case of a defined benefit plan). The plan may require that repayment be made before the earlier of five years after the participant is re-employed or the close of the first period of five consecutive one-year breaks after the cash-out.

5. In the case of a participant in a defined contribution plan or certain insured defined benefit plans, post-break service of a participant who has five consecutive one-year breaks in service is not required to be counted in determining the vested portion of the participant's accrued benefit derived from employer contributions made prior to the five-year break period.

* * *

Example 1-28: Counting pre-break years for vesting purposes.

George is a participant in Company Y's profit-sharing plan. He terminates employment in 2004 when he has four years of service with Y and an account in the profit-sharing plan that is 40% vested. He returns to work for Y in 2010 after incurring five consecutive one-year breaks in service. If the plan so provides, George's years of service after his return to work in 2010 need not be counted in determining the vested portion of his pre-2004 account balance. However, *all* years must be counted in determining the vested portion of his benefit that accrues after his return to work in 2010.

In calculating a participant's years of service, service with members of commonly controlled businesses is included as well as service with employers who must be aggregated pursuant to IRC Sec. 414 Years of service for vesting purposes are the same as for eligibility purposes. Likewise, hours of service has the same meaning for vesting purposes as it does for eligibility purposes.

The computation period for determining service for vesting purposes is a 12-consecutive-month period designated by the plan. Generally, the computation period for vesting purposes is the plan year, whereas the computation period for eligibility purposes must, for the initial eligibility computation period, commence on the date on which the first hour of service is earned. Best practices indicate that it is unusual for the vesting and eligibility computation periods to be the same except for subsequent eligibility computation periods when the eligibility computation period shifts. The vesting computation period does not have to begin on the date the employee commenced work. A plan may designate any 12-consecutive-month period as the vesting computation period, as long as it is applied equally to all participants. This does not mean the same period must apply to all participants, but that the same criteria must be applied. For example, the employee's employment year could be specified as the vesting computation period. However, the plan is prohibited from using any period that artificially delays vesting, such as a period that is based on the anniversaries of the date four months following the employment commencement date. For vesting purposes, the break in service computation period must be the vesting computation period.

When May Vested Benefits Be Forfeited or Suspended?

A plan may provide that a participant's vested benefit will be forfeited or suspended under the following circumstances:

a. *Death.* A plan may provide that an accrued benefit attributable to employer contributions [including 401(k) elective deferrals] will not be paid if the participant dies, except when a survivor annuity is required to be paid to a participant's spouse.

b. *Re-employment of a Retiree.* A plan may provide that benefit payments will be suspended (but not forfeited) upon the re-employment of a retiree meeting certain conditions.

c. *Withdrawal of Mandatory Employee Contributions.* A plan may provide that a participant who is less than 50% vested will forfeit an accrued benefit attributable to employer contributions if that participant withdraws mandatory employee contributions. A plan that wants to use such a forfeiture provision must also give the employee a chance to buy back the forfeited amount by repaying the mandatory employee contributions, plus interest in the case of a defined benefit plan. In the case of a defined contribution plan, the plan may impose certain time limits on the employee's right to repay.

d. *Treatment of Matching Contributions Forfeited by Reason of Excess Deferrals or Contributions.* A plan must provide for the forfeiture of matching employer contributions that relate to excess contributions resulting from a failed ADP test, excess deferrals, or excess aggregate contributions resulting from a failed ACP test.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. The rate at which a plan participant earns benefits under the plan is the benefit accrual. The method of benefit accrual depends on which of the following?

    a. If the contributions are mandatory or voluntary.

    b. How the plan measures eligibility periods.

    c. If the plan is a defined benefit or defined contribution plan.

15. Which of the following statements most accurately describes benefit accrual in a defined contribution plan?

    a. A participant may receive a partial year's accrual on a pro rata basis if the plan requires up to 2,000 hours for a full year's accrual.

    b. Accrued benefit is decided by the plan's benefit accrual specifications as the periodic pension payable as of the normal retirement date.

    c. Participants having 1,000 service hours during the year must accrue a benefit.

    d. A nonstandardized, volume submitter must be selected by any employer that utilizes the last day rule for benefit accrual.

16. Which of the following examples is One schedule employers must follow regarding the accrued benefit derived from employer contributions in a top-heavy defined benefit plan?

    a. Calvin has completed three years of service at June's Jewels, Inc. Calvin has a nonforfeitable entitlement to 100% of the accrued benefit derived from employer matching contributions.

    b. Dot has completed five years of service at Unlimited Possibilities, Inc. Dot has a nonforfeitable entitlement to 20% of the accrued benefit derived from employer matching contributions.

17. Which of the followings statements regarding vesting schedules is most accurate?

    a. An employer who endures high turnover rate during the first three to five years will benefit using cliff vesting under the top-heavy schedules.

    b. Plan must maintain the same vesting schedule that it initially adopts.

    c. The number of years an employee participates in plan determines the employee's vesting percentage.

    d. An employee who leaves before they are fully vested will forfeit their vested percentage.

18. Which of the following statements regarding the break in service rules for vesting is most accurate?

    a. Rules similar to eligibility rules do not apply to maternity and paternity leave of absences.

    b. A rule of parity applies when determining vesting.

    c. A plan must count years of pre-break service of a participant who acquires a one-year break in service until the participant has completed a year of service upon return.

    d. The computation for determining service for vesting purposes should start on the date which the first hour of service is earned.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. The rate at which a plan participant earns benefits under the plan is the benefit accrual. The method of benefit accrual depends on which of the following? **(Page 34)**

    a. If the contributions are mandatory or voluntary. [This answer is incorrect. Mandatory and voluntary contributions are an important factor to consider when determining vesting in defined benefit plans, not benefit accrual. In the case of a defined benefit plan, the accrued benefit derived from contributions made by an employee on any given determination date depends on whether the contributions are mandatory or voluntary.]

    b. How the plan measures eligibility periods. [This answer is incorrect. Measuring and crediting service does not affect the method of benefit accrual. However, it does affect when the employee can accrue benefits.]

    c. If the plan is a defined benefit or defined contribution plan. [This answer is correct. The benefit accrual is the rate at which a plan participant earns benefits under the plan. The method of benefit accrual depends on whether the plan is a defined contribution plan or defined benefit plan per IRC regulations.]

15. Which of the following statements most accurately describes benefit accrual in a defined contribution plan? **(Page 34)**

    a. A participant may receive a partial year's accrual on a pro rata basis if the plan requires up to 2,000 hours for a full year's accrual. [This answer is incorrect. The partial accrual concept applies only to defined benefit plans not defined contribution plans. However, a benefit accrual requiring more than 501 hours of service may be considered discriminatory under IRC Sec. 410(b).]

    b. Accrued benefit is decided by the plan's benefit accrual specifications as the periodic pension payable as of the normal retirement date. [This answer is incorrect. For a defined benefit plan, the accrued benefit is determined by the plan's benefit accrual formula as the periodic pension payable as of the normal retirement date. In the case of a defined contribution plan, the benefit accrual is the amount of contributions, forfeitures, expenses, earnings, gains, and losses allocated to the participant's account.]

    c. Participants having 1,000 service hours during the year must accrue a benefit. [This answer is incorrect. Generally, any participant in a defined benefit plan having 1,000 hours of service during the year must accrue a benefit. In regards to the defined contribution plan, the benefit accrual rule can require both a minimum number of hours of service (of no more than 1,000 hours) and employment at the end of the plan year (often referred to as the *last day rule*).]

    d. A nonstandardized, volume submitter must be selected by any employer that utilizes the last day rule for benefit accrual. [This answer is correct. For defined contribution benefit plans, an employer who wants to use the 1,000 hours or last day rule for the benefit accrual needs to adopt a nonstandardized, volume submitter, or an individually designed plan. The plan will need to meet the nondiscrimination tests. Most employers adopt a prototype document rather than having their own individually designed plan. A standardized prototype cannot have a last day rule or 1,000-hour rule. Many will have a 500-hour rule, which is allowed for terminated employees. These standards ensure the plan is *safe harbor* in that there is no way to exclude anyone from the minimum benefit accrual rules and potentially fail a nondiscrimination test.]

16. Which of the following examples is One schedule employers must follow regarding the accrued benefit derived from employer contributions in a top-heavy defined benefit plan? **(Page 37)**

    a. Calvin has completed three years of service at June's Jewels, Inc. Calvin has a nonforfeitable entitlement to 100% of the accrued benefit derived from employer matching contributions. [This

answer is correct. Special rules apply for determining the vesting schedule for employer contributions or benefits for all defined contribution plans and top-heavy defined benefit plans. A defined contribution plan or a top-heavy plan satisfies the three-year cliff vesting schedule if a Calvin who has completed three years of service has a nonforfeitable right to 100% of the accrued benefit derived from employer matching contributions.]

b. Dot has completed five years of service at Unlimited Possibilities, Inc. Dot has a nonforfeitable entitlement to 20% of the accrued benefit derived from employer matching contributions. [This answer is incorrect. A top-heavy defined benefit plan must provide Dot a vesting schedule such as the six-year cliff vesting schedule. If Dot completes five years of service she should have a nonforfeitable right to 80% of the accrued benefit derived from employer contributions.]

17. Which of the followings statements regarding vesting schedules is most accurate? **(Page 39)**

a. An employer who endures high turnover rate during the first three to five years will benefit using cliff vesting under the top-heavy schedules. [This answer is correct. Using cliff vesting under either the top-heavy or non-top-heavy schedules is most beneficial when the employer experiences high turnover of employees during the first three to five years. For example, an employer using a non-top-heavy five-year cliff vesting schedule would benefit if experiencing high turnover of employees before their fifth year of employment. Employees leaving before they are fully vested will forfeit their nonvested percentage.]

b. Plan must maintain the same vesting schedule that it initially adopts. [This answer is incorrect. According to IRC Sec. 411(a)(10); Reg. 1.411(a)-8T(b), a plan is not required to keep the same vesting schedule it originally adopts. The plan may change the vesting schedule as long as it does not decrease the vested percentage of the participants. Further, if a plan amendment changes a schedule, a participant who has at least three years of service must be given the right to elect to continue to vest under the former schedule, unless the participant's vested percent under the new vesting schedule is always at least equal to the prior vesting schedule.]

c. The number of years an employee participates in plan determines the employee's vesting percentage. [This answer is incorrect. When determining an employee's vesting percentage, years of service (not years of plan participation) with the employer are counted. When making this determination, generally all years of service must be counted to the extent stated in the plan under IRC Sec. 411(a)(4).]

d. An employee who leaves before they are fully vested will forfeit their vested percentage. [This answer is incorrect. Employees leaving before they are fully vested will forfeit their nonvested percentage. In defined contribution plans, employers may reduce contribution costs by applying the forfeitures to future contributions, or may increase benefits by reallocating the forfeitures. Defined benefit plans must reduce future contributions in applying forfeitures.]

18. Which of the following statements regarding the break in service rules for vesting is most accurate? **(Exhibit 1-4)**

a. Rules similar to eligibility rules do not apply to maternity and paternity leave of absences. [This answer is incorrect. Rules identical to those for eligibility apply to maternity, paternity, or family medical leave act absences for determining whether a break in service has occurred per IRC Sec. 411(a)(6)(E).]

b. A rule of parity applies when determining vesting. [This answer is correct. According to IRC Sec. 411(a)(6)(D), a rule of parity identical to that which applies for determining years of service for eligibility also applies in determining vesting.]

c. A plan must count years of pre-break service of a participant who acquires a one-year break in service until the participant has completed a year of service upon return. [This answer is incorrect. In a rule similar to the one-year holdout rule for eligibility, a plan is not required to count years of pre-break service of a participant who incurs a one-year break in service until the participant has completed a year of service on returning to work per IRC Sec. 411(a)(6)(B).]

d. The computation for determining service for vesting purposes should start on the date which the first hour of service is earned. [This answer is incorrect. Usually, the computation period for determining service for vesting purposes is a 12-consecutive-month period designated by the plan according to DOL Reg. 2530.200b-1(a). Generally, the computation period for vesting purposes is the plan year, whereas the computation period for eligibility purposes must, for the initial eligibility computation period, commence on the date on which the first hour of service is earned. For vesting purposes, the break in service computation period must be the vesting computation period.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (RETTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Match the following regulations with the appropriate descriptions. (**Note**: Some descriptions may apply to both regulations.)

A. ERISA	1. Includes standards regarding the minimum age and length of service requirements an employer can impose on employees before allowing them to participate in the employer's qualified plan.
B. Internal Revenue Code	2. Does not preclude an employer from setting plan participation standards unrelated to age and service.
	3. Includes coverage requirements that may limit an employer's ability to provide a plan for some groups of employees, but not for others.
	4. Regulates benefit accrual, and vesting standards applicable to most employee pension benefit plans.

   a. A: 1, 2, 3, 4; B: 1, 2, 4.

   b. A: 1, 2, 4: B: 1, 3, 4.

   c. A: 2, 3, 4; B: 3, 4.

   d. A: 1, 3, 4: B: 1, 2, 3, 4.

2. Which of the following statements is accurate regarding age and service eligibility for participation in a qualified plan?

   a. ERISA places no age or service restrictions on employers for their plan participation agreements.

   b. Participation eligibility in a qualified plan is restricted to individuals who are employees of the sponsoring employer. Leased employees are not eligible.

   c. The Code states that governmental plans are not exempt from the age and service eligibility standards.

   d. A plan cannot require an eligible employee to complete a period of service extending past the later of the date on which the employee reaches age 21 or one year of service.

3. Which of the following bases credit for participation and vesting on the entire period of time an employee works for the employer, starting with the date employment begins and ending when employment is terminated?

   a. Hours method.

   b. Elapsed time method.

c. Hour equivalence method.

d. Safe harbor method.

4. What does universal availability require?

   a. An employee complete one year of service to be eligible to participate in the plan.

   b. Service for the predecessor be credited according to the regulations.

   c. An employee to be at least 21 years of age and to complete one year of service to participate in the plan.

   d. An employee is allowed to make elective deferrals immediately if any employee of the employer may make elective deferrals.

5. The concept of a year of service is **not** used for which of the following?

   a. Accrual of benefits.

   b. Employee participation.

   c. Minimum age.

   d. Vesting.

6. Norman Enterprises maintains a defined benefit plan with a calendar year-end. The plan requires that an employee complete one year of service to be eligible to participate in the plan. A year of service is defined by the plan as the annual period beginning on the employee's date of employment. Alvin, an employee, began work on May 1, 2009. Alvin had completed 900 hours of service as of April 30, 2010, the end of his initial eligibility period. Since Alvin did not meet the service requirement in the initial period, when will his subsequent eligibility period begin and end?

   a. May 1, 2010; April 30, 2011.

   b. January 1, 2010; January 1, 2011.

   c. July 1, 2010; July 1, 2011.

   d. January 1, 2010; December 31, 2011.

7. When must an hour of service be credited to an employee?

   a. When an employee is paid only for reimbursement of medical expenses.

   b. When compensation is paid under a plan solely for the purpose of complying with workman's compensation.

   c. When an employee receives back pay for any hour of service and the hour is credited to the eligibility period that the back pay refers to.

   d. When compensation is paid under a plan solely for the purpose of complying with unemployment compensation.

8. Tom, an employee, spent three weeks on a paid vacation. Tom's salary is set at an annual rate but is paid on a biweekly basis. The amount of salary payments for paid vacation is calculated on the basis of units of time (weeks). Tom has no regular work schedule but works at least 45 hours per week. The plan provides for the calculation of hours of service to be credited for periods of paid absences on the basis of a 40-hour workweek. Tom must be credited with how many hours of service for his vacation?

   a. 0.

   b. 120.

   c. 135.

   d. 200.

9. When are equivalencies used?

   a. When an employee is salaried.

   b. When an employee uses vacation time.

   c. When an employee works overtime.

   d. When an employee is on disability.

10. Plan XYZ provides for a minimum age requirement of 21 and a minimum service requirement of one year with semiannual entry dates of January 1 and July 1. Employee A met the minimum age and service requirements on March 20, 2010. A quit work on April 5, 2010, and then returned to work on December 1, 2010. Using the elapsed time method, when must the plan allow A to participate?

    a. April 5, 2011.

    b. March 20, 2011.

    c. January 1, 2011.

    d. December 1, 2010

11. If an employee incurs a one-year break in service under the counting hours method, what was the maximum number or hours that the employee was credited with?

    a. 423.

    b. 450.

    c. 500.

    d. 501.

12. In which of the following examples is the pre-break service disregarded?

    a. Joy Luck participates in the XYZ, Inc., profit-sharing plan. XYZ's plan uses the rule of parity. She has participated for two years and is not vested in any of XYZ's contributions allocated to her account. Joy terminates employment and incurs three consecutive one-year breaks in service. She then returns to XYZ's employment.

    b. Jorge Benson has participated for eight years in the XYZ, Inc. plan which uses the parity rule. He is fully vested in XYZ's contributions allocated to his account. Jorge terminates employment and incurs four consecutive one-year breaks in service before returning to XYZ's employment.

    c. Janice Joplin has participated for three years in the XYZ, Inc., profit-sharing plan, which uses the rule of parity. She is not vested in any of XYZ's contributions allocated to her account. Janice terminates employment and incurs seven consecutive one-year breaks in service. She then returns to XYZ's employment.

    d. Do not select this answer choice.

13. In regards to defined contribution plans, any rehired military employees who are subject to USERRA are entitled to______ that they would have enjoyed if they had not been absent due to uniformed service.

    a. Earnings.

    b. Forfeitures.

    c. Contributions.

    d. Do not select this answer choice.

14. Employer contribution rates (for rehired military personnel subject to USERRA participating in defined contribution plans) that cannot be reasonably measured are based on which of the following?

    a. 40-hour workweek.

    b. Plan year or the military employment anniversary date.

    c. Employee's military work compensation.

    d. Employee's wages for the 12-month period prior to the military absence.

15. Under which of the following plans are rehired military personnel completely restored to the same accrued benefit position they would have received had they not been absent due to military service?

    a. Defined benefit.

    b. Defined contribution.

    c. 401(k).

    d. 403(b).

16. A cash balance plan falls under which of the following classifications?

    a. Defined benefit.

    b. Define contribution.

    c. 401(k).

    d. 403(b).

17. Sadie is a participant in her employer's 401(k) plan. She has not made any elective contributions and her employer has not made any contributions to the plan. Sadie is considered which of the following?

    a. Fully vested.

    b. Partially vested.

    c. Nonvested.

    d. Do not select this answer choice.

18. Which of the following statements regarding when vested benefits can be forfeited or suspended is accurate?

    a. A plan may provide that payments be forfeited once a retiree is re-employed independent of any special conditions present.

    b. A participant who is less than 50% vested may forfeit an accrued benefit attributable to employer contributions if mandatory contributions are withdrawn.

    c. Accrued benefit attributable to employer contributions may be paid if the participant dies and a survivor annuity is not paid to the survivor spouse.

    d. Matching employer contributions are paid related to excess contributions when the ADP test failed.

Lesson 2: Testing for Minimum Coverage and Participation

INTRODUCTION

Qualified plans must meet certain requirements to maintain favorable tax status. The Internal Revenue Code contains three sets of minimum participation and coverage rules for qualified plans:

a. *Minimum Age and Service Requirements* These requirements deal with the employees' ability to participate in the plan by placing limits on the greatest age and service conditions that the plan can require before allowing employees to join the plan.

b. *Minimum Participation Rules*. These rules apply only to defined benefit plans. They measure how many employees are covered under the plan in comparison to the entire workforce of the employer.

c. *Minimum Coverage Rules*. These rules measure the plan's coverage of rank-and-file workers (NHCEs) and of highly compensated employees (HCEs). Their purpose is to prevent employers from establishing plans that primarily benefit only HCEs.

This lesson discusses the minimum participation and coverage rules (items b and c).

Both the minimum coverage rules and the minimum participation rules generally apply to all employees, including certain leased employees. However, certain employees are allowed to be excluded for purposes of these rules. Employees of a single employer are considered, as well as employees of an employer that is part of a group of businesses under common control.

The term *employee* refers to individuals who perform services for the employer. The term includes all common-law employees, self-employed individuals treated as employees under IRC Sec. 401(c)(1), and any leased employees who are not excluded.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how the plan document affects coverage and if the plan should be tested.
- Summarize how to identify plans to be tested for minimum coverage and identify controlled groups.
- Determine nonexcludable, active employees and highly compensated employees.
- Describe the average benefit test, and the consequences of failing the minimum coverage testing; and the minimum participation rules for defined benefit plans.

HOW DOES THE PLAN DOCUMENT AFFECT COVERAGE?

This lesson contains step-by-step guidance for determining if a plan passes the minimum coverage and minimum participation (if applicable) requirements based on the Internal Revenue Code and regulations. The actual application of these requirements will vary depending on the particular plan's design. For example, plan provisions for age and service requirements may be more generous than what is required by the Code. The plan document is the authoritative source of information about a particular plan and how the plan is to be administered. It is therefore imperative that the plan document be reviewed before coverage testing is done. If the plan document is not available, the latest summary plan description, along with summaries of material modifications, should contain the same information.

Information that should be found in the plan document includes the following:

- Are there any commonly controlled businesses to be considered?

- Are there multiple plans for testing purposes?
- Does the plan exclude any employees from participation other than for age or service requirements?
- Is the document a standardized or a nonstandardized prototype plan or a volume submitter plan?
- What is the minimum age required for eligibility?
- Is there a required amount of service for eligibility?
- What are the entry dates?
- When does an eligible employee become a participant in the plan?
- Is employment on the last day of the plan year required to receive a benefit?
- Is there a service requirement to accrue a benefit?
- Are there any special provisions in the document for correcting coverage failure?
- Is there a service requirement of 501 or more hours to receive the benefit for the year?

IRS CODE AND REGULATIONS (MINIMUM COVERAGE RULES)

The minimum coverage rules apply to all plans that qualify for favorable tax treatment under IRC Sec. 401 (i.e., qualified plans). The coverage rules are in the Internal Revenue Code; there are no parallel provisions in ERISA. To maintain their qualified status, such plans must cover a broad base of employees and not discriminate in favor of highly compensated employees (HCEs). The coverage rules make sure a retirement plan benefits a sufficient or minimum number of nonhighly compensated employees (NHCEs) in comparison to the number of HCEs covered under the plan.

Coverage testing is only required for plans qualifying for favorable tax treatment under IRC Sec. 401. The concept of coverage does apply to simplified employee pension plans (SEPs) and savings incentive match plans for employees (SIMPLE plans). However, these plans receive favorable tax treatment under IRC Sec. 408 and satisfy coverage automatically based on the participation requirements for these special plans. SEP and SIMPLE plans.

Minimum Coverage Tests

The plan must satisfy one of two minimum coverage tests in each plan year to demonstrate it is covering a broad base of employees:

a. *The Ratio Percentage Test.* The percentage of active NHCEs benefiting under the plan must be at least 70% of the percentage of active HCEs benefiting under the plan.

b. *The Average Benefit Test.* This test has two parts, both of which must be met:

    (1) *The Nondiscriminatory Classification Test.* This tests the classification of employees benefiting under the plan to make sure it does not discriminate in favor of HCEs.

    (2) *The Average Benefit Percentage Test.* The average percentage of benefits for NHCEs must equal at least 70% of the average percentage of benefits for HCEs.

The plan must pass either the *ratio percentage test* or the *average benefit test* each year; the plan need not pass the same test each year, as long as the plan passes one of the tests each year.

A Step-by-step Approach to Testing for Coverage

Depending on the plan design and employee population, coverage testing can be simple or rather complicated. The following is an eight-step process to coverage testing. However, all the steps may not apply to every plan.

Step 1 Determine if the plan must be tested or if it will pass coverage because of plan design or certain characteristics of the participant population. If the plan must be tested, proceed to Step 2.

Step 2 Identify all separate plans maintained by the employer.

Step 3 Determine if the employer is part of a controlled group or affiliated service group.

Step 4 Identify nonexcludable, active employees with respect to each plan.

Step 5 Identify the HCEs for each plan.

Step 6 Identify and group employees benefiting under the plan.

Step 7 Perform the ratio percentage test. If the plan fails the ratio percentage test, proceed to Step 8.

Step 8 Perform the average benefits test.

STEP 1 DETERMINE IF THE PLAN MUST BE TESTED

The flow chart in Exhibit 2-1 may be used to determine if a plan will pass coverage automatically or if it must be tested. For example, standardized plan documents do not contain provisions that allow a plan to fail minimum coverage. A plan administered in accordance with a standardized document will pass coverage based on plan design. A plan of an employer who employs only highly compensated employees (HCEs) will pass coverage because there are no nonhighly compensated employees (NHCEs) to test. Plans that benefit only NHCEs will also pass coverage because of the participant population.

Which Plans Must Apply the Minimum Coverage Rules?

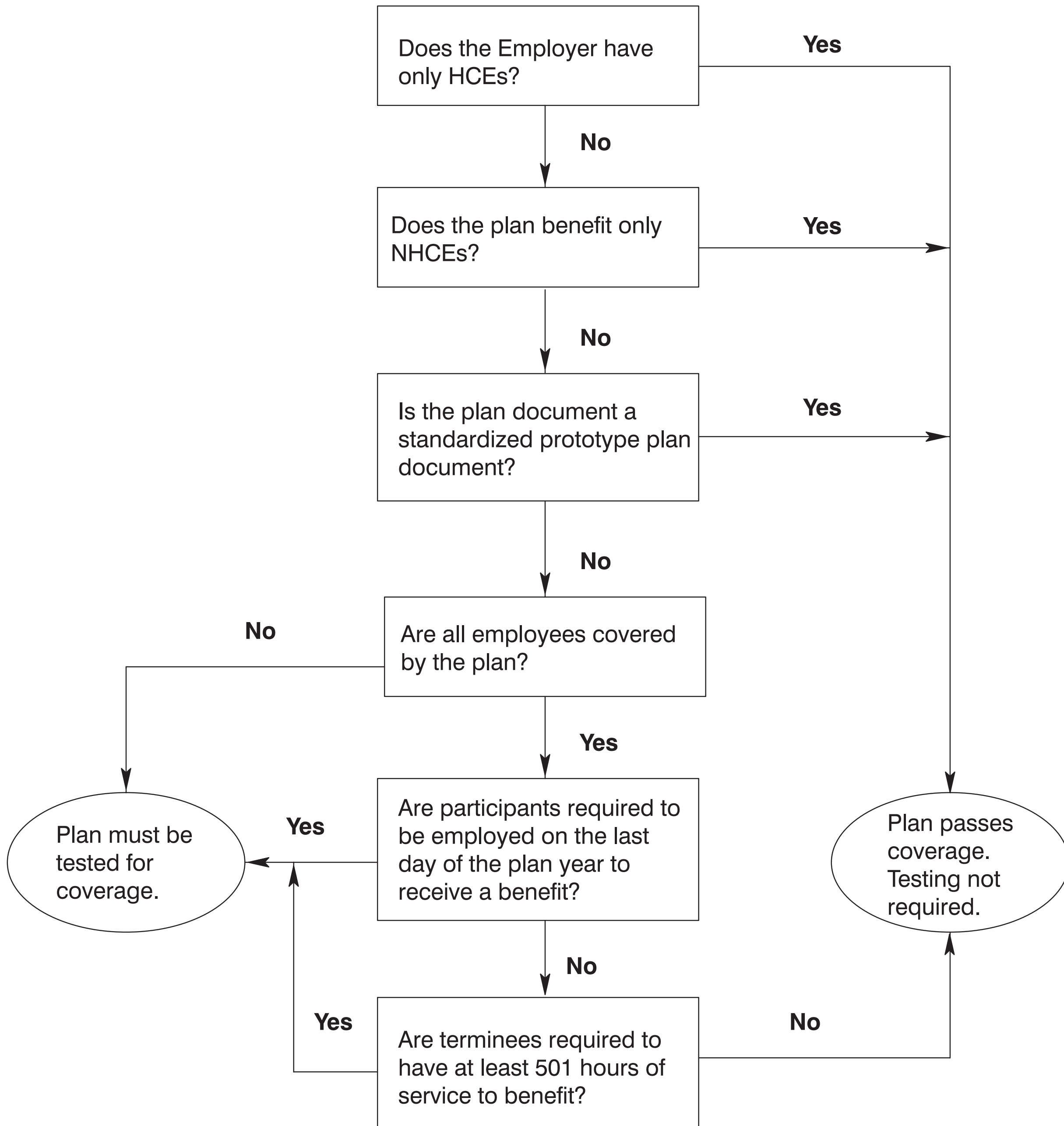
The following plans must be tested for coverage (unless they automatically pass).

a. *Defined Contribution Plans.* All defined contribution plans, such as profit-sharing, money purchase pension, target benefit, 401(k) plans, SIMPLE 401(k)s, and ESOPs, must apply the minimum coverage rules.

b. *Defined Benefit Plans.* All defined benefit plans (including cash balance plans) must apply the minimum coverage rules.

Exhibit 2-1

Flow Chart to Determine if a Plan Must Be Tested for Coverage[a]



Note:

[a] In making this determination, the controlled group and affiliated service group rules apply, and leased employees must be considered.

* * *

Which Employees Must Be Considered?

With the exception of the qualified separate lines of business (QSLOB) rules, all employees must be considered on an employer-wide basis when applying the minimum coverage requirements for the plan year. If the employer is

part of a group of businesses under common control or an affiliated service group, all the employees of the controlled group must be considered. Certain leased employees must also be taken into account for minimum coverage purposes.

Exception for Qualified Separate Lines of Business (QSLOB) Rules. If an employer maintains qualified separate lines of business (QSLOBs), the ratio percentage test and the average benefit test can be applied separately with respect to the employees of each QSLOB. This means the employer does not have to satisfy these coverage tests on an employer-wide basis. The QSLOB exception does not apply to an affiliated service group.

Leased Employees. Leased employees must generally be considered for plan coverage if they have performed services for the recipient employer under the primary direction or control of the recipient, and they have performed those services for the recipient on a substantially full-time basis for at least one year.

Shared Employees. Shared employees must generally be considered for plan coverage. However, they may be excluded as a class from plan participation if their exclusion does not preclude the plan from satisfying the nondiscretionary classification test.

Frequency of Testing

How Often to Test. A plan is required to satisfy the minimum coverage requirements for a plan year using one of the following testing methods:

a. Daily.

b. Quarterly.

c. Annually.

Method Allowed for 401(k) and 401(m) Plans. The annual testing method must be used in applying the minimum coverage rules to a 401(k) plan or a 401(m) plan, and in applying the average benefit percentage test for these plans.

When to Apply Plan Provisions. The plan provisions and other relevant facts (as of the last day of the plan year) that identify those employees benefiting under the plan are applied to the employees taken into account under the testing method used for the plan year (i.e., daily, quarterly, or annually).

Daily Testing Method. Under this method, the minimum coverage requirements must be satisfied for each day of the plan year, taking into account only those employees (or former employees) who were employed and not excludable on the testing date.

Quarterly Testing Method. Under this method, the minimum coverage requirements must be satisfied on at least one day in each quarter of the plan year. Only those employees (or former employees) who were employed and not excludable on the testing dates are taken into account. However, this option is only available if the days selected are reasonably representative of the coverage of the plan for the entire plan year.

Example 2-1: Using the quarterly testing method.

The CyberCity, Inc., Plan is a profit-sharing plan that does not have 401(k) or 401(m) features. Employees must be employed on the last day of the plan year to receive an allocation of employer contributions. The CyberCity, Inc., Plan is being tested for minimum coverage for the calendar plan year using the quarterly testing method. January 1 was chosen as the testing date for the first quarter. In testing the plan on January 1, an employee, Michael, is taken into account because he was an employee on that testing day and was not an excludable employee of the plan on that day. For the testing year, Michael was a participant on January 1, was still employed as of the end of the plan year, December 31, and received an allocation under the plan. Under these facts, Michael is treated as benefiting under the plan on January 1. This is true even though he had not satisfied all of the conditions for receiving an allocation on that day, because he satisfied all of those conditions as of the last day of the plan year. The plan must choose one representative day for each of the remaining quarters for testing purposes.

Annual Testing Method. Under this method, the minimum coverage requirements must be satisfied as of the last day of the plan year. All individuals who were employees on any day during the plan year are taken into account for purposes of identifying the testing group, even if the employee terminated employment during the plan year. For an employee to be excludable under the annual testing method, he or she must have been excludable for the entire plan year. This option must be used in coverage testing of plans subject to IRC Sec. 401(k) or IRC Sec. 401(m) and also in applying the average benefit percentage test.

Snapshot Variation of Annual Testing Method. This method was originally designed for use by large companies that found it administratively difficult to track employees over an entire plan year. Under this method, a single testing date is chosen. Any date is allowed as long as it is reasonably representative of the work force and plan coverage for the plan year.

Short Plan Year. The regulations do not address how to handle a short plan year. Presumably for the annual method, a plan would simply have fewer than 12 months in the year, and in the quarterly method, the short plan year would be divided into four equal parts with a testing date in each quarter.

Using a Simplified Method

The IRS issued Rev. Proc. 93-42 to grant significant relief for the frequency of testing and the data used to satisfy the minimum coverage requirements of IRC Sec. 410(b) and the nondiscrimination requirements of IRC Sec. 401(a)(4). The procedure refers to the Section 410(b) and Section 401(a)(4) requirements collectively as *nondiscrimination*. Employers are relieved from using precise data; they may choose a representative day, or snapshot day, to perform testing. Also, testing need only be performed once every three years. The three-year testing cycle applies if the plan sponsor "reasonably concludes that there are no significant changes" that would adversely impact the discrimination and coverage testing.

The simplified procedures cannot be used for ACP or ADP testing. These are nondiscrimination tests that must be done for elective deferral and matching contributions of 401(k) and 401(m) plans. Section 401(k)/401(m) arrangements must use the annual testing method.

Quality of Data. In using the simplified method, employers who do not have precise data available at reasonable cost may substantiate compliance with the coverage and nondiscrimination requirements using a reliable substitute. This data must be the best available for the plan year at reasonable expense, and the employer must reasonably conclude that using this data demonstrates a high likelihood that the plan would satisfy the nondiscrimination requirements if precise data were used. The procedure refers to data that may be used as *substantiation quality data* and gives examples illustrating the data to be considered as substantiation quality data.

Compensation. The compensation used under the simplified method must reasonably approximate the employee's compensation for the plan year. The compensation used is that within the meaning of IRC Sec. 415(c)(3), which includes deferrals from the following plans: 401(k) plans, SARSEPs, SIMPLE plans, tax-sheltered annuity plans, cafeteria plans, transportation fringe benefit plans, and deferred compensation plans of tax-exempt organizations and state and local governments. If the test is made before the end of the plan year, compensation must be projected using a reasonable method selected by the employer.

Three-year Testing Cycle. Employers will not be required to test a plan more than once every three years provided no significant changes occur subsequent to the test (e.g., changes in plan provisions, the employer's work force, or compensation practices). Whether a change is significant depends on the relative margin by which the plan has satisfied the nondiscrimination requirements in the most recent testing year and the likelihood that the change would eliminate that margin. A significant change could include a change in the plan's provisions or compensation practices.

Using Snapshot Testing

Employers may substantiate compliance with the coverage and nondiscrimination requirements using snapshot testing on a single day during the plan year. The day must be reasonably representative of the employer's workforce and the plan's coverage throughout the year, and generally must be consistent from year to year.

The employees to be tested are solely those who are employees on the snapshot day. The procedure includes guidance for when certain types of plan provisions or conditions may distort the results of snapshot testing and may require adjustments to the test results. For example, the snapshot population may not reflect the level of turnover if the snapshot day is the last day of the plan year in a plan with a minimum service requirement. In this situation, an adjustment to the test results would be needed to more accurately reflect actual differences between the relative turnover rates of eligible HCEs and NHCEs during the plan year. Safe harbor rates are established in such a case when applying the ratio percentage test; 73.5% is substituted for the 70% test for defined benefit plans and 77% is substituted for defined contribution plans.

Risks Associated with Simplified Testing

It is important to remember that relief provided by Rev. Proc. 93-42 is limited to nondiscrimination and coverage testing. There are many other areas where a qualified retirement plan must use precise data without the benefit of any shortcuts. Precise data must be collected in a defined benefit plan for the actuary to perform actuarial valuations. For defined contribution plans, precise data must be collected to properly perform the periodic valuations the plan requires and to allocate contributions and forfeitures. A coverage determination must be made to ensure that the valuation includes all the required participants. The three-year cycle permitted by the revenue procedure is of no value in satisfying allocation and valuation requirements.

Analysis of the revenue procedure will reveal many other areas where precise data is needed. For example, the relief provided will not apply when the plan sponsor cannot reasonably be assured the nondiscrimination tests and coverage requirements will be satisfied if precise data is used. In many circumstances, actual testing with precise data may be required to determine whether the relief afforded by the procedure will apply. It is not always possible to be assured that precise data will not produce different results; therefore, it is possible that anyone taking advantage of the relief may be at risk in the event the plan is audited.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. The IRC lists three sets of minimum participation and coverage for qualified plans. Which of the following applies only to defined benefit plans?

    a. Minimum coverage rules.

    b. Minimum participation rules.

    c. Minimum age and service requirements.

20. The initial design of which of the following methods was implemented to be used by large companies that found it challenging to track employees over an entire plan year?

    a. Snapshot.

    b. Daily testing.

    c. Quarterly testing.

    d. Annual testing.

21. Rev. Proc. 93-42 grants significant relief for the frequency of testing and the date used to satisfy the minimum coverage requirements of IRC Sec. 410(b) and the nondiscrimination requirements of IRC Sec. 401(a)(4). Which of the following is **not** part of those procedures?

    a. Three-year testing cycle.

    b. Snapshot day.

    c. Compensation.

    d. Quarterly testing.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. The IRC lists three sets of minimum participation and coverage for qualified plans. Which of the following applies only to defined benefit plans? **(Page 53)**

    a. Minimum coverage rules. [This answer is incorrect. According to IRC Sec. 410(b), the minimum coverage rules measure the plan's coverage of rank-and-file workers (NHCEs) and of highly compensated employees (HCEs). Their purpose is to prevent employers from establishing plans that primarily benefit only HCEs and are not limited to defined benefit plans.]

    b. Minimum participation rules. [This answer is correct. The minimum participation rules apply only to defined benefit plans per the Internal Revenue Code. They measure how many employees are covered under the plan in comparison to the entire workforce of the employer.]

    c. Minimum age and service requirements. [This answer is incorrect. The minimum age and service requirements deal with the employees' ability to participate in the plan by placing limits on the greatest age and service conditions that the plan can require before allowing employees to join the plan and are not limited to defined benefit plans.]

20. The initial design of which of the following methods was implemented to be used by large companies that found it challenging to track employees over an entire plan year? **(Page 58)**

    a. Snapshot. [This answer is correct. The snapshot variation of annual testing method was originally designed for use by large companies that found it administratively difficult to track employees over an entire plan year. Under this method, a single testing date is chosen. Any date is allowed as long as it is reasonably representative of the work force and plan coverage for the plan year.]

    b. Daily testing. [This answer is incorrect. Under the daily testing method, the minimum coverage requirements must be satisfied for each day of the plan year, taking into account only those employees (or former employees) who were employed and not excludable on the testing date according to Reg. 1.410(b)-8(a)(2). This method would not be a better choice for large companies.]

    c. Quarterly testing. [This answer is incorrect. The minimum coverage requirements must be satisfied on at least one day in each quarter of the plan year under the quarterly testing method. Only those employees (or former employees) who were employed and not excludable on the testing dates are taken into account per Reg. 1.410(b)-8(a)(3). This method would be a little less time consuming for large companies, but was not specifically designed for them.]

    d. Annual testing. [This answer is incorrect. Under the annual testing method the minimum coverage requirements must be satisfied as of the last day of the plan year. All individuals who were employees on any day during the plan year are taken into account for purposes of identifying the testing group, even if the employee terminated employment during the plan year per to Reg. 1.410(b)-8(a)(4). This method would be less work for larger companies, but was not specifically designed for them.]

21. Rev. Proc. 93-42 grants significant relief for the frequency of testing and the date used to satisfy the minimum coverage requirements of IRC Sec. 410(b) and the nondiscrimination requirements of IRC Sec. 401(a)(4). Which of the following is **not** part of those procedures? **(Page 58)**

    a. Three-year testing cycle. [This answer is incorrect. Under the three-year testing cycle, employers will not be required to test a plan more than once every three years provided no significant changes occur subsequent to the test (e.g., changes in plan provisions, the employer's work force, or compensation practices). Whether a change is significant depends on the relative margin by which the plan has satisfied the nondiscrimination requirements in the most recent testing year and the likelihood that the change would eliminate that margin.]

b. Snapshot day. [This answer is incorrect. By using a snapshot day, employers are relieved from using precise data to perform testing. Employers may substantiate compliance with the coverage and nondiscrimination requirements using snapshot testing on a single day during the plan year. The day must be reasonably representative of the employer's workforce and the plan's coverage throughout the year, and generally must be consistent from year to year per Rev. Proc. 93-42.]

c. Compensation. [This answer is incorrect. The compensation used under the simplified method must reasonably approximate the employee's compensation for the plan year. The compensation used is that within the meaning of IRC Sec. 415(c)(3), which includes deferrals from the following plans: 401(k) plans, SARSEPs, SIMPLE plans, tax-sheltered annuity plans, cafeteria plans, transportation fringe benefit plans, and deferred compensation plans of tax-exempt organizations and state and local governments.]

d. Quarterly testing. [This answer is correct. Under this method, the minimum coverage requirements must be satisfied on at least one day in each quarter of the plan year. Only those employees (or former employees) who were employed and not excludable on the testing dates are taken into account. However, this option is only available if the days selected are reasonably representative of the coverage of the plan for the entire plan year as stated in Reg. 1.410(b)-8(a)(3). This method is not considered a simplified method as issued by Rev. Proc. 93-42.]

STEP 2 IDENTIFY ALL SEPARATE PLANS MAINTAINED BY THE EMPLOYER

Identify the plans to be tested for minimum coverage. Trusteed qualified plans and nontrusteed qualified annuity plans are included in the plans to be tested.

General Rule

In general, each single plan is a separate plan for minimum coverage purposes. Separate asset pools are separate plans if the assets within the pool are available only to certain employees.

Example 2-2: One plan for a controlled group of corporations.

Amalgamated, Inc., and Mammoth, Inc., are wholly owned subsidiaries of Metropolis, Inc. Each corporation has adopted a separate pension plan for its employees. The assets for all three plans are maintained in one trust, from which any of the assets can be used to provide benefits for any employee of any of the corporations.

How many separate plans are maintained by the controlled group for minimum coverage purposes? Only one plan exists for this controlled group of corporations, even though each member has adopted a separate plan document. This is because the plan assets are maintained in one trust from which any of the assets can be used to provide any participant's benefits.

Example 2-3: Separate asset pools are separate plans.

Roy, Inc., maintains a defined benefit plan. Benefits are provided to managerial employees out of certain plan assets, and the remaining assets are available only in certain limited cases to provide managerial benefits (but are available in all cases for the benefit of other employees).

How many separate plans are maintained by Roy, Inc., for minimum coverage purposes? There are two separate plans, because there are two separate asset pools, one of which is available only to managerial employees.

Certain defined benefit plans that have contribution features of a defined contribution plan (when employer contributions are based partly on the balance of the separate account of a participant) are treated as two separate plans in applying the minimum coverage rules. Thus, the defined contribution portion is treated as a separate plan and the defined benefit portion is also treated as a separate plan.

A single plan is still considered to be a single plan for minimum coverage purposes even if the plan has more than one plan document and more than one trust with each having a separate determination letter. In addition, a defined contribution plan is not considered to comprise separate plans just because it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Assets of a plan that are separately invested in individual insurance or annuity contracts for employees are also not considered to be separate plans.

Exceptions to the General Rule

A number of rules can make identifying a separate plan quite complex. Certain plans that would be considered a single plan under the general rule are required to be disaggregated (referred to as mandatory disaggregation) and treated as separate plans for testing purposes. On the other hand, some rules allow an employer to combine, or aggregate, otherwise separate plans (referred to as permissive aggregation) or require aggregation of otherwise separate plans (referred to as mandatory aggregation). In addition to the aggregation and disaggregation rules, single plans may have been restructured into separate plans for the nondiscrimination tests under IRC Sec. 401(a)(4).

Dealing With Mandatory Disaggregation

401(k) and 401(m) Plans. IRC Sec. 401(k) plans and 401(m) plans are tested under special rules requiring these plans to be disaggregated (i.e., tested as separate plans) when applying the ratio percentage test and the

nondiscriminatory classification portion of the average benefit test. The portion of the plan attributed to the 401(k) portion or the 401(m) portion cannot be combined with other portions of the plan for testing purposes. The following paragraphs discuss these rules for 401(k) and 401(m) plans and qualified nonelective contributions (QNECs).

A 401(k) plan is a qualified profit-sharing or stock bonus plan with a special provision under which an eligible employee may elect to have the employer make pre-tax contributions (or designated Roth contributions) to the plan on the employee's behalf or pay an equivalent amount to the employee in currently taxable cash. A 401(k) plan or any portion of a plan that includes a 401(k) feature may not be aggregated with any other plan for minimum coverage testing except another 401(k) plan or a portion of another plan that is considered a 401(k) feature of that plan.

A 401(k) plan may also require matching employer contributions and/or permit employees to make after-tax contributions to the plan. [Roth 401(k) contributions are not "after-tax contributions" for purposes of this rule but are mandatorily disaggregated with other elective deferrals.] Plans other than 401(k) plans may also provide for employee after-tax contributions and employer matching contributions. See section for further discussion of employer and matching contributions. A plan that permits such employer matching and/or employee after-tax contributions is often referred to as a 401(m) plan. A 401(m) plan or the portion of a plan that includes a 401(m) feature may not be aggregated with any other plan for minimum coverage testing except another 401(m) plan or a portion of another plan that is considered a 401(m) feature of that plan. However, mandatory aggregation is required for the average benefit percentage test.

Example 2-4: Mandatory disaggregation of 401(k) and 401(m) plans.

ABC, Inc., maintains a plan that consists of (1) elective contributions under a 401(k) feature; (2) matching employer contributions and after-tax, employee voluntary contributions under a 401(m) feature; and (3) employer discretionary profit-sharing contributions other than elective, employee, or matching contributions (i.e., employer nonelective contributions).

How many plans does ABC maintain for purposes of the minimum coverage requirements? For minimum coverage purposes, ABC, Inc., maintains the following three separate component plans that must each satisfy the coverage testing requirements:

Plan #1 The 401(k) feature providing for elective deferrals including Roth 401(k) contributions.

Plan #2 The 401(m) feature providing for both matching employer contributions and after-tax, employee voluntary contributions (not including designated Roth accounts), notwithstanding whether the matching contributions are mandatory or discretionary.

Plan #3 The employer discretionary profit-sharing contribution feature providing employer contributions that are not elective on the part of the employees. These employer contributions have no relationship to the pre-tax employee contributions under the 401(k) feature, the after-tax employee voluntary contributions under the 401(m) feature, and the matching contribution that the employer makes under the 401(m) feature, nor are they contributed by the employer as a qualified nonelective contribution (QNEC) not treated as an elective or matching contribution.

Qualified Nonelective Contributions (QNECs). QNECs treated as elective or matching contributions to pass the actual deferral percentage (ADP) or actual contribution percentage (ACP) tests are not treated as part of the 401(k) or 401(m) plan. For IRC Sec. 410(b) testing purposes, such contributions are treated as part of the separate plan consisting of employer nonelective contributions. In Example 2-4, QNECs treated as elective or matching contributions for purposes of passing the ADP or ACP tests would be treated as part of Plan #3 for purposes of the minimum coverage test.

Dealing with Mandatory Disaggregation of Other Plans

In addition to the mandatory disaggregation of 401(k) and 401(m) plans, several other types of plans must be tested separately under the minimum coverage rules.

ESOPs and Non-ESOPs. The portion of a plan that is an ESOP and the portion of a plan that is not an ESOP must generally be tested separately for minimum coverage purposes, except as otherwise permitted under Reg. 54.4975-11(e). However, mandatory aggregation is required for the nondiscriminatory classification portion of the average benefit percentage test.

Plans Benefiting Collectively Bargained Employees. The portion of a plan that benefits collectively bargained employees is generally treated separately from the portion of a plan that benefits noncollectively bargained employees and employees covered under different collective bargaining agreements.

Plans Maintained by More Than One Employer. If a plan benefits employees of more than one unrelated employer (e.g., a multiple-employer plan), the plan is treated as consisting of a separate plan for each employer.

Plans Benefiting Employees of Qualified Separate Lines of Business (QSLOBs). If the employer elects to be treated as operating QSLOBs, the portion of a plan that benefits employees of one QSLOB is generally treated as a separate plan from the portion that benefits employees of the other QSLOBs of the employer. This rule does not apply to a plan tested under the special rule for employer-wide plans in Reg. 1.414(r)-1(c)(2)(ii). Also, if a plan benefiting employees of more than one QSLOB satisfies the reasonable classification requirement without disaggregation, then each plan treated as a separate plan under the QSLOB rules is deemed to satisfy the reasonable classification requirement.

Voluntary Disaggregation of Plans Benefiting Otherwise Excludable Employees

A plan may establish minimum age and service conditions as a prerequisite to participation. However, these conditions may not require an employee to complete more than one year of service (unless the employee is fully vested immediately, in which case up to two years of service may be required for plans other than 401(k) plans which are limited to a one year eligibility period) or attain an age greater than 21 years. In the case of a plan with age and service conditions that are less than these statutory minimums, the employer may elect to treat the plan as two plans for testing purposes. One plan would then consist of those employees who have met the statutory minimums, and the other plan consists of those employees who meet the minimum age and service requirements for the plan, but do not meet the statutory minimums.

Example 2-5: Disaggregation of plans benefiting otherwise excludable employees.

B & B Corporation maintains a profit-sharing plan for its employees. The plan permits an employee to participate after six months of employment. B & B may elect to treat the plan as two separate plans for testing purposes. The first plan will consist of all plan participants who have reached age 21 and have completed one year of service; this plan will be tested with respect to all B & B employees who meet these statutory minimums and are not otherwise excludable for minimum coverage purposes The second plan will consist of all plan participants who do not meet these statutory minimums (i.e., those who have completed six months of employment but who do not have one year of service or are under age 21). This plan will be tested with respect to all B & B employees who completed six months of employment and who are not otherwise excludable for minimum coverage purposes, but who have not yet met the statutory minimum requirements of age 21 and one year of service.

Dealing with Permissive Aggregation

For purposes of the ratio percentage test and the nondiscriminatory classification portion of the average benefit test, two or more separate plans of an employer may be aggregated and treated as a single plan. Plans that are aggregated for the minimum coverage tests are also required to be aggregated for the nondiscrimination tests of IRC Sec. 401(a)(4).

Example 2-6: Aggregating plans to pass coverage tests.

An employer maintains a defined benefit plan benefiting only highly compensated employees (HCEs). A separate profit-sharing plan is maintained for the benefit of only nonhighly compensated employees (NHCEs). If tested separately, the plan for the HCEs would not pass the ratio percentage test nor the nondiscrimination tests. However, when the plans are combined, they may be able to meet both tests.

Subject to the limitations discussed in the following paragraph, an employer may elect to aggregate the following:

a. Two or more trusts.

b. One or more trusts and one or more annuity plans.

c. Two or more annuity plans.

Plans That Cannot Be Aggregated. The following plans may not be aggregated:

a. Plans subject to the mandatory disaggregation rules.

b. An ESOP with another ESOP, except as permitted under Reg. 54.4975-11(e).

c. A single plan formed by combining two or more plans. For example, an employer that maintains plans A, B, and C may not aggregate plans A and B and plans A and C to form two single plans. However, the employer may apply the permissive aggregation rules to form any one (and only one) of the following combinations: plan ABC, plans AB and C, plans AC and B, or plans A and BC.

d. Plans with different plan years.

Dealing with Mandatory Aggregation

For purposes of the average benefit percentage portion of the average benefit test, all plans maintained by the employer must be aggregated, except in the following instances:

a. With respect to noncollectively bargained plans, the whole or a portion of a plan covering members of a collective-bargaining unit.

b. The whole or a portion of a plan benefiting employees whom an employer has elected to be treated as being employed by a QSLOB that is not a participating employer of the plan.

c. The portion of a multiple employer plan maintained by each unrelated separate employer [i.e., not related under IRC Sec. 414(b), (c), or (m)].

d. The whole or a portion of a plan benefiting employees who have not satisfied the greatest statutory minimum age and service conditions (if the employer so elects).

Dealing with Restructuring

A single plan may be divided, or restructured into one or more separate, or component, plans for purposes of nondiscrimination testing under IRC Sec. 401(a)(4). When this is done, each separate plan that results from restructuring is required to meet the minimum coverage requirements of IRC Sec. 410(b).

The restructuring rules apply solely to testing for coverage and nondiscrimination. That is, they apply only for the nondiscrimination rules of IRC Sec. 401(a)(4), the permitted disparity rules of IRC Sec. 401(l), and those portions of the coverage rules of IRC Sec. 410(b) and any other provisions that specifically apply to determining whether the nondiscrimination requirements of IRC Sec. 401(a)(4) are satisfied. A component plan is not treated as a separate plan in testing minimum coverage (i.e., the plan as a whole must satisfy coverage).

STEP 3 DETERMINE IF THE EMPLOYER IS PART OF A CONTROLLED GROUP

Defining Businesses under Common Control

Employees of two or more trades or businesses under common control for any period are treated as employed by a single employer. "Two or more trades or businesses under common control" means any of the following:

a. Members of a controlled group of corporations under IRC Sec. 1563. These are two or more organizations connected through common ownership described in IRC Sec. 1563(a)(1), (2), or (3), regardless of whether a corporation is a *component member* of a controlled group within the meaning of IRC Sec. 1563(b). Controlled groups include parent-subsidiary, brother-sister, and combined controlled groups.

b. Commonly controlled trades or businesses. Under this rule, the principle of common ownership of controlled groups found in IRC Sec. 1563 is applicable to partnerships, proprietorships, and other businesses under common control. Reg. 1.414(c)-1 through -4 explains this rule.

c. Members of an affiliated service group (ASG).

d. Members of an ASG performing management functions.

The related employer provisions utilize the attribution rules of IRC Sec. 1563 for purposes of applying the related employer ownership test.

Defining *Controlling Interest* in Commonly Controlled Businesses. For the purposes of the commonly controlled rules, defining *controlling interest* depends on the type of organization as follows:

a. Corporation—ownership of stock that possesses at least 80% of the total voting power or value of all classes of stock.

b. Trust or estate—ownership of at least 80% of an actuarial interest.

c. Partnership—ownership of at least 80% of profits or capital interest.

d. Sole proprietorship—ownership of the proprietorship.

Common Control of Tax-exempt Organizations. Common control exists if at least 80% of the directors or trustees of one exempt organization are either representatives of, or directly or indirectly controlled by, another organization. A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. A trustee or director is controlled by another organization if the other organization has the power to terminate that trustee or director and select a new trustee or director.

Exempt organizations may treat themselves as under common control if each of the organizations regularly coordinates their day-to-day exempt activities. For example, two tax-exempt entities providing the same type of services may treat themselves as under common control if a single plan covers employees of both entities and they each regularly coordinate their day-to-day activities. This aggregation would apply for purposes of most employee benefits as well as 403(b) arrangements.

For plan years beginning after 2008, a 403(b) plan that covers employees of more than one tax-exempt organization must apply the universal availability rules separately for each common law entity (i.e., each tax-exempt organization).

A Parent-subsidiary Group. A parent-subsidiary group is basically two or more organizations where at least an 80% interest in each of the organizations (other than the common parent) is owned by one or more organizations in the group. The common parent must own at least an 80% interest in at least one member of the group. For

purposes of determining the parent's ownership percentage, an interest owned by other members of the group is ignored. For example, if 60% of a corporation is owned by another member of the group and the remaining 40% is owned by the common parent, the common parent is deemed to own 100%.

Example 2-7: A parent-subsidiary group.

L Corporation owns 80% of the only class of stock of T Corporation, and T, in turn, owns 50% of the capital interest in the GHI Partnership. L also owns 80% of the only class of stock of N Corporation and N, in turn, owns 30% of the capital interest in the GHI Partnership. The ownership is summarized in the following chart:

	L	T	N	GHI
L Corp.	0	80	80	0
T Corp.	0	0	0	50
N Corp.	0	0	0	30

Is there a common parent of a parent-subsidiary group? L is the common parent of a parent-subsidiary group consisting of L Corporation, T Corporation, N Corporation, and the GHI Partnership because L owns at least 80% of T, N, and GHI. In determining L's ownership of GHI, L is deemed to own 80%, as the partnership interest and stock owned by T and N is ignored for this purpose.

A Brother-sister Group. A brother-sister group exists if two ownership tests are met: (a) for each organization in the group, more than a 50% interest must be owned by five or fewer individuals, estates, or trusts, counting only identical ownership of each shareholder in each organization (the more-than-50% test), and (b) at least an 80% interest must be owned by five or fewer persons, (e.g., individuals, estates, or trusts). In performing the 80% test, the five or fewer persons whose ownership is considered must be the same persons whose ownership is considered for the more-than-50% test. However, in the 80% test, identical ownership is not required.

Example 2-8: A brother-sister group.

The stock of Corporations P, S, and T is owned as follows:

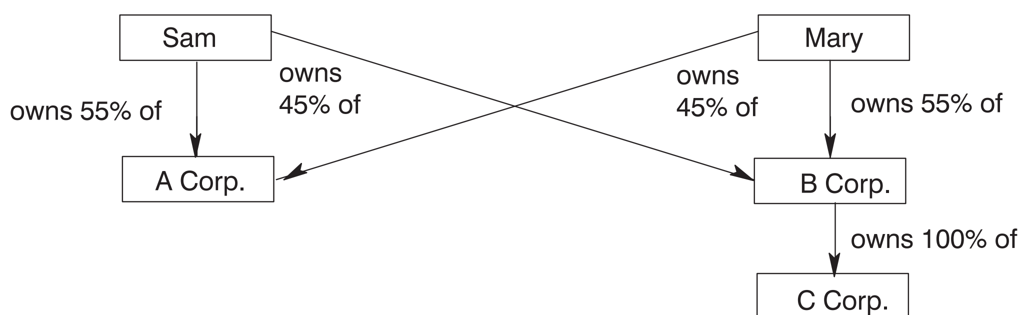
	Corporations			
Individuals	**P**	**S**	**T**	**Identical Ownership**
A	30%	40%	20%	20%
B	40%	20%	30%	20%
C	30%	40%	50%	30%
Total	100%	100%	100%	70%

Which corporations are included in a brother-sister group? Corporations P, S, and T are members of a brother-sister controlled group because (1) at least 80% of the stock of each is owned by a group of five or fewer persons who own stock in each corporation (satisfying the 80% test); and (2) identical ownership is 70% (satisfying the more-than-50% test).

A Combined Group. A combined group is three or more organizations where each organization is a member of either a parent-subsidiary group or a brother-sister group, and at least one organization is the common parent organization of a parent-subsidiary group and a member of a brother-sister group.

Example 2-9: Combined group.

The ownership structure of Corporations A, B, and C is shown in the following diagram.



Which corporations constitute a combined group? A, B, and C are members of a combined group because A and B are members of a brother-sister group, B and C are members of a parent-subsidiary group, and B is both the parent of the parent-subsidiary group and a member of the brother-sister group.

An Affiliated Service Group. The Affiliated Service Group (ASG) rules require aggregation of multiple employers if the employers are closely connected because they perform significant services for each other or together for third parties. An ASG is a group consisting of a first service organization (FSO) and one or more of the following:

a. A-ORG—Any service organization that is a shareholder or partner with the FSO and regularly performs services for the FSO or is regularly associated with the FSO in performing services for third persons.

b. B-ORG—Any other organization if a significant portion of its business is (1) performing services for the FSO or A-ORG that are services historically performed by employees and (2) 10% or more of the interest in such organization is held by persons who are HCEs of the FSO or A-ORG.

Example 2-10: Members of an ASG.

The Physicians Group, Inc. (PGI) is a service organization consisting of a group of doctors who perform services for the doctors' patients. The doctors, who are HCEs, own 100% of PGI. The same doctors also own 60% of The Laboratory, Inc., which is a service organization performing laboratory services solely for PGI, and those services are a significant portion of the business of The Laboratory, Inc.

Do the organizations meet the definition of an ASG? Yes, the organizations qualify as an ASG because (1) more than 10% of The Laboratory, Inc. is owned by HCEs of PGI and (2) The Laboratory, Inc. performs services solely for PGI.

Management Service Organization. Members of an ASG performing management functions constitute a group consisting of—

a. an organization (first organization) with its principal business of performing management functions for other organizations related to the first organization on a regular, continuing basis; and

b. the related organizations for which such functions are so performed by the first organization.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. William Jones has a company that has a 401(k) and a 401(m) plan that each requires matching employer contribution and permits employee after-tax contribution for these plans. This is an example of which of the following?

    a. Mandatory aggregation.

    b. Mandatory disaggregation.

    c. Permissive aggregation.

23. In regards to the average benefit percentage section of the average benefit test; which of the following plans supported by the employer must be aggregated?

    a. Any plan not excluded by regulations that are maintained by the employer.

    b. A whole or portion of a plan including members of a collective-bargaining unit in regards to noncollectively bargained plans.

    c. The whole or section of a plan that benefits employees whom an employer has chosen to be treated as employed by a qualified separate line of business (QSLOB) that is not a participating plan employer.

    d. The whole of the section of a plan serving employees who have not fulfilled the greatest statutory minimum age and service provisions.

24. Which of the following statements regarding a brother-sister group is most accurate?

    a. More than 80% interest must be owned by eight or less individuals counting only identical ownership of each shareholder in each organization.

    b. Identical ownership is required in the 80% test.

    c. No less than 80% must be owned by five or less individuals.

25. Which of the following groups consists of a first service organization (FSO) plus another organization?

    a. Parent-subsidiary.

    b. Combined.

    c. Affiliated service.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. William Jones has a company that has a 401(k) and a 401(m) plan that each requires matching employer contribution and permits employee after-tax contribution for these plans. This is an example of which of the following? **(Page 64)**

    a. Mandatory aggregation. [This answer is incorrect. According to IRC Sec. 401(a)(4), certain rules allow an employer to require aggregation of otherwise separate plans. A 401(m) plan or the portion of a plan that includes a 401(m) feature may not be aggregated with any other plan for minimum coverage testing except another 401(m) plan or a portion of another plan that is considered a 401(m) feature of that plan.]

    b. Mandatory disaggregation. [This answer is correct. 401(k) and 401(m) Plans. IRC Sec. 401(k) plans and 401(m) plans are tested under special rules requiring these plans to be disaggregated (i.e., tested as separate plans) when applying the ratio percentage test and the nondiscriminatory classification portion of the average benefit test. The portion of the plan attributed to the 401(k) portion or the 401(m) portion cannot be combined with other portions of the plan for testing purposes.]

    c. Permissive aggregation. [This answer is incorrect. According to IRC Sec. 401(a)(4), some rules allow an employer to combine, or aggregate, otherwise separate plans which is referred to as permissive aggregation. A 401(m) plan or the portion of a plan that includes a 401(m) feature may not be aggregated with any other plan for minimum coverage testing except another 401(m) plan or a portion of another plan that is considered a 401(m) feature of that plan.]

23. In regards to the average benefit percentage section of the average benefit test; which of the following plans supported by the employer must be aggregated? **(Page 67)**

    a. Any plan not excluded by regulations that are maintained by the employer. [This answer is correct. For purposes of the average benefit percentage portion of the average benefit test, all plans maintained by the employer must be aggregated except for those excluded by Reg. 1.410(b)-7(e).]

    b. A whole or portion of a plan including members of a collective-bargaining unit in regards to noncollectively bargained plans. [This answer is incorrect. According to Reg. 1.410(b)-7(e), the whole or a portion of a plan covering members of a collective-bargaining unit with respect to noncollectively bargained plans do not have to be aggregated.]

    c. The whole or section of a plan that benefits employees whom an employer has chosen to be treated as employed by a qualified separate line of business (QSLOB) that is not a participating plan employer. [This answer is incorrect. The whole or a portion of a plan benefiting employees whom an employer has elected to be treated as being employed by a QSLOB that is not a participating employer of the plan does not have to be aggregated per Reg. 1.410(b)-7(e).]

    d. The whole of the section of a plan serving employees who have not fulfilled the greatest statutory minimum age and service provisions. [This answer is incorrect. According to Reg. 1.410(b)-7(e), the whole or a portion of a plan benefiting employees who have not satisfied the greatest statutory minimum age and service conditions does not have to be aggregated.]

24. Which of the following statements regarding a brother-sister group is most accurate? **(Page 69)**

    a. More than 80% interest must be owned by eight or less individuals counting only identical ownership of each shareholder in each organization. [This answer is incorrect. A brother-sister group exists if two ownership tests are met one of which is for each organization in the group, more than a 50% interest must be owned by five or fewer individuals, estates, or trusts, counting only identical ownership of each shareholder in each organization (the more-than-50% test) per Reg.1.414(c)-2(c).]

b. Identical ownership is required in the 80% test. [This answer is incorrect. According to the Regulations, in the 80% test, identical ownership is not required.]

c. No less than 80% must be owned by five or less individuals. [This answer is correct. A brother-sister group exists if two ownership tests are met. The second of which is at least an 80% interest must be owned by five or fewer persons, (e.g., individuals, estates, or trusts). In performing the 80% test, the five or fewer persons whose ownership is considered must be the same persons whose ownership is considered for the more-than-50% test per Reg.1.414(c)-2(c).]

25. Which of the following groups consists of a first service organization (FSO) plus another organization? **(Page 70)**

a. Parent-subsidiary. [This answer is incorrect. A parent-subsidiary group is basically two or more organizations where at least an 80% interest in each of the organizations (other than the common parent) is owned by one or more organizations in the group. This group is based on ownership, not services.]

b. Combined. [This answer is incorrect. A combined group is three or more organizations where each organization is a member of either a parent-subsidiary group or a brother-sister group, and at least one organization is the common parent organization of a parent-subsidiary group and a member of a brother-sister group. This group is based on membership, not services.]

c. Affiliated service. [This answer is correct. The Affiliated Service Group (ASG) rules require aggregation of multiple employers if the employers are closely connected because they perform significant services for each other or together for third parties. An ASG is a group consisting of a first service organization (FSO) and one or more of the following: A-ORG—Any service organization that is a shareholder or partner with the FSO and regularly performs services for the FSO or is regularly associated with the FSO in performing services for third persons; or B-ORG—Any other organization if a significant portion of its business is (1) performing services for the FSO or A-ORG that are services historically performed by employees and (2) 10% or more of the interest in such organization is held by persons who are HCEs of the FSO or A-ORG.]

STEP 4 IDENTIFY NONEXCLUDABLE, ACTIVE EMPLOYEES WITH RESPECT TO EACH PLAN

All current, or active, employees must be included for purposes of minimum coverage testing, unless they are excludable employees. In general, excludable employees are determined separately with respect to each plan identified in Step 2.

Excludable Employees

Employees Not Meeting the Plan's Minimum Age and Service Conditions. Employees that have not satisfied the age and service conditions of a plan are excluded. If a plan, including plans treated as a single plan under the aggregation rules, has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy all of the different sets of age and service conditions are excludable employees. However, an employee who satisfies any one of the different sets is generally not an excludable employee.

> **Example 2-11: Employees who meet a plan's minimum age and service requirements are nonexcludable.**
>
> Exco maintains Plan A for hourly employees and Plan B for salaried employees. Plan A has no minimum age or service condition. Plan B has no minimum age condition and requires one year of service. Under the permissive aggregation rules, Exco treats Plans A and B as a single plan for purposes of the minimum coverage tests.
>
> Are any of Exco's employees excludable for purposes of the minimum coverage rules? Because Plan A imposes no minimum age or service conditions, all of Exco's employees automatically satisfy the minimum age and service conditions of Plan A. Therefore, no employees are excludable for minimum coverage purposes.

Employees of a 501(c)(3) Organization. Certain employees of tax-exempt entities are excludable for coverage purposes when identifying excludable employees under a 401(k) or 401(m) plan. Employees of an organization exempt from tax under IRC Sec. 501(c)(3) who are eligible to make salary deferral contributions to a 403(b) plan may be excludable employees for purposes of testing a 401(k) or 401(m) plan that is provided under the same general arrangement. The regulations provide for that result if no employee of the tax-exempt organization is eligible to participate in the 401(k) or 401(m) plan, and at least 95% of the employees who are neither (a) employees of the tax-exempt organization nor (b) employees of a governmental entity prohibited from sponsoring a 401(k) plan, are eligible to participate in the 401(k) or 401(m) plan.

Nonresident Aliens. Nonresident aliens who receive no earned income from U.S. sources are excludable employees. Also, nonresident aliens receiving income from U.S. sources are excludable if the income is exempt from U.S. income tax under a tax treaty. See IRS Pub. 519, "U.S. Tax Guide for Aliens," for information on how to determine if someone is a non-resident alien or a resident alien.

Collectively Bargained Employees. These individuals are excludable when testing a plan or a portion thereof that does not benefit members of the unit. However, if more than 2% of the employees covered by the plan are professionals, none of the employees covered by the plan are excludable as collective bargained employees.

Noncollectively Bargained Employees. These individuals are excludable when testing a plan or a portion thereof that does not benefit noncollectively bargained employees.

Employees of Other QSLOBs. Employees of the employer's other QSLOBs are excludable employees. However, this rule does not apply when satisfying the nondiscriminatory classification portion of the average benefit test when that test must be applied on an employer-wide basis.

Certain Terminating Employees. An employee who terminates employment before the last day of the plan year with fewer than 501 hours of service [or the lesser of 91 consecutive calendar days or three consecutive calendar

months if the elapsed time method is used for determining years of service] is excludable if all of the following apply:

a. The employee does not benefit under the plan for the plan year.

b. The employee is eligible to participate in the plan.

c. The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (*last-day requirement*) to accrue a benefit or receive an allocation for the plan year.

d. The employee fails to accrue a benefit or receive an allocation only because of the failure to satisfy the minimum period of service or last-day requirement.

Accounting for Leased Employees

Nonexcludable Leased Employees. Active employees include leased employees who have performed services for the recipient employer (the employer receiving the service of the leased employee) and are under the primary direction or control of the recipient. To meet the definition of a leased employee, the individual must have performed services for the recipient on a substantially full-time basis for at least one year. A person is considered to have performed services on a substantially full-time basis if they have worked the lesser of 1,500 hours of service or 75% of the average number of hours customarily performed by an employee of the recipient in the particular position.

Common-law Leased Employees. The determination of whether an individual is a leased employee is made after determining whether the individual is a common-law employee of the recipient employer. A leased employee who in fact is the employer's common-law employee must be treated as any other employee of the recipient employer, notwithstanding the leasing arrangement under which the individual works. However, the fact that an individual meets the requirement of a leased employee by being under the primary direction or control of the recipient employer does not necessarily mean that the individual is a common-law employee. An individual would not be under the primary direction and control of the recipient if, for example, the leasing organization retained the responsibility to direct and supervise the individual's job performance.

Example 2-12: Leased employee.

Missy is a temporary secretary who works for Temps Unlimited, Inc. Missy has been placed with a doctor's office for over a year. Missy, who works at least 1500 hours, does not meet the definition of a common-law employee of the doctor's office. The doctor's office instructs her on where and how she is to work. Missy is closely supervised by the office manager of the doctor's office.

Is Missy a leased employee of the doctor's office? Yes, because the doctor's office (recipient employer) tells Missy where and how she is to work, and supervises her work (even though she is not a common-law employee).

Excludable Leased Employees. A plan may be able to exclude leased employees, provided the coverage and nondiscrimination tests are still passed. IRC Sec. 414(n) requires that a leased employee be treated as an employee—not that a leased employee be a participant in the recipient employer's plan. Leased employees may even be excluded from participation in the plan as a class, as long as the plan otherwise satisfies the minimum participation requirements of IRC Sec. 410(b)(1), with the leased employees also taken into account. The recipient employer's plan document must specifically state the treatment of leased employees under the plan.

Example 2-13: Exclusion of leased employee.

Carrie is an ER nurse for Healthcare Unlimited, Inc. and has been leased on a full-time basis to Running Bear Health Services Inc. (RBHS) for the last 20 months. Neither Healthcare Unlimited nor RBHS cover Carrie under their 401(k) plan. Because she has been providing services under the primary direction or control of RBHS and within the terms of a lease agreement for at least one year, RBHS must treat Carrie as an employee for purposes of the Section 410(b) minimum coverage test.

However, RBHS employs enough NHCEs to exclude Carrie (and other leased employees) from actual participation in the plan and still pass the coverage test.

Safe Harbor Exception. Leased employees are not considered for plan coverage if such employees do not constitute more than 20% of the recipient's NHCEs and if those employees are covered by a nonintegrated, money purchase pension plan maintained by the leasing organization. The money purchase plan must provide for full and immediate vesting, must have a contribution of at least 10% of compensation, and each employee of the leasing organization (other than employees who perform substantially all their services for the leasing organization) must be allowed immediate participation in the plan. However, there is an exception to the immediate participation rule for individuals whose compensation from the leasing organization is less than $1,000 annually for the four-year period ending with the plan year under consideration. The organization that leases the employee to the recipient can be any organization and, therefore, not necessarily an organization that conducts a business leasing employees.

Leased Employees Defined by Tax Code and ERISA. An employee who satisfies the minimum age and service requirements and who is otherwise entitled to participate in the plan must be permitted to join the plan. The *otherwise entitled* language has generated numerous lawsuits. A district court looking at IRC Sec. 414(n)(1)(A) and Reg. 1.410(b)-9 found that leased employees could not be excluded by category. This finding was reversed by the Tenth Circuit Court who said ERISA does not prohibit an employer from providing benefits for some employees but not others. In a similar case, the court found that it is well established under ERISA that employers may exclude specific categories of employees as long as the distinction is not based on age or length of service.

Neither IRC Sec. 414(n)(2)(A) nor IRS Notice 84-11 limits the term *leasing organization* to a business engaged in the leasing of employees. Therefore, any direct or indirect arrangement (whether written or oral) between a recipient employer and another organization in which employees of the organization are provided to the recipient may result in those employees being considered leased employees of the recipient. A common arrangement that would fall into this situation is the renting of office space that includes secretarial services. The only IRS guidance in this area is IRS Notice 84-11, and that notice does not reflect amendments made to IRC Sec. 414(n) effective after 1984. Proposed regulations issued under IRC Sec. 414(n) have been withdrawn, leaving this area without any regulatory guidance. A determination application as to the plan's qualification under IRC Sec. 401(a) will only cover the leased employee issues where the application specifically asks for these issues to be considered.

Independent Contractors as Employees. Correctly identifying employees (who should be covered by a plan) and independent contractors (who should not be covered by a plan) is a very important issue, as illustrated by several court cases. Only employees can participate in an employer's qualified plan. Misclassifying employees as independent contractors (who are not covered under the plan) may cause a small plan to fail to pass coverage under IRC Sec. 410.

Example 2-14: Incorrectly classified independent contractors cause plan to be disqualified.

Donald Kenney, the sole shareholder, director, and officer of a corporation, hired a secretary and a property manager as independent contractors. The corporate plan covered only Donald Kenney and was thought to pass coverage by benefiting 100% of the employees.

The IRS found the workers were misclassified. The secretary and property manager were actually employees of the corporation. This meant that the plan had covered only one of three employees of the corporation (or 33%) and therefore failed to meet the coverage requirement under IRC Sec. 410.

The plan was retroactively disqualified, and the shareholder's entire vested accrued benefit of $696,000 was included in his income for the year of disqualification.

Accounting for Shared Employees

Shared Employees. *Shared employees* are employees who perform services as an employee for more than one employer at shared business premises or common locations. While there is no formal guidance available on how shared employees are considered for plan coverage, two pre-ERISA rulings dealing with now obsolete Internal Revenue Code sections provide logic as to how shared employees are handled. According to these rulings, shared

employees are full time employees of all employers. Thus, each employer credits the employee with the employee's full hours of service. Each employer also credits each employee with the employer's pro rata share of the employee's compensation.

Example 2-15: Shared employees.

Susie is a shared employee of Doctors East and West. She works 1,900 hours a year and earns a total of $30,000. Thus, Susie is deemed to have been paid her salary equally from Doctors East and West since each credits her with her full hours of service. Doctor East has a 10% profit-sharing plan, while Doctor West has a 15% profit-sharing plan. Susie meets the eligibility and participation requirements for both plans. Doctor East will contribute $1,500 to his plan and Doctor West will contribute $2,250 to his plan for Susie.

Waiver of Participation

An employee who waives participation in a plan is nonetheless not an excludible employee for coverage purposes. No special rule in the regulations permit a plan to treat a waiving employee differently from any other employee.

STEP 5 IDENTIFYING HIGHLY COMPENSATED EMPLOYEES

The purpose of minimum coverage testing is to make sure that qualified plans do not discriminate in favor of highly compensated employees (HCEs). An employee is highly compensated based on employment status and compensation.

Highly Compensated Employees

An HCE is an employee who meets either of the following tests:

a. *5% Owner Test.* An employee who is a more-than-5% owner, or family member of that owner, at any time during the current or preceding (look-back) year, or

b. *Compensation Test.* An employee who for the look-back year—

   (1) had compensation greater than $80,000, indexed for cost of living ($110,000 for 2009 and 2010), and

   (2) if the employer so elects, was in the top-paid group of employees for the preceding year (without regard to the current-year status of the employee).

Look-back Year. The *look-back year* is the 12-month period before the current plan year. However, under the calendar year election, the look-back year may be measured on a calendar year basis for a plan year that is not maintained on a calendar year basis.

Impact of Attribution

An individual is considered to own any interest directly or indirectly owned by any family member. Thus, an employee who is a family member of an individual with a more-than-5% interest in the employer at any time during the look-back year or the determination year is treated as an HCE, regardless of the employee's compensation level. A family member is an individual treated as owning an interest directly or indirectly by:

a. A spouse (other than one legally separated). (See Example 2-16.)

b. A child (including any legally adopted child), grandchild, or parent.

Example 2-16: HCE based on spousal attribution rules.

Hank and Trudy are husband and wife. During 2009, Hank owned 3% of Corporation ABC, and Trudy owned 4% of Corporation ABC. Each spouse is a 7% owner of ABC. Hank directly owns 3% and indirectly owns 4%

of ABC. His wife directly owns 4% and indirectly owns 3% of ABC. Both are considered more-than-5% owners and are HCEs of ABC for 2009 and 2010, if still employed in 2010.

Example 2-17: HCE based on grandchild attribution rules.

Billy owns 100% of Corporation F, which employs Billy and his grandson, Ted. Ted does not indirectly own his grandfather's interest in Corporation F because attribution does not extend to grandchildren from grandparents. Therefore, he will not be considered an HCE. However, if Ted were the sole owner of Corporation F, his grandfather, Billy, would be considered to own Ted's interest in F because of attribution and both would be considered HCEs of Corporation F.

Note: Because Ted is not an HCE based on the 5% owner test, he is not precluded from being an HCE as a result of the compensation test.

Attribution between the following entities must also be considered:

a. *Between a Trust and Trust Beneficiaries.* A beneficiary will be considered to own his or her proportionate share or interest of the trust. However, attribution does not apply from a qualified plan trust to the plan participants and beneficiaries. (See Examples 2-18 and 2-19.)

b. *Between a Partner and Partnership.* A partner will be considered to own his or her proportionate share or interest owned directly or indirectly by the partnership. (See Example 2-20.)

c. *Between S Corporation Shareholders and the S Corporation.* These rules are similar to those that apply between a partnership and its partners. There is no minimum ownership threshold of 5% in this situation as there is for a C corporation.

d. *Between a Corporation and Its More-than-5% Shareholders.* A 5%-or-more shareholder of a corporation will be considered to own proportionately the interest owned directly or indirectly by the corporation. However, a corporation will only be considered to own the interest owned directly or indirectly by a shareholder when that shareholder is a 50%-or-more shareholder of the corporation. If the shareholder owns less than 50%, the attribution will not extend from the shareholder to the corporation. (See Example 2-21.)

e. *Between an Estate and Its Beneficiary.* The attribution rules here are identical to those found between a partnership and its partners.

Example 2-18: Trust attribution rules.

Ben is a 25% beneficiary of Trust A. The Trust owns 100% of the stock of Corporation C. Ben is an employee of Corporation C. By attribution, he is considered to own 25% of Corporation C's stock and would be considered an HCE.

Example 2-19: Attribution from stock held by qualified plan.

Jim is a participant in Corporation C's 401(k) plan. His account represents over 70% of the plan's trust. The plan holds as an investment 15% of the stock in Corporation C. Jim would not be considered to own any stock in Corporation C because of his participation in the 401(k) plan.

Example 2-20: Partnership attribution rules.

Although Mike does not own any stock of his employer, Corporation ABC, he does own 50% of the interest in the XYZ Partnership, which owns 20% of Corporation ABC. By attribution, Mike would be considered to own 10% of the corporate stock and would be considered an HCE.

Example 2-21: Corporate attribution rules.

Dave owns 50% of Corporation C. Corporation C owns 100% of Corporation F. Dave is an employee of Corporation F, but does not own any stock. Dave, by attribution, owns 50% of Corporation F. Therefore, he would be considered an HCE of Corporation F by attribution.

Reattribution. The rules of IRC Sec. 318 prohibit reattribution. Therefore, if a person constructively owns an interest in a corporation or partnership, that interest is not reattributed to another person. Reattribution does not apply from one family member to another or from a corporation, partnership, trust, or estate to which ownership has been attributed from an owner of that entity.

Example 2-22: Reattribution.

Kyle owns 60% and Bill owns 40% of Corporation S. Kyle owns 10% of Corporation M. Bill and Kyle both work for Corporation M. By attribution from Kyle, Corporation S owns 10% of Corporation M, because Kyle is a 50%-or-more shareholder of Corporation S. However, there is no reattribution from Corporation S to Bill. Corporation S is not an owner of Corporation M for purposes of reattributing Corporation S's indirect ownership to Bill, notwithstanding the normal attribution from a corporation to its 5%-or-more shareholders. Therefore, Bill will not be considered an HCE of Corporation M.

Top-paid Group Election

The effect of this election is that an employee who is not a more-than-5% owner (at any time during the determination year or the look-back year) with compensation for the look-back year greater than $80,000 (indexed for cost of living) ($110,000 for 2009 and 2010) is included in the top-paid group for the look-back year. The top-paid group for the look-back year will be those employees who are part of the top 20% of employees ranked by compensation for the preceding plan year. Employers electing to use the top-paid group definition are not required to file any such election with the IRS. Once the employer makes the top-paid group election, it applies to all subsequent years unless changed by the employer. This election must be consistently applied to all plans of the employer that begin with or within the same calendar year. The employer must amend the plan to make the election or change the election in subsequent years.

How to Determine the Top-paid Group

An employer may elect to exclude from its definition of HCEs 5%-or-less owners who earn more than $110,000 (for 2010) if such employees are not in the top-paid group. Generally, the top-paid group of employees for a particular year consists of the highest compensated 20% of the employer's employees. This identification is a two-step process: (a) determining the number of employees that represent 20% of the employer's employees, and (b) identifying the particular employees who are among the number of employees who receive the most compensation during this year. In determining the number of employees in step (a), certain employees may be excluded.

Excludable Employees. Certain employees are not taken into account when determining the *number* of employees in the top-paid group (even though they may still be a *member* of the top-paid group). For example, an employee that works for only five months of the year, but earns $120,000, will still be a top-paid employee, even though the employee is not counted in the *number* of employees in the top-paid group. Employees satisfying the following exclusions are not taken into account in determining the *number* of employees in the top-paid group:

a. *Age and Service Exclusion.* Unless the employer elects otherwise, employees who have not completed six months of service or attained age 21 by the end of the look-back year are excluded in calculating the number of employees in the top-paid group. For purposes of this exclusion, service means the employee's service in the current year, as well as the immediately preceding year. The employer may substitute a lesser, or no, service or age requirement. (See Example 2-23.)

b. *Part-time Exclusion.* Employees who normally work fewer than 17½ hours per week during the year are excluded for such determination year. An employee who works fewer than 17½ hours a week for 50% or more of the total weeks worked by such employee during the year is deemed to meet this exclusion. (See Example 2-24.)

c. *Six-month Rule.* Employees who normally work fewer than six months during any year are excluded for such year. Whether an employee normally works more than six months in any year is determined by the facts and circumstances related to the particular employer's typical experience in the years prior to the determination year. An employee who works on one day during a month is deemed to have worked during that month.

d. *Nonresident Aliens.* Employees who are nonresident aliens with no earned income from U.S. sources are excluded.

e. *Collective-bargaining Employees.* There is an exclusion available if 90% or more of the employees of an employer are covered under collective-bargaining agreements and the plan being tested covers only employees who are *not* covered under such agreements. The employees who are covered under such collective-bargaining agreements are not counted in determining the number of noncollective-bargaining employees who will be included in the top-paid group for purposes of testing such plan. The employer may elect not to apply this exclusion. However, if more than 2% of the employees in a unit covered by a collective-bargaining agreement are professionals, no employees in the unit are excludable.

Example 2-23: Exclusion based on service.

More Money Corp. maintains a calendar year profit-sharing plan. Mr. Shorttimer, an employee, is hired on August 1, 2009, and terminates employment on May 1, 2010.

Is Mr. Shorttimer excluded from the calculation of the *number* of employees in the top-paid group for either 2009 or 2010? Mr. Shorttimer may be excluded in 2009 because he completed only five months of service by December 31, 2009. However, Mr. Shorttimer cannot be excluded in 2010 because he completed nine months of service under this rule by the end of 2010.

Example 2-24: Excluding part-time employees.

K & M Manufacturing has 200 active employees during the determination year, 100 of whom normally work fewer than 17$^1/_2$ hours per week during such year and 80 of whom normally work fewer than 15 hours per week during such year. K & M Manufacturing elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group.

How many employees are in the top-paid group? Eighty employees are excluded in determining the number of employees in the top-paid group since such employees work less than 15 hours per week. Thus, K & M's top-paid group for the determination year consists of 20% of 120 (200 − 80), or 24 employees.

Example 2-25: Identifying the employees in the top-paid group.

Using Example 2-24, all 200 of K & M's employees must be ranked in order by compensation received during the year. The 24 employees who were paid the greatest amount of compensation during the year are the top-paid employees for that year.

Rounding Calculations. When ranking employees by compensation in determining the top-paid group, it may be necessary to break a tie between two or more employees. Any tie-breaking or rounding rules may be applied as long as they are reasonable, nondiscriminatory, and uniformly and consistently applied.

Calendar Year Data Election

To simplify this HCE determination, employers with fiscal year plans can make a calendar year data election. If this is done, the calendar year beginning with or within the look-back year is treated as the employer's look-back year for purposes of determining an employee's HCE status.

Once the calendar year data election is made, it applies for all subsequent determination years unless changed by the employer and must be consistently applied to all plans whose look-back year begins with or within the same calendar year.

Employers using a calendar year data election are not required to file any such election with the IRS, but must amend the plan to recognize the election or to change the election in subsequent years.

Definition of Compensation

When identifying HCEs and NHCEs, *compensation* has the same definition used for the annual addition limitation applicable to defined contribution plans under IRC Sec. 415(c)(3). In addition, elective or salary reduction contribu-

tions to 401(k) plans, SARSEPs, cafeteria plans, transportation fringe benefit plans, 403(b) plans, and 457(b) plans are included in compensation to identify HCEs and NHCEs. Thus, the definition of compensation used when identifying HCEs and NHCEs automatically includes such salary deferrals and reductions. The same treatment applies in determining the compensation of self-employed individuals [i.e., earned income within the meaning of IRC Sec. 401(c)(2) with, however, the add-back for elective contributions].

Compensation is not annualized for purposes of determining if an employee is an HCE. Only compensation received by an employee during the determination year or during the look-back year will be considered in the decision of whether an employee is a highly compensated employee.

STEP 6 IDENTIFY AND GROUP EMPLOYEES BENEFITING UNDER THE PLAN

This step requires that the following items be identified:

a. The total number of nonexcludable, active employees who are highly compensated employees (HCEs).

b. The total number of nonexcludable, nonhighly compensated employees (NHCEs).

c. The number of employees in each category who benefit under each employer plan.

Identifying the Employees Benefiting under the Plan

An employee benefits under the plan only if the employee accrues a benefit for the plan year. Whether an employee is considered to have accrued a benefit depends on the type of plan the employee is participating in.

a. *Defined Contribution Plan [Other Than a 401(k) or 401(m) Plan].* An employee accrues benefits for a plan year when contributions or forfeitures are allocated for the plan year. See section for further discussion of allocations and forfeitures under defined contribution plans.

b. *Defined Benefit Plan.* An employee accrues benefits for a plan year if the employee receives a benefit accrual for the plan year.

c. *401(k) Plan.* An employee benefits for a plan year if the employee is *eligible* to make an elective contribution, regardless of whether or not the salary deferral or contribution is actually made. An eligible employee making a one-time irrevocable waiver of participation in a 401(k) plan is not an eligible employee under the plan.

d. *401(m) Plan.* An employee benefits if the employee is eligible to receive a matching employer contribution or is *eligible* to make a voluntary, nondeductible contribution under the 401(m) portion of the plan.

Example 2-26: Benefiting under a defined benefit plan.

Coval, Inc., has 35 employees who are eligible under a defined benefit plan. The plan requires 1,000 hours of service to accrue a benefit. Only 30 employees satisfy the 1,000-hour requirement and accrue a benefit. The five employees who do not satisfy the 1,000-hour requirement during the plan year are taken into account for purposes of minimum coverage testing, but are treated as not benefiting under the plan.

Generally, if no benefit is accrued or annual addition made only because of the Section 415 limitations, an employee is still treated as benefiting from the plan. Likewise, an employee also benefits if the employee fails to receive an increase in accrued benefit or an allocation solely because the plan has a limit as to maximum years of service and/or retirement benefits that are taken into account in calculating benefit limits under the plan.

Example 2-27: Employee benefits when maximum years of service limited.

Metroplex Manufacturing maintains a defined benefit plan. The formula under the plan takes into account only the first 30 years of service for accrual purposes. Don, an employee, has completed 35 years of service.

Is Don treated as benefiting under the plan? Yes, even though Don has more than 30 years of service, he is still treated as benefiting under the plan.

No benefit is accrued if the benefit accrual is offset by the contributions or benefits of another plan, but the employee is still treated as benefiting under the plan.

An employee is considered to still benefit after attaining normal retirement age even though the employee fails to accrue a benefit under a defined benefit plan because of the provisions of IRC Sec. 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

STEP 7 PERFORMING THE RATIO PERCENTAGE TEST

Of the coverage tests available to meet the IRC Sec. 410(b) minimum coverage requirements, the ratio percentage test is generally the least complicated.

Satisfying the Ratio Percentage Test

A plan satisfies the ratio percentage test if the percentage of active, nonhighly compensated employees (NHCEs) benefiting under the plan is at least 70% of the percentage of active, highly compensated employees (HCEs) benefiting under the plan. The percentage should be rounded to the nearest one-hundredth of one percent. This test incorporates both the percentage test of IRC Sec. 410(b)(1)(A) and the ratio test of IRC Sec. 410(b)(1)(B).

Example 2-28: Satisfying the ratio percentage test.

For the current plan year, Plan A has 70 nonexcludable NHCEs who benefit under the plan. The plan has a total of 100 nonexcludable NHCEs. Thus, the plan benefits 70% (70 ÷ 100) of the employer's NHCEs. There are five total nonexcludable HCEs, and all of them benefit under the plan. Thus, the plan benefits 100% (5 ÷ 5) of the employer's HCEs. The plan's ratio percentage test for the year is 70% (70% ÷ 100%) and, thus, the plan satisfies the ratio percentage test.

Failing the Ratio Percentage Test

If the plan fails the ratio percentage test, it may be permissively aggregated with one or more other plans of the employer to see if the aggregated plans in total pass the test. However, the aggregated plans must also be tested for nondiscrimination under IRC Sec. 401(a)(4) on a combined basis. A plan that fails the ratio percentage test, even if it is permissively aggregated with another plan, must meet the coverage requirements under the average benefit test.

Example 2-29: Failing the ratio percentage test.

For the current plan year, Plan B benefits 40% of the employer's NHCEs and 60% of the employer's HCEs. Plan B fails to satisfy the ratio percentage test because the plan's ratio percentage is 66.67% (40% ÷ 60%), which is below the test threshold of 70%. Assuming the employer has no other plans (i.e., aggregation is not possible), Plan B will have to meet the average benefit test to satisfy the coverage requirements.

Fail-safe Provision. If a plan fails the ratio percentage test, the plan document may have a *fail-safe* mechanism that automatically expands coverage to an extent necessary for the plan to pass the ratio test. If not, the plan may pass the average benefits test.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. An employee who terminates employment before the last day of the plan year with fewer than 501 hours of service [or the lesser of 91 consecutive calendar days or three consecutive calendar months if the elapsed time method is used for determining years of service] is excludable if all four of the requirements apply. Which of the following is **not** one of those requirements?

    a. Darren, an employee of Taylor's Inc., has no benefit under Taylor's plan for the entire year.

    b. Phillip, an employee of Binder's Inc. is eligible to participate in Binder's plan.

    c. Charlie does not accrue a benefit due to his failure to fulfill the minimum last-day requirement.

    d. Jewels Inc. does not have a minimum service period requirement for employee, Jack, to accrue a benefit for the plan year.

27. Which of the following statements regarding accounting for leased employees is most accurate?

    a. The Code excludes leased employees from being active employees.

    b. An individual is not considered a leased employee unless they have performed services on a largely full-time basis for at least six months.

    c. Services performed by a leased employee must at least 1,000 hours.

    d. Before making the determination that an individual is a leased employee, the employer must determine if the employee is a common-law employee of the recipient employer.

28. A plan may be able to exclude leased employees based on which of the following?

    a. Nondiscrimination tests are passed.

    b. Leased employee is an active employee.

    c. Leased employee is under the control of the recipient.

29. What is a shared employee?

    a. An employee who performs services as an employee for multiple employers at similar locations.

    b. An employee who fulfills any one of the various sets of age and service conditions.

    c. An employee who has performed services for employer on a substantially full-time basis for a minimum of one year.

    d. Leased employee who has worked 1,875 hours.

30. A family member is treated as owning interest directly or indirectly by all of the following **except**:

    a. Spouse.

    b. Parent.

    c. Grandchild.

    d. Sibling.

31. Which of the following has attribution rules that are identical to the rules between an estate and its beneficiary?

    a. Partner and partnership.

    b. Trust and trust beneficiaries.

    c. S corporation shareholders and the S corporation.

    d. Corporation and its more-than-5% shareholders.

32. Which of the following is an example of attribution from stock held by a qualified plan?

    a. Daniel owns 50% of Corporation A. Corporation A owns 100% of Corporation B. Daniel is an employee of Corporation B, but does not own any stock. Daniel, by attribution, owns 50% of Corporation B.

    b. Although Milton does not own any stock of his employer, Corporation XYZ, he does own 50% of the interest in the ABC Partnership, which owns 20% of Corporation XYZ.

    c. Joel is a participant in Corporation Z's 401(k) plan. His account represents over 70% of the plan's trust. The plan holds as an investment 15% of the stock in Corporation Z.

    d. Buford is a 25% beneficiary of Trust X. The Trust owns 100% of the stock of Corporation Y. Buford is an employee of Corporation Y. By attribution, he is considered to own 25% of Corporation Y's stock and would be considered an HCE.

33. When determining the number of employees in the top-paid group, specific employees are disregarded. If an employee satisfies certain exclusions, they are not taken into account when determining the number of employees in the top-paid group. Which of the following example is included in the number of employees in the top-paid group?

    a. Veronica is a secretary at Johnson's Consulting, Inc. She has been working at Johnson's Consulting for three months.

    b. Viola works 15 hours a week at Ashleigh's Boutique. Viola has been employed at Ashleigh's Boutique for five years.

    c. Vernon is an employee of Fite's Construction. Vernon, age 19, is a graduate of Leon's Construction Trade School. Vernon will be 20 by the end of the look-back year.

    d. Vincent is employed at Dexter's Dentals. Vincent is not included in Dexter's collective bargaining agreement.

34. Which of the following statements regarding how to identify and group employees under the plan is most accurate?

    a. If an employee does not accrue benefit under the plan because of adjustments for delayed retirement, he or she is not treated as benefiting from the plan.

    b. An employee is treated as benefiting under a plan even if the benefit is offset by another plan.

    c. An employee does not benefit if he or she fails to receive an increase in accrued benefit due to the plans limitations as to maximum service years that are referred to when calculating benefit limits under the plan.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. An employee who terminates employment before the last day of the plan year with fewer than 501 hours of service [or the lesser of 91 consecutive calendar days or three consecutive calendar months if the elapsed time method is used for determining years of service] is excludable if all four of the requirements apply. Which of the following is **not** one of those requirements? **(Page 74)**

    a. Darren, an employee of Taylor's Inc., has no benefit under Taylor's plan for the entire year. [This answer is incorrect. According to Reg. 1.410(b)-6(f), if Darren does not benefit under Taylor's plan for the entire year, he is considered excludable.]

    b. Phillip, an employee of Binder's Inc. is eligible to participate in Binder's plan. [This answer is incorrect. According to Reg. 1.410(b)-6(f), if Phillip can be considered excludable if he is eligible to participate in Binder's plan.]

    c. Charlie does not accrue a benefit due to his failure to fulfill the minimum last-day requirement. [This answer is incorrect. If Charlie fails to accrue a benefit or receive an allocation only because of the failure to satisfy the minimum period of service or last-day requirement, he is considered excludable.]

    d. Jewels Inc. does not have a minimum service period requirement for employee, Jack, to accrue a benefit for the plan year. [This answer is correct. If Jewels has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) to accrue a benefit or receive an allocation for the plan year, then that employee is excluded. Jewels Inc. does not have this requirement.]

27. Which of the following statements regarding accounting for leased employees is most accurate? **(Page 75)**

    a. The Code excludes leased employees from being active employees. [This answer is incorrect. According to IRC Sec. 414(n)(1)–(3), active employees include leased employees who have performed services for the recipient employer (the employer receiving the service of the leased employee) and are under the primary direction or control of the recipient.]

    b. An individual is not considered a leased employee unless they have performed services on a largely full-time basis for at least six months. [This answer is incorrect. To meet the Code's definition of a leased employee, an individual must have performed services for the recipient on a substantially full-time basis for at least one year.]

    c. Services performed by a leased employee must at least 1,000 hours. [This answer is incorrect. According to IRS Notice 84-11, Q&A-7, A person is considered to have performed services on a substantially full-time basis if they have worked the lesser of 1,500 hours of service or 75% of the average number of hours customarily performed by an employee of the recipient in the particular position.]

    d. Before making the determination that an individual is a leased employee, the employer must determine if the employee is a common-law employee of the recipient employer. [This answer is correct. The determination of whether an individual is a leased employee is made after determining whether the individual is a common-law employee of the recipient employer. A leased employee who in fact is the employer's common-law employee must be treated as any other employee of the recipient employer, notwithstanding the leasing arrangement under which the individual works per IRS Notice 84-11, Q&A-3.]

28. A plan may be able to exclude leased employees based on which of the following? **(Page 75)**

    a. Nondiscrimination tests are passed. [This answer is correct. A plan may be able to exclude leased employees, provided the coverage and nondiscrimination tests are still passed. IRC Sec. 414(n) requires that a leased employee be treated as an employee—not that a leased employee be a participant in the recipient employer's plan.]

b. Leased employee is an active employee. [This answer is incorrect. According to IRC Sec. 414(n)(1)–(3), active employees include leased employees who have performed services for the recipient employer (the employer receiving the service of the leased employee) and are under the primary direction or control of the recipient. An active employee could be a nonexcludable leased employee.]

c. Leased employee is under the control of the recipient. [This answer is incorrect. According to IRC Sec. 414(n)(1)–(3), active employees include leased employees who have performed services for the recipient employer (the employer receiving the service of the leased employee) and are under the primary direction or control of the recipient. This is not a requirement for an excludable leased employee.]

d. Leased employee who has worked 1,875 hours. [This answer is incorrect. To meet the definition of a leased employee, the individual must have performed services for the recipient on a substantially full-time basis for at least one year per IRC Sec. 414(n)(1)–(3). A person is considered to have performed services on a substantially full-time basis is they have worked the lesser of 1,500 hours of service or 75% of the average number of hours customarily performed.]

29. What is a shared employee? **(Page 76)**

a. An employee who performs services as an employee for multiple employers at a joint location. [This answer is correct. Shared employees are employees who perform services as an employee for more than one employer at shared business premises or common locations. While there is no formal guidance available on how shared employees are considered for plan coverage, two pre-ERISA rulings dealing with now obsolete Internal Revenue Code sections provide logic as to how shared employees are handled.]

b. An employee who fulfills any one of the various sets of age and service conditions. [This answer is incorrect. Employees that have not satisfied the age and service conditions of a plan are excluded. If a plan, including plans treated as a single plan under the aggregation rules, has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy all of the different sets of age and service conditions are excludable employees. However, an employee who satisfies any one of the different sets is generally not an excludable employee per Reg. 1.410(b)-6(b).]

c. An employee who has performed services for employer on a substantially full-time basis for a minimum of a year. [This answer is incorrect. This does not apply to shared employees. However, it is one of the requirements of a nonexcludable leased employee. Active employees include leased employees who have performed services for the recipient employer (the employer receiving the service of the leased employee) and are under the primary direction or control of the recipient. To meet the definition of a leased employee, the individual must have performed services for the recipient on a substantially full-time basis for at least one year per IRC Sec. 414(n)(1)–(3).]

30. A family member is an individual who is treated as owning interest directly or indirectly by all of the following **except**: **(Page 77)**

a. Spouse. [This answer is incorrect. An individual is considered to own any interest directly or indirectly owned by any family member. According to IRC Sec. 318, a family member is an individual treated as owning an interest directly or indirectly by a spouse as long as the spouse is not legally separated.]

b. Parent. [This answer is incorrect. According to IRC Sec. 318, a family member is an individual treated as owning an interest directly or indirectly by a parent or a child.]

c. Grandchild. [This answer is incorrect. A family member is an individual treated as owning an interest directly or indirectly by a child, grandchild, or legally adopted child per IRC Sec. 318.]

d. Sibling. [This answer is correct. For purposes of IRC Sec. 318 attribution rules, an individual's grandparents and siblings are not considered family members.]

31. Which of the following has attribution rules that are identical to the rules between an estate and its beneficiary? **(Page 78)**

    a. **Partner and partnership. [This answer is correct. A partner will be considered to own his or her proportionate share or interest owned directly or indirectly by the partnership which are identical to the attribution rules between an estate and its beneficiary per the Code.]**

    b. Trust and trust beneficiaries. [This answer is incorrect. According to the Code, the attribution rules for trust and trust beneficiaries are different from those between and estate and its beneficiary. A beneficiary will be considered to own his or her proportionate share or interest of the trust. However, attribution does not apply from a qualified plan trust to the plan participants and beneficiaries.]

    c. S corporation shareholders and the S corporation. [This answer is incorrect. According to the Code, the attribution rules between an S corporation shareholders and the S corporation are also different from those between and estate and its beneficiary. These rules are similar to those that apply between a partnership and its partners. There is no minimum ownership threshold of 5% in this situation as there is for a C corporation.]

    d. Corporation and its more-than-5% shareholders. [This answer is incorrect. As stated in the Code, attribution rules between corporation and its more-than-5% shareholders are also different from those between and estate and its beneficiary. A 5%-or-more shareholder of a corporation will be considered to own proportionately the interest owned directly or indirectly by the corporation. However, a corporation will only be considered to own the interest owned directly or indirectly by a shareholder when that shareholder is a 50%-or-more shareholder of the corporation. If the shareholder owns less than 50%, the attribution will not extend from the shareholder to the corporation.]

32. Which of the following is an example of attribution from stock held by a qualified plan? **(Example 2-19)**

    a. Daniel owns 50% of Corporation A. Corporation A owns 100% of Corporation B. Daniel is an employee of Corporation B, but does not own any stock. Daniel, by attribution, owns 50% of Corporation B. [This answer is incorrect. This is an example of corporate attribution.]

    b. Although Milton does not own any stock of his employer, Corporation XYZ, he does own 50% of the interest in the ABC Partnership, which owns 20% of Corporation XYZ. [This answer is incorrect. This is an example of partnership attribution.]

    c. **Joel is a participant in Corporation Z's 401(k) plan. His account represents over 70% of the plan's trust. The plan holds as an investment 15% of the stock in Corporation Z. [This answer is correct. According to IRC Sec. 318(a)(2), Joel would not be considered to own any stock in Corporation C because of his participation in the 401(k) plan, which is considered attribution from stock held by a qualified plan.]**

    d. Buford is a 25% beneficiary of Trust X. The Trust owns 100% of the stock of Corporation Y. Buford is an employee of Corporation Y. By attribution, he is considered to own 25% of Corporation Y's stock and would be considered an HCE. [This answer is incorrect. This is an example of the trust attribution rules.]

33. When determining the number of employees in the top-paid group, specific employees are disregarded. If an employee satisfies certain exclusions, they are not taken into account when determining the number of employees in the top-paid group. Which of the following example is included in the number of employees in the top-paid group? **(Page 79)**

    a. Veronica is a secretary at Johnson's Consulting, Inc. She has been working at Johnson's Consulting for three months. [This answer is incorrect. Employees who normally work fewer than six months during any year are excluded for such year. Whether an employee normally works more than six months in any year is determined by the facts and circumstances related to the particular employer's typical experience in the years prior to the determination year. An employee who works on one day during a month is deemed to have worked during that month.]

    b. Viola works 15 hours a week at Ashleigh's Boutique. Viola has been employed at Ashleigh's Boutique for five years. [This answer is incorrect. Employees who normally work fewer than 17-1/2 hours per week

during the year are excluded for such determination year. An employee who works fewer than 17-1/2 hours a week for 50% or more of the total weeks worked by such employee during the year is deemed to meet this exclusion.]

c. Vernon is an employee of Fite's Construction. Vernon, age 19, is a graduate of Leon's Construction Trade School. Vernon will be 20 by the end of the look-back year. [This answer is incorrect. Unless the employer elects otherwise, employees who have not attained age 21 by the end of the look-back year are excluded in calculating the number of employees in the top-paid group. The employer may substitute a lesser, or no, age requirement.]

d. Vincent is employed at Dexter's Dentals. Vincent is not included in Dexter's collective bargaining agreement. [This answer is correct. There is an exclusion available if 90% or more of the employees of an employer are covered under collective-bargaining agreements and the plan being tested covers only employees who are *not* covered under such agreements. The employees who are covered under such collective-bargaining agreements are not counted in determining the number of noncollective-bargaining employees who will be included in the top-paid group for purposes of testing such plan. The employer may elect not to apply this exclusion. However, if more than 2% of the employees in a unit covered by a collective-bargaining agreement are professionals, no employees in the unit are excludable.]

34. Which of the following statements regarding how to identify and group employees under the plan is most accurate? **(Page 82)**

a. If an employee does not accrue benefit under the plan because of adjustments for delayed retirement, he or she is not treated as benefiting from the plan. [This answer is incorrect. An employee is considered to still benefit after attaining normal retirement age even though the employee fails to accrue a benefit under a defined benefit plan because of the provisions of IRC Sec. 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.]

b. An employee is treated as benefiting under a plan even if the benefit is offset by another plan. [This answer is correct. No benefit is accrued if the benefit accrual is offset by the contributions or benefits of another plan, but the employee is still treated as benefiting under the plan per Reg. 1.410(b)-3(a)(2).]

c. An employee does not benefit if he or she fails to receive an increase in accrued benefit due to the plans limitations as to maximum service years that are referred to when calculating benefit limits under the plan. [This answer is incorrect. According to Reg. 1.410(b)-3(a)(2), an employee also benefits if the employee fails to receive an increase in accrued benefit or an allocation solely because the plan has a limit as to maximum years of service and/or retirement benefits that are taken into account in calculating benefit limits under the plan.]

STEP 8 PERFORMING THE AVERAGE BENEFIT TEST

A plan failing to satisfy the ratio percentage test may still meet the minimum coverage requirements of IRC Sec. 410(b) if it can satisfy the average benefit test. The average benefit test consists of two parts: (a) the nondiscriminatory classification test, and (b) the average benefit percentage test. Both tests must be met to pass the average benefit test and are discussed in this lesson.

Nondiscriminatory Classification Test

The following are the four steps involved in performing the nondiscriminatory classification test:

Step 1 Establish a reasonable classification of covered employees.

Step 2 Meet the safe harbor rule (i.e., cover sufficient employees to meet the safe harbor percentage).

If Step 1 and Step 2 are met, the nondiscriminatory classification test is satisfied (the plan must then pass the average benefit percentage test to pass the average benefit test). If Step 1 and Step 2 are not met, go to Step 3.

Step 3 Meet the unsafe harbor rule (i.e., cover sufficient nonhighly compensated employees to meet at least the unsafe harbor percentage).

If Step 3 is met, go to Step 4. If Step 3 is not met, the plan fails the average benefit test.

Step 4 Reasonable classification of employees must meet a nondiscriminatory facts and circumstances test.

If Step 4 is met, the plan passes the nondiscriminatory classification test (the plan must then pass the average benefit percentage test to pass the average benefit test). Otherwise, the plan fails the average benefit test.

A plan satisfies the nondiscriminatory classification test for a plan year if—

a. the plan benefits employees who qualify under a classification established by the employer (i.e., *reasonable classification*), and

b. the classification of employees is not discriminatory (i.e., nondiscriminatory classification).

Reasonable Classification. The classification of employees must be reasonable (based on facts and circumstances) and established under objective business criteria that identify the category of employees who benefit under the plan. Examples of reasonable classifications include specified job categories (e.g., managers), nature of compensation (e.g., salaried or hourly), geographic location, and other similar bona fide business criteria. A listing of employees by name (or other specific criteria having the same effect as a listing by name) is not considered a reasonable classification. For example, an individual serving as corporate vice president could not be excluded by name, but the plan could exclude all vice presidents. The IRS has also informally indicated that classifying employees by the last day rule (inclusion of only participants employed at the end of the year) is not a reasonable classification.

Nondiscriminatory Classification. A classification is considered nondiscriminatory for a plan year if the group of employees included in the classification benefiting under the plan satisfies either of the two following rules:

a. *Safe Harbor Rule.* Simply stated, the safe harbor rule looks at the difference between the coverage percentage of HCEs and the coverage percentage of NHCEs. The safe harbor rule becomes complex in the mechanics of its application. A plan satisfies the safe harbor rule if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage. These two terms are defined as follows:

   (1) *Ratio Percentage.* This is the ratio of the percentage of nonexcludable NHCEs benefiting under the plan to the percentage of nonexcludable HCEs benefitting under the plan.

(2) *Safe Harbor Percentage.* This value depends on the value of yet another percentage; namely, the NHCE concentration percentage (concentration percentage). The concentration percentage is the ratio of nonexcludable NHCEs over the employer's total nonexcludable workforce. For example, an employer with a total nonexcludable workforce of 200, of which 120 are NHCEs, has a concentration percentage of 60% (120 ÷ 200).

$$\text{Concentration \%} = \frac{\text{Nonexcludable NHCEs}}{\text{Total nonexcludable employees}}$$

The safe harbor percentage is 50% if the concentration percentage is 0% through 60%. For each whole percentage point by which the concentration percentage exceeds 60%, the safe harbor percentage declines 3/4% with a floor of 20.75%

b. *Facts and Circumstances Rule.* A plan satisfies this rule if—

(1) the plan's ratio percentage [see item a(1)] is greater than or equal to the unsafe harbor percentage (see the following discussion) but less than the safe harbor percentage [see item a(2)], and

(2) the reasonable classification of employees is nondiscriminatory based on all relevant facts and circumstances. Whether the classification is nondiscriminatory is determined based on the facts and circumstances considering: (a) the business reason for the classification, (b) the percentage of the employer's employees benefiting under the plan (the higher the percentage the more likely to be nondiscriminatory), (c) the extent of the difference between the ratio percentage and the safe harbor percentage, (d) the extent to which the plan's average benefit percentage exceeds 70%, and (e) whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce.

The *unsafe harbor percentage* depends on the value of the concentration percentage discussed previously in item a(2). The unsafe harbor percentage is 40% if the concentration percentage is 0% through 60%. For each whole percentage point by which the concentration percentage exceeds 60%, the unsafe harbor percentage declines 3/4% with a 20% floor.

Average Benefit Percentage Test

To satisfy the average benefit percentage test, the benefits provided to NHCEs under all plans of the employer must generally be at least 70% as great, on average, as the benefits provided to the employer's HCEs.

Computing the Benefit Percentage. To apply and satisfy this test the employer is required to determine an employee benefit percentage for each employee taken into account for testing purposes. All nonexcludable employees are taken into account for this purpose, even if they are not benefiting under any plan taken into account. Each active employee's benefit percentage is the employer-provided benefit as a percentage of the employee's compensation. The percentages of all employees in the highly compensated and nonhighly compensated groups are then separately averaged.

Benefit percentages may be determined on the basis of either contributions or benefits as long as it is calculated consistently for all employer-provided benefits. Employee after-tax contributions and benefits attributable to these contributions are not taken into account in calculating benefit percentages. However, 401(k) salary deferrals are considered to be employer contributions and are taken into account in calculating benefit percentages. An employee's benefit percentage may be an allocation rate or a benefit rate. Generally, the percentage for defined *contribution* plans is expressed as an *allocation rate*, and the percentage for defined *benefit* plans is expressed as a *benefit ratio*.

The following rules found in Reg. 1.410(b)-5(d)(5) apply when computing the benefit percentages:

a. *Defined Benefit Plan.* In defined benefit plans, the benefit rate is the increase in the employee's accrued benefit for the measurement period (normally the current plan year, but prior and future years can also be used) divided by the employee's testing service for such period. The benefit rate is generally expressed

as a percentage of average compensation. The methods used to determine the benefit rate are the same as those used under IRC Sec. 401(a)(4) for nondiscrimination testing purposes. A simplified method is available when only defined benefit plans are being tested.

b. *Defined Contribution Plan.* The allocation rate for a defined contribution plan is calculated by dividing the allocations for the plan year by the employee's compensation for the plan year. Allocations consist of forfeitures and employer contributions [including any 401(k) deferrals and matching contributions]. This calculation is the same as the one used under IRC Sec. 401(a)(4) for nondiscrimination testing purposes.

c. *Compensation.* The definition of compensation used in determining allocation rates or benefit ratio is the same as used under IRC Sec. 414(s) for nondiscrimination testing.

d. *Cross-testing.* Generally, all plans to be tested must use either a benefit basis or a contribution basis. A defined contribution plan may use benefit ratios instead of allocation rates. Likewise, a defined benefit plan may use allocation rates instead of benefit ratios. This method is known as cross-testing. Cross-testing might be used when the plan (or one of the plans in the average benefit ratio testing group) also uses cross-testing for nondiscrimination purposes or when both a defined contribution plan *and* a defined benefit plan are included in the average benefit ratio testing group.

e. *Imputing Permitted Disparity.* The benefit percentages may be adjusted by imputing permitted disparity.

f. *Average Benefit Calculation.* The average benefit percentage test must be calculated under an annual testing method, even if the plan tests for coverage using another method.

Example 2-30: Computing the benefit percentage for a participant in a 401(k) plan.

Randy is a participant in the Flowers, Inc., 401(k) plan. For the plan year Randy has been allocated the following contributions: (1) $1,200 elective deferrals, (2) matching employer contributions of $600, and (3) an employer discretionary contribution of $800. Randy's compensation for the year is $20,000.

What is Randy's benefit percentage? Randy's benefit percentage is 13% [($1,200 + $600 + $800) ÷ $20,000].

The specific mechanics of applying the average benefit percentage test are quite complex. The following is an example of this test after each participant's benefit percentage has been determined. The services of an actuary would be helpful in calculating the average benefit percentage, particularly if cross-testing and/or imputed disparity is involved.

Example 2-31: Average benefit percentage test.

Beta, Inc., has 18 nonexcludable employees, three of whom are HCEs. Their pension plan covers 12 salaried employees, including the three HCEs. Six nonexcludable NHCEs are not eligible for the plan because they are paid hourly. On the basis of this information, the plan fails the *ratio percentage test*, as the ratio percentage is 60% (9 NHCEs benefiting under the plan ÷ 15 nonexcludable NHCEs compared to 100% of the HCEs benefiting under the plan). Thus, the plan must meet the *average benefit test*.

The plan passes the nondiscrimination classification test, because (1) the salaried classification for plan coverage is reasonable and (2) the concentration percentage of 83.33% correlates to a safe harbor percentage of 32.75%. The concentration percentage is calculated as follows:

$$83.33\% = \frac{\text{15 nonexcludable NHCEs}}{\text{18 total nonexcludable employees}}$$

The ratio percentage is then determined by comparing the percentage of NHCEs benefiting under the plan of 60% (9 ÷ 15) and the percentage of HCEs benefiting under the plan of 100% (3 ÷ 3).

The ratio percentage is calculated as follows:

$$60\% = \frac{60\% \text{ of NHCEs benefiting}}{100\% \text{ of HCEs benefiting}}$$

The safe harbor percentage is then subtracted from the ratio percentage to yield a nondiscriminatory test result of 27.25% (60% − 32.75%). As this number is greater than or equal to zero, the nondiscriminatory test is passed.

Given the following employee benefit percentages, does the plan meet the average benefit percentage test? Yes, the plan meets the average benefit percentage test. The average benefit percentage of HCEs is 7.07% (21.22% ÷ 3 HCEs), while the average benefit percentage of NHCEs is 5.05% (75.80% ÷ 15 NHCEs). The average benefits provided to the NHCEs are 71.43% (5.05% ÷ 7.07%) of the average benefits provided to HCEs, so the plan passes the average benefit percentage test.

	Employee	Benefit Percentage
1. HCEs	1.	9.95 %
	2.	7.63 %
	3.	3.64 %
Total HCE Benefit Percentage		21.22 %
2. NHCEs		
Covered by Plan:	4.	12.10 %
	5.	11.20 %
	6.	10.40 %
	7.	9.70 %
	8.	8.30 %
	9.	7.65 %
	10.	6.98 %
	11.	5.45 %
	12.	4.02 %
Not Covered by Plan:	13.	0.00 %
	14.	0.00 %
	15.	0.00 %
	16.	0.00 %
	17.	0.00 %
	18.	0.00 %
Total NHCE Benefit Percentage		75.80 %

The average benefit percentage is generally calculated with respect to all the employer's qualified plans on a combined basis. The test is applied on the basis of plan years ending with or within the same calendar year. These plan years are referred to in the aggregate as the testing period. However, an optional rule permits the calculation of the employee benefit percentages for the current testing period by averaging the benefit percentages over a three-year period.

To simplify the calculations that must be made to determine whether a plan satisfies the average benefit percentage test, a number of optional rules may be used. For example, statistical sampling techniques and tables converting benefits to contributions and contributions to benefits are provided to aid employers. Other optional rules described in Reg. 1.410(b)-5(e) include the use of alternative compensation definitions and a simplified method for defined benefit plans.

FAILING MINIMUM COVERAGE TESTING

Consequences of Failing Minimum Coverage Tests

If the minimum coverage tests discussed earlier in this lesson are not met, the plan may lose its qualified status. Loss of a plan's qualified status generally results in the following consequences:

a. The plan's earnings become taxable.

b. The value of contributions or accrued pension benefits to participants' accounts after disqualification generally become taxable as vesting occurs.

c. Distributions from the plan become ineligible for special tax treatment and cannot be rolled over on a tax-deferred basis.

d. The employer's deduction for plan contributions is no longer determined under the rules applicable to qualified plans. (Instead, if the plan is a defined contribution plan, the employer's deduction coincides with the amounts and timing of the participant's inclusion in income. If the plan is a defined benefit plan, the employer's deduction may be permanently lost.) Also, such contributions will be subject to payroll taxes.

However, when one of the reasons for the plan's loss of qualified status is failure to satisfy the minimum coverage requirements or the minimum participation requirements, each highly compensated employee must include in income an amount equal to the employee's entire vested accrued benefit not previously included in income, not just the current vested plan contributions. Additionally, if the plan is not qualified solely because it fails to satisfy either the minimum coverage requirements or the minimum participation requirements, no adverse tax consequences will be imposed on nonhighly compensated employees.

Remedies for Failing Coverage Testing

A plan failing to meet the minimum coverage requirements or the minimum participation requirements may be retroactively amended to satisfy the requirements. Such plans may consider the following alternative actions to meet the minimum coverage or minimum participation requirements:

a. Some plan documents contain very specific provisions to expand coverage by benefiting certain terminated or otherwise excluded active employees until the plan benefits enough participants to pass coverage without requiring an amendment. Such fail-safe language can only be used if included in the plan document.

b. Expand coverage for nonhighly compensated employees (NHCEs) to satisfy the ratio test or nondiscriminatory classification test.

c. Consider certain retroactive plan mergers permitted under Reg. 1.401(4)-11(g).

d. Improve benefits or contributions for active NHCEs in the case of failure to meet the average benefit percentage test.

e. If the employer maintains another plan, consider aggregating the plans to test for minimum coverage as a single plan. (Note that a plan amendment is not needed in this situation.)

f. Modify eligibility conditions such as minimum age and service requirements.

Conditions for Corrective Amendments. A corrective amendment is not taken into account prior to its adoption unless certain requirements are satisfied. If any of the applicable requirements are not satisfied, any additional accruals arising from an amendment adopted after the end of a plan year are not given retroactive effect and, thus, are tested in the plan year in which the amendment is adopted:

a. Benefits may not be reduced as a result of the amendment.

b. Corrective amendments must be adopted and taken into account on or before the 15th day of the 10th month after the close of the plan year, and must be retroactive to the beginning of the plan year.

c. A determination letter may be requested by the employer or plan administrator, which will extend the compliance period if timely done.

d. Retroactive benefits must be provided to a nondiscriminatory group, or a corrective amendment must conform to a safe harbor specified in Reg. 1.401(a)(4)-2(b) or -3(b).

e. Certain conditions for corrective amendment of the availability of benefits, rights, and features must be met.

f. Special rules for 401(k) plans and 401(m) plans specified in Reg. 1.401(a)(4)-11(g)(3)(vii) must be met.

g. Corrective amendments must have substance (i.e., it must have actual economic benefit to employers to be recognized).

Alternative to Disqualification

A plan that cannot be retroactively amended to satisfy the minimum coverage requirements may be able to use one of the IRS administrative correction programs under the Employee Plans Compliance Resolution System (EPCRS) to correct the failure without losing the plan's qualified status. Coverage violations that are not corrected within the allowed time period (i.e., within 9½ months of the plan's year end) are considered *demographic failures* under EPCRS and must be corrected with use of the voluntary correction program (VCP).

COMPLYING WITH THE MINIMUM PARTICIPATION RULES FOR DEFINED BENEFIT PLANS

The minimum participation rules of IRC Sec. 401(a)(26) measure how many employees are covered under the plan in comparison to the employer's entire workforce. A defined benefit plan that does not pass the minimum participation requirements will lose its qualified plan status.

The minimum participation rules, which apply *only* to defined benefit plans, set forth a certain number or percentage (i.e., a minimum) of employees who must benefit under the plan for it to maintain its qualified tax status.

A defined benefit plan satisfies the minimum participation requirements if it benefits on each day of the plan year at least the lesser of—

a. 50 nonexcludable employees, or

b. the greater of—

   (1) 40% of all nonexcludable employees of the employer, or

   (2) two nonexcludable employees (or one employee if there is only one employee).

Plans Not Subject to the Minimum Participation Requirements

The following plans are deemed to satisfy the minimum participation requirements:

a. *Plans Not Benefiting Highly Compensated Employees.* Certain plans that do not benefit any HCEs or former HCEs are deemed to satisfy the minimum participation requirements. These plans must not be aggregated with any other plans of the employer when satisfying the minimum coverage requirements and the nondiscrimination requirements. However, the plan must be aggregated with the employer's other plans for purposes of the average benefit percentage test.

b. *Multiemployer Plans.* The portion of a multiemployer plan benefiting only collectively bargained employees may be treated as a separate plan for minimum participation purposes. The separate plan is deemed to

satisfy the minimum participation requirements. However, this rule does not apply to the portion of the plan benefiting noncollectively bargained employees, and such portion is subject to the minimum participation requirements. There is an exclusion for a multiemployer plan benefiting noncollectively bargained employees if the plan benefits 50 employees (including collectively bargained employees). Such a plan is deemed to satisfy the minimum participation requirements.

c. *Certain Underfunded Defined Benefit Plans.* An underfunded defined benefit plan is deemed to satisfy the minimum participation requirements if all benefit accruals have ceased. For the plan year, no employees or former employees can accrue additional benefits under the plan. The plan must be subject to Title IV of ERISA for the plan year (i.e., covered by PBGC insurance). The employer's timely filed actuarial report required by IRC Sec. 6059 must demonstrate that the plan does not have sufficient assets to satisfy all plan liabilities.

d. *Certain Acquisitions or Dispositions.* Similar to the rules under the minimum coverage requirements, the minimum participation requirements are deemed to be satisfied for certain plans of an employer involved in an acquisition or disposition. Conditions specified in Reg. 1.401(a)(26)-1(b)(5) must be met for the employer to take advantage of this rule.

e. *Frozen Defined Benefit Plans.* Only frozen defined benefit plans meeting the prior benefit structure requirements in Reg. 1.401(a)(26)-3 are deemed to have met the minimum participation requirements.

f. *Governmental Plans.* All governmental plans, as defined in IRC Sec. 414(d), are exempt from the minimum participation requirements, effective for plan years beginning after August 17, 2006.

Identifying the Plan

For the minimum participation rules, *plan* has the same meaning as for the minimum coverage rules. However, the permissive and mandatory aggregation rules do not apply. Additionally, special rules may apply to multiple employer plans, multiemployer plans, and certain defined benefit plans.

No Permissive Aggregation Allowed. The minimum participation rules apply separately to each plan maintained by the employer. Thus, plans may not be aggregated to satisfy the minimum participation rules even when the plans are identical in all respects or when the plans are treated as a single plan for purposes of the minimum coverage rules and the nondiscrimination tests. Note that special rules apply to offsetting arrangements.

Dealing with Mandatory Disaggregation. For purposes of testing for minimum participation, some plans or portions of plans must be treated as separate plans. This requirement is known as *mandatory disaggregation*. Each separate asset pool available to pay benefits only to a specified group of employees is to be treated as a separate plan [Reg. 1.410(b)-7(b)]. As in the minimum coverage rules, a plan is still considered to be a single plan even if it has more than one plan document or more than one trust (each having a separate determination letter). Likewise, assets of a plan that are separately invested in individual insurance or annuity contracts for employees are also not considered to be separate plans.

Dealing with Permissive Disaggregation. Certain plans are allowed, but not required, to be treated as separate plans. Permissive disaggregation is useful when the plan, or portions of the plan, would not pass the participation requirements when tested together, but when tested separately would pass the tests. The minimum participation test need not be satisfied by each component of a defined benefit plan when the components are restructured for nondiscrimination testing.

Plans Benefiting Otherwise Excludable Employees. If an employer applies the participation requirements separately to the portion of a plan benefiting employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions allowed under IRC Sec. 410(a), the plan is treated as two separate plans. The first plan is one benefiting the employees who have satisfied the lower minimum age and service requirements [but not the greatest minimum age and service conditions permitted under. The second plan is one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under IRC Sec. 410(a).

Which Employees Must Be Considered?

As in the minimum coverage rules, all employees must be considered on an employer-wide basis when applying the minimum participation requirements for the plan year. An employer may test minimum coverage on a qualified separate line of business (QSLOB) basis by applying the QSLOB rules without regard to the 50-employee requirement for post-1996 plan years. This permits funding of a defined benefit plan with fewer than 50 participants which cannot pass the 40% test on an employer-wide basis, as long as the plan covers a separate line of business that meets the QSLOB definition, but for the 50-employee requirement. This exemption does not apply for testing coverage under IRC Sec. 410(b) [IRC Sec. 401(a)(26)(F), requiring approval of the IRS].

If an employer is part of a group of businesses under common control, all employees of the controlled group must be considered. Certain leased employees must also be taken into account.

Active employees benefiting under the plan are considered in applying the minimum participation rules. An active employee benefits under a defined benefit plan only if the employee accrues a benefit for the year.

Employees are deemed to benefit during a year even if they do not accrue a benefit because of the Section 415 limits, the plan's uniformly applicable benefit limit, or an offset from contributions or benefits from another plan.

If a plan does not benefit 50 active employees, the 40% test must be met. To meet this test, certain employees may be excluded.

Excludable Employees

Minimum Age and Service Exclusions. If a plan applies minimum age and service eligibility conditions and excludes all employees who do not meet those conditions from benefiting under the plan, all employees failing to satisfy those conditions are excludable employees. The minimum age and service eligibility conditions must meet the requirements of IRC Sec. 410(a)(1).

> **Example 2-32: Employees not meeting age and service requirements are excludable employees.**
>
> The Spicy Food Company maintains a defined benefit plan under which employees must complete one year of service to be eligible for participation. The Spicy Food Company has six employees. Two of the employees participate in the plan; the other four employees have not completed one year of service and are not eligible to participate.
>
> Which employees are excludable? The four employees who have not completed one year of service are excludable employees and may be disregarded for purposes of applying the minimum participation test. Therefore, the plan satisfies the minimum participation requirements because both of the two employees who must be considered are participants in the plan.
>
> **Example 2-33: Employees who meet a plan's minimum age and service requirements are nonexcludable.**
>
> The Ocean Corporation has 100 employees and maintains a defined benefit plan, The Spray Plan, which has no minimum age or service condition.
>
> Are any of The Ocean Corporation's employees excludable for purposes of the minimum participation rules? No employees are excludable for minimum participation purposes because The Spray Plan has no minimum age or service conditions.

Plans Benefiting Otherwise Excludable Employees. An employer may elect to treat a plan as two separate plans if the plan applies a more lenient minimum age and service condition than is required by IRC Sec. 410(a)(1). One plan consists of the otherwise excludable employees (i.e., those who would be excluded under the greatest permissible minimum age and service conditions). The other plan consists of the remaining employees benefiting under the plan. The more lenient conditions allow employees who would normally be otherwise excludable to benefit, and such employees may be treated as excludable employees with respect to the minimum participation requirements. This treatment is only available if each of the following conditions are satisfied:

a. The plan under which the otherwise excludable employees benefit also benefits employees who are not otherwise excludable.

b. The plan under which the otherwise excludable employees benefit satisfies the minimum participation requirements, both by reference only to otherwise excludable employees and by reference only to employees who are not otherwise excludable.

c. The contributions or benefits provided to the otherwise excludable employees (expressed as percentages of compensation) are not greater than the contributions or benefits provided to those not otherwise excludable under the plan.

d. No HCE is included in the group of otherwise excludable employees for more than one plan year.

Nonresident Aliens. Nonresident aliens who receive no earned income from U.S. sources are excludable employees. Also, nonresident aliens receiving income from U.S. sources are excludable if the income is exempt from U.S. income tax under a tax treaty. This exclusion applies only if all such employees are so excluded.

Collectively Bargained Employees. Collectively bargained employees may be excluded; this is in contrast for the coverage rules, where disaggregation of collectively bargained employees is mandatory. However, if more than 2% of the employees in a unit covered by a collective-bargaining agreement are professionals, no employees in the unit are excludable. A professional is any HCE who, on any day of the plan year, performs professional services for the employer as an actuary, architect, attorney, chiropodist, chiropractor, dentist, executive, investment banker, medical doctor, optometrist, osteopath, podiatrist, psychologist, certified or other public accountant, stockbroker, or veterinarian, or in any other professional capacity determined by the Commissioner in a notice or other document of general applicability to constitute the performance of services as a professional.

Frequency of Testing

While the law indicates the minimum participation requirement must be met on each day of the plan year, the regulations treat a plan as satisfying the requirement if it does so on any single day during the year, provided the day is "reasonably representative of the employer's workforce and the plan's coverage." This testing day may vary from year to year.

Example 2-34: Applying the minimum participation test.

On July 31, a reasonably representative day, 45 out of 100 total employees are participating in the plan. As of the last day of the plan year, 41 out of the original 45 employees accrue a benefit for the plan year. As of the last day of the plan year, there are 110 employees. The plan satisfies the minimum participation requirements for the plan year, because, out of a workforce of 100 employees on a reasonably representative day, 41 employees (more than 100 × 40%) actually benefited under the plan.

Consequences of Failing Minimum Participation Tests

The consequences of failing to meet the minimum participation tests are the same as for minimum coverage failures.

Remedies for Failing Minimum Participation Tests

A plan failing to meet the minimum participation requirements may be retroactively amended to satisfy these requirements. Such plans may consider the following alternative actions to meet the minimum participation tests.

a. Modify eligibility conditions such as minimum age and service requirements.

b. Merge the failing plan into another plan in the case of failure to meet the minimum participation standards.

c. Determine if the plan is not subject to the minimum participation requirements, in which case the minimum participation requirements are deemed to be satisfied.

d. Although usually of limited use, the qualified separate lines of business rules can be considered.

In general, such actions must be taken on or before the 15th day of the 10th month after the close of the plan year, and must be retroactive to the beginning of the plan year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. When performing the nondiscriminatory classification test, which of the following steps should follow satisfying the safe harbor rule if steps 1 and 2 are **not** met?

    a. Establish a logical covered employee classification.

    b. Satisfy the unsafe harbor rule.

    c. The reasonable classification of covered employees are required to meet a nondiscriminatory facts and circumstances test.

36. Which of the following statements regarding reasonable classification is most accurate?

    a. Employee classification is reasonable if established under objective ERISA.

    b. A classification is considered reasonable classification for a plan year if the group of employees included in the classification benefiting under the plan satisfies the safe harbor rule.

    c. A list of employees does not qualify as reasonable classification.

37. Which of the following statements regarding computing the benefit percentage test is correct?

    a. Nonexcludable employees who are not benefiting under any plan implemented are not considered when performing this test.

    b. Employee after-tax contributions are included in calculating benefit percentages.

    c. The percentage for defined contribution plans is expressed as a benefit ratio.

    d. Employee 401(k) deferrals are considered in calculating benefit percentages.

38. Which of the following plans is **not** deemed to satisfy the minimum participation requirements?

    a. Plans benefiting noncollectively bargained employees.

    b. Plans not benefiting HCEs.

    c. Certain underfunded defined benefit plans.

    d. Certain acquisitions or dispositions.

39. Which of the following statements is most accurate?

    a. Plans under the minimum participation rules may be aggregated to meet the minimum participation rules.

    b. Mandatory disaggregation may apply when testing for minimum participation.

    c. Permissive disaggregation is required for purposes of testing for minimum participation.

    d. A plan is not considered a single plan if it has multiple plan documents.

40. Which of the following is **not** considered an excludable employee?

    a. Natasha is a nonresident alien who received earned income from U.S. sources.

    b. Theodore is a collectively bargained employee who does not profit from unit members.

    c. Matthew is a noncollectively bargained employee who is part of a plan that does not benefit noncollectively bargained employees.

    d. Warren is an employee of his employer's other QSLOB.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. When performing the nondiscriminatory classification test, which of the following steps should follow satisfying the safe harbor rule if steps 1 and 2 are **not** met? **(Page 89)**

    a. Establish a logical covered employee classification. [This answer is incorrect. According to the Code, establishing a reasonable classification of covered employees is the first step in performing the nondiscriminatory test.]

    b. Satisfy the unsafe harbor rule. [This answer is correct. If steps 1 and 2 are not met, the employer should go to step 3 to meet the unsafe harbor rule by covering sufficient employees to meet the safe harbor percentage.]

    c. The reasonable classification of covered employees are required to meet a nondiscriminatory facts and circumstances test. [This answer is incorrect. This step is the last step in performing the nondiscriminatory test and does not follow meeting the safe harbor rule per the Code.]

36. Which of the following statements regarding reasonable classification is most accurate? **(Page 89)**

    a. Employee classification is reasonable if established under objective ERISA. [This answer is incorrect. The classification of employees must be reasonable (based on facts and circumstances) and established under objective business criteria that identify the category of employees who benefit under the plan.]

    b. A classification is considered reasonable classification for a plan year if the group of employees included in the classification benefiting under the plan satisfies the safe harbor rule. [This answer is incorrect. A classification is considered nondiscriminatory for a plan year, not necessarily reasonable, if the group of employees included in the classification benefiting under the plan satisfies either the safe harbor or facts and circumstances rule.]

    c. A list of employees does not qualify as reasonable classification. [This answer is correct. A listing of employees by name (or other specific criteria having the same effect as a listing by name) is not considered a reasonable classification as state in Reg. 1.410(b)-4(b). For example, an individual serving as corporate vice president could not be excluded by name, but the plan could exclude all vice presidents. The IRS has also informally indicated that classifying employees by the last day rule (inclusion of only participants employed at the end of the year) is not a reasonable classification.]

37. Which of the following statements regarding computing the benefit percentage test is correct? **(Page 90)**

    a. Nonexcludable employees who are not benefiting under any plan implemented are not considered when performing this test. [This answer is incorrect. To apply and satisfy this test the employer is required to determine an employee benefit percentage for each employee taken into account for testing purposes. All nonexcludable employees are taken into account for this purpose, even if they are not benefiting under any plan taken into account.]

    b. Employee after-tax contributions are included in calculating benefit percentages. [This answer is incorrect. According to the regulations, employee after-tax contributions and benefits attributable to these contributions are not considered in calculating benefit percentages.]

    c. The percentage for defined contribution plans is expressed as a benefit ratio. [This answer is incorrect. An employee's benefit percentage may be an allocation rate or a benefit rate. Generally, the percentage for defined contribution plans is expressed as an allocation rate, and the percentage for defined benefit plans is expressed as a benefit ratio.]

    d. Employee 401(k) deferrals are considered in calculating benefit percentages. [This answer is correct. 401(k) salary deferrals are considered to be employer contributions and are taken into

account in calculating benefit percentages per Reg. 1.401(k)-1(a)(4)(ii). An employee's benefit percentage may be an allocation rate or a benefit rate.]

38. Which of the following plans is **not** deemed to satisfy the minimum participation requirements? **(Page 94)**

   a. Plans benefiting noncollectively bargained employees. [This answer is correct. The portion of a multiemployer plan that benefits only collectively bargained employees may be treated as a separate plan for minimum participation purposes. The separate plan is deemed to satisfy the minimum participation requirements. However, this rule does not apply to the portion of the plan benefiting noncollectively bargained employees, and such portion is subject to the minimum participation requirements.]

   b. Plans not benefiting HCEs. [This answer is incorrect. Certain plans that do not benefit any HCEs or former HCEs are deemed to satisfy the minimum participation requirements per Reg. 1.401(a)(26)-1(b)(1).]

   c. Certain underfunded defined benefit plans. [This answer is incorrect. An underfunded defined benefit plan is deemed to satisfy the minimum participation requirements if all benefit accruals have ceased. For the plan year, no employees or former employees can accrue additional benefits under the plan. The plan must be subject to Title IV of ERISA for the plan year (i.e., covered by PBGC insurance).]

   d. Certain acquisitions or dispositions. [This answer is incorrect. Similar to the rules under the minimum coverage requirements, the minimum participation requirements are deemed to be satisfied for certain plans of an employer involved in an acquisition or disposition. Conditions specified in Reg. 1.401(a)(26)-1(b)(5) must be met for the employer to take advantage of this rule.]

39. Which of the following statements is most accurate? **(Page 95)**

   a. Plans under the minimum participation rules may be aggregated to meet the minimum participation rules. [This answer is incorrect. The minimum participation rules apply separately to each plan maintained by the employer. Thus, plans may not be aggregated to satisfy the minimum participation rules even when the plans are identical in all respects or when the plans are treated as a single plan for purposes of the minimum coverage rules and the nondiscrimination tests.]

   b. Mandatory disaggregation may apply when testing for minimum participation. [This answer is correct. For purposes of testing for minimum participation, some plans or portions of plans must be treated as separate plans. This requirement is known as mandatory disaggregation. Each separate asset pool available to pay benefits only to a specified group of employees is to be treated as a separate plan.]

   c. Permissive disaggregation is required for purposes of testing for minimum participation. [This answer is incorrect. According to Reg. 1.401(a)(4)-(9)(c)(5), certain plans are allowed, but not required, to be treated as separate plans. Permissive disaggregation is useful when the plan, or portions of the plan, would not pass the participation requirements when tested together, but when tested separately would pass the tests.]

   d. A plan is not considered a single plan if it has multiple plan documents. [This answer is incorrect. As in the minimum coverage rules, a plan is still considered to be a single plan even if it has more than one plan document or more than one trust (each having a separate determination letter). Likewise, assets of a plan that are separately invested in individual insurance or annuity contracts for employees are also not considered to be separate plans.]

40. Which of the following is **not** considered an excludable employee? **(Page 97)**

    a. **Natasha is a nonresident alien who received earned income from U.S. sources. [This answer is correct. Nonresident aliens who receive no earned income from U.S. sources are excludable employees. However, Natasha had earned income from U.S. sources; therefore, she not an excludable employee.]**

    b. Theodore is a collectively bargained employee who does not profit from unit members. [This answer is incorrect. Collectively bargained employees may be excluded per Reg. 1.401(a)(26)-2(d)(2)(i); this is in contrast for the coverage rules, where disaggregation of collectively bargained employees is mandatory.]

    c. Matthew is a noncollectively bargained employee who is part of a plan that does not benefit noncollectively bargained employees. [This answer is incorrect. According to Reg.1.410(b)-6(d), Matthew is excluded because when testing the plan or a portion of the plan, it does not benefit noncollectively bargained employees.]

    d. Warren is an employee of his employer's other QSLOB. [This answer is incorrect. Employees of the employer's other QSLOBs are excludable employees. However, this rule does not apply when satisfying the nondiscriminatory classification portion of the average benefit test when that test must be applied on an employer-wide basis under Reg. 1.410(b)-6(e).]

EXAMINATION FOR CPE CREDIT

Lesson 2 (RETTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. What is the authoritative source of information for determining how a plan is implemented and information about a particular plan?

    a. ERISA.

    b. The plan document.

    c. IRC.

    d. IRC Regulations.

20. When must a plan be tested for coverage?

    a. When the plan document is a standardized prototype plan document.

    b. When participants are required to be employed on the last day of the plan year to receive a benefit.

    c. When the plan benefits only non-highly compensated employees (NHCEs).

    d. When terminated employees are not required to have at least 501 hours of service to benefit.

21. The IRS issued Rev. Proc. 93-42 to grant significant relief for the frequency of testing. This relief is limited to which of the following?

    a. Coverage and nondiscrimination testing.

    b. Cross-testing.

    c. Coverage and cross-testing.

    d. Nondiscrimination testing.

22. Allied, Inc., and Mercer, Inc., are wholly owned subsidiaries of Juniper, Inc. Each corporation has adopted a separate pension plan for its employees. The assets for all three plans are maintained in one trust, from which any of the assets can be used to provide benefits for any employee of any of the corporations. How many separate plans are maintained by the controlled group for minimum coverage purposes?

    a. One.

    b. Two.

    c. Three.

    d. Do not select this answer choice.

23. Troy, Inc., maintains a defined benefit plan. Benefits are provided to managerial employees out of certain plan assets, and the remaining assets are available only in certain limited cases to provide managerial benefits (but are available in all cases for the benefit of other employees). How many separate plans are maintained by Troy, Inc., for minimum coverage purposes?

    a. One.

    b. Two.

    c. Three.

    d. Do not select this answer choice.

24. Match the following with regard to minimum coverage.

A. Plans that may be aggregated	1. A single plan formed by adding two or more plans
B. Plans that cannot be aggregated	2. Two annuity plans
	3. ESOP with another ESOP
	4. Two or more trusts
	5. Plans with different plan years

    a. A 2, 4; B 1, 3, 5.

    b. A 1, 3, 5; B 2, 4.

    c. A 2, 3, 4; B 1, 5.

    d. A 4, 5; B 1, 2, 3.

25. An employer that maintains plans X, Y, and Z may not aggregate plans X and Y and plans X and Z to form two single plans. However, the employer may apply the permissive aggregation rules to form any one (and only one) of which of the following combinations?

    a. Plan XZ and plan YZ.

    b. Plan XYZ, plans XZ, or plans X and Y and plans X and Z.

    c. Plan XYZ, plans XY and Z, plans XZ and Y, or plans X and YZ.

    d. Plan XY and plan X and YZ.

26. N Corporation owns 90% of the only class of stock of B Corporation, and B, in turn, owns 50% of the capital interest in the STU Partnership. N also owns 80% of the only class of stock of C Corporation and C, in turn, owns 40% of the capital interest in the STU Partnership. The ownership is summarized in the following chart:

	N	**B**	**C**	**STU**
N Corp.	0	90	80	0
B Corp.	0	0	0	50
C Corp.	0	0	0	40

Which of the following is the common parent of a parent-subsidiary group?

a. STU.

b. N.

c. B.

d. C.

27. Shared employees are which of the following.

a. Full-time employees of all employers.

b. Always excludable for purposes of the nondiscrimination test.

c. Are determined separately with respect to each employer's plan.

d. Are not considered for plan coverage.

28. The safe harbor exception stipulates leased employees are not considered for plan coverage if such employees do not constitute more than what percent of the recipient's NHCEs?

a. 5%.

b. 10%.

c. 15%.

d. 20%.

29. Libby is a temporary secretary who works for Worker's Unlimited, Inc. Libby has been placed with a doctor's office for over a year. Libby, who works 1750 hours, does not meet the definition of a common-law employee of the doctor's office. The doctor's office instructs her on where and how she is to work. Libby is closely supervised by the office manager of the doctor's office. Is Libby a leased employee?

a. Yes.

b. No.

c. Do not select this answer choice.

d. Do not select this answer choice.

30. Malley is an ER nurse for Healthcare Unlimited, Inc. and has been leased on a full-time basis to Feel Good Health Services Inc. (FGHS) for the last 17 months. Neither Healthcare Unlimited nor FGHS cover Malley under their 401(k) plan. Because she has been providing services under the primary direction or control of FGHS and within the terms of a lease agreement for at least one year, FGHS must treat Malley as an employee for purposes of which of the following?

    a. Nondiscriminatory classification test.

    b. Minimum coverage test.

    c. Nondiscretionary classification test.

    d. Average benefit percentage test

31. When does an employee qualify as an HCE?

    a. When the employee owns more than 5% of the company or received compensation greater than $75,000 indexed for the cost of living for the look-back year.

    b. When the employee owns more than 15% of the company or received compensation greater than $80,000 indexed for the cost of living for the look-back year.

    c. When the employee owns more than 5% of the company or received compensation greater than $80,000 indexed for the cost of living for the look-back year.

    d. When the employee owns more than 10% of the company or received compensation greater than $90,000 indexed for the cost of living for the look-back year.

32. Which of the following statements is accurate regarding the following scenario?

    Sue owns 60% and William owns 40% of Corporation S. Sue owns 10% of Corporation M. William and Sue both work for Corporation M. By attribution from Sue, Corporation S owns 10% of Corporation M, because Sue is a 50%-or-more shareholder of Corporation S. However, there is no reattribution from Corporation S to William. Corporation S is not an owner of Corporation M for purposes of reattributing Corporation S's indirect ownership to William, notwithstanding the normal attribution from a corporation to its 5%-or-more shareholders.

    a. Sue is not considered an HCE of Corporation M.

    b. William is not considered an HCE of Corporation M.

    c. Sue is not considered an HCE of Corporation S.

    d. William is not considered an HCE of Corporation S.

33. The effect of the top-paid election is that an employee who is less-than-5% owner (at any time during the determination year or the look-back year) with compensation for the look-back year greater than _______ (indexed for cost of living) for 2009 and 2010 is included in the top-paid group for the look-back year.

    a. $80,000.

    b. $100,000.

    c. $110,000.

    d. $150,000.

34. Once the employer elects the top-paid group, all of the following can occur **except**:

    a. The election will apply to all succeeding years if it does not change.

    b. The employer must file the election with the IRS.

    c. The employer must amend the plan to change the election in succeeding years.

    d. The employer must regularly apply the election to all plans starting with or within the same calendar year.

35. A & B Manufacturing has 250 active employees during the determination year, 100 of whom normally work fewer than 17½ hours per week during such year and 30 of whom normally work fewer than 15 hours per week during such year. A & B Manufacturing elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group. How many employees are in the top-paid group?

    a. 50.

    b. 44.

    c. 30.

    d. 6.

36. What is the percentage of active nonhighly compensated employees benefiting under a plan that must be met to satisfy the ratio percentage test?

    a. 50%.

    b. 70%.

    c. 75%.

    d. 80%.

37. When does a plan meet the nondiscriminatory test for a plan year?

    a. When the plan benefits HCEs and the ratio percentage test is met.

    b. When the plan benefits 70% of the employer's NHCEs and the QSLOB rules satisfies the reasonable classification test.

    c. When the plan benefits employees who qualify under a classification established by the employer.

    d. When the plan benefits employees who qualify under a classification established by the employer, and the classification is nondiscriminatory.

38. Brandy is a participant in the Royal, Inc., 401(k) plan. For the plan year Brandy has been allocated the following contributions: (1) $2,400 elective deferrals, (2) matching employer contributions of $1,200, and (3) an employer discretionary contribution of $2,280. Brandy's compensation for the year is $42,000. What is Brandy's benefit percentage?

    a. 12%.

    b. 13%.

    c. 14%.

    d. 15%.

39. Bells, Inc., has 36 nonexcludable employees, six of whom are HCEs. Their pension plan covers 24 salaried employees, including the six HCEs. Twelve nonexcludable NHCEs are not eligible for the plan because they are paid hourly. Based on this information, this plan fails which of the following test?

    a. Ratio percentage.

    b. Nondiscrimination.

    c. Average benefit test.

    d. Do not select this answer choice.

40. When complying with the minimum participation rules for defined benefit plans, how many active employees must a plan benefit without requiring the 40% test to be met?

    a. 25.

    b. 35.

    c. 40.

    d. 50.

GLOSSARY

401(k) plan: A 401(k) plan (or a cash or deferred arrangement plan) is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a profit-sharing or stock bonus plan, a pre–Employee Retirement Income Security Act of 1974 (ERISA) money purchase plan, or a rural cooperative plan. In addition, contributions to the plan may be made by the employee, employer, or both (i.e., through a matching arrangement). Contributions to the plan are made pre-tax (tax-deferred). Earnings, gains, or losses within the account are tax-deferred. Distributions from the account are fully taxable.

Affiliated service group: The Affiliated Service Group (ASG) rules require aggregation of multiple employers if the employers are closely connected because they perform significant services for each other or together for third parties.

Annual testing method: Under this method, the minimum coverage requirements must be satisfied as of the last day of the plan year. All individuals who were employees on any day during the plan year are taken into account for purposes of identifying the testing group, even if the employee terminated employment during the plan year.

A-ORG: Any service organization that is a shareholder or partner with the FSO and regularly performs services for the FSO or is regularly associated with the FSO in performing services for third persons.

Average benefit percentage test: The average percentage of benefits for NHCEs must equal at least 70% of the average percentage of benefits for HCEs.

B-ORG: Any other organization if a significant portion of its business is (1) performing services for the FSO or A-ORG that are services historically performed by employees and (2) 10% or more of the interest in such organization is held by persons who are HCEs of the FSO or A-ORG.

Brother-sister group: A brother-sister group exists if two ownership tests are met: (a) for each organization in the group, more than a 50% interest must be owned by five or fewer individuals, estates, or trusts, counting only identical ownership of each shareholder in each organization (the more-than-50% test), and (b) at least an 80% interest must be owned by five or fewer persons, (e.g., individuals, estates, or trusts). In performing the 80% test, the five or fewer persons whose ownership is considered must be the same persons whose ownership is considered for the more-than-50% test.

Cash balance plan: A cash balance plan falls under the defined benefit category, yet benefits are expressed as a cash account rather than as an accrued pension payable at normal retirement (i.e., rather than the traditionally defined, normal retirement benefit). The annual accrual under a cash balance plan is a stated contribution and a prescribed interest rate (irrespective of actual plan investment earnings). The rate of benefit accruals under this plan design may tend to decrease with age as compared to the traditional defined benefit accrual.

Combined group: A combined group is three or more organizations where each organization is a member of either a parent-subsidiary group or a brother-sister group, and at least one organization is the common parent organization of a parent-subsidiary group and a member of a brother-sister group.

Compensation: There are several definitions for compensation that can be used for various purposes. Compensation for the purpose of determining the employer deduction limit is referred to as *qualified compensation* in this course. Qualified compensation for self-employed participants is determined by earned income and adjusted by half of the self-employment tax and the participant's deductible contribution to the plan. For purposes of the deduction limit, compensation is defined as the amount paid or accrued during the tax year to plan participants, not including contributions to a qualified plan.

Daily testing method: Under this method, the minimum coverage requirements must be satisfied for each day of the plan year, taking into account only those employees (or former employees) who were employed and not excludable on the testing date.

Defined benefit plan: A pension plan that defines the amount of pension benefit to be provided, usually as a function of one or more factors including age, years of service, or compensation. Accounting is difficult because annual expense is based on estimates of future benefits. The employer bears the investment risk and must provide sufficient funds to meet the defined level of benefit. The Employee Retirement Income Security Act of 1974 (ERISA) made funding of defined benefit plans mandatory.

Defined contribution plan: A pension plan that specifies the amounts contributed to the plan and does not specify the amount of the benefits to be received by the retired employees. Contributions to the plan are based on specified amounts (e.g., 7% of the employee's salary). The benefits to be received by the retired employee are unspecified and uncertain. The employee bears the investment risk and the pension expense is the amount funded (paid in). Defined contribution plans can be profit-sharing plans or money purchase plans.

Elapsed time method: The elapsed time method for crediting service is based on a period of service, rather than determining the hours credited toward a year of service. Under the elapsed time method, the plan disregards actual hours worked and instead bases credit for participation and vesting on the total period of time an employee works for the employer, beginning with the date employment begins and ending when employment is severed.

Employee: The term employee refers to individuals who perform services for the employer. The term includes all common-law employees, self-employed individuals treated as employees under IRC Sec. 401(c)(1), and any leased employees who are not excluded.

Employee Plans Compliance Resolution System (EPCRS): The IRS has issued guidance on self-correcting plan errors, including the timing of corrective distributions, in EPCRS. Under EPCRS, significant excess annual additions will generally not present a qualification problem as long as the plan distributes the excess by the end of the second year after the year the excess contribution was made.

Equivalencies based on earnings: This method determines the hours of service credited to employees based on the employee's compensation under the rules in DOL Reg. 2530.200b-3(f). This rule converts an employee's compensation into hours of service. After dividing an hourly employee's compensation by the employee's hourly rate, an employee needs only 870 hours to be credited with 1,000 hours of service, and only 435 hours to be credited with 500 hours of service.

Five-year cliff vesting: A plan satisfies this schedule if a participant who has completed five years of service has a nonforfeitable right to 100% of the accrued benefit derived from employer contributions.

Hours method: The hours method for crediting service is used by most plans. The number of hours worked in a 12 month period is equated to years of service for determining eligibility for participation, vesting, and benefit accruals. An employee generally earns an hour of service for each hour the employee is paid or entitled to compensation. This method either uses the actual hours of service earned by employees or one of the simplified methods of determining service equivalences.

Initial eligibility period: An employee's initial eligibility period must begin with the employment commencement date (the first day of which the employee is credited with an hour of service) and end with the date that is one year after the date of employment.

Limitation year: The limits on contributions and benefits apply to a limitation year. The limitation year is a calendar year, unless the employer elects to use any other consecutive 12-month period.

Look-back year: The look-back year is the 12-month period before the current plan year. However, under the calendar year election, the look-back year may be measured on a calendar year basis for a plan year that is not maintained on a calendar year basis.

Minimum age and service requirements: These requirements deal with the employees' ability to participate in the plan by placing limits on the greatest age and service conditions that the plan can require before allowing employees to join the plan.

Minimum coverage rules: These rules measure the plan's coverage of rank-and-file workers (NHCEs) and of highly compensated employees (HCEs). Their purpose is to prevent employers from establishing plans that primarily benefit only HCEs.

Minimum participation rules: These rules apply only to defined benefit plans. They measure how many employees are covered under the plan in comparison to the entire workforce of the employer.

Nondiscriminatory classification test: This tests the classification of employees benefiting under the plan to make sure it does not discriminate in favor of HCEs.

One-year holdout rule: In determining an employee's eligibility to participate, a plan may provide that an employee who has a one-year break in service must complete a year of service after returning to work before the plan will count pre-break service. This is known as the one-year holdout rule.

Parent-subsidiary group: A parent-subsidiary group is basically two or more organizations where at least an 80% interest in each of the organizations (other than the common parent) is owned by one or more organizations in the group. The common parent must own at least an 80% interest in at least one member of the group.

Qualified military service: Any service in the uniformed services by an individual entitled to reemployment upon the end of the service.

Qualified retirement plan: Programs established under the Internal Revenue Code by an employer to provide retirement income for employees. The plans receive tax-favored status by complying with the qualification requirements under one of several Internal Revenue Code Sections.

Quarterly testing method: Under this method, the minimum coverage requirements must be satisfied on at least one day in each quarter of the plan year. Only those employees (or former employees) who were employed and not excludable on the testing dates are taken into account. However, this option is only available if the days selected are reasonably representative of the coverage of the plan for the entire plan year.

Ratio percentage test: The percentage of active NHCEs benefiting under the plan must be at least 70% of the percentage of active HCEs benefiting under the plan.

Reasonable classification: The classification of employees must be reasonable (based on facts and circumstances) and established under objective business criteria that identify the category of employees who benefit under the plan. Examples of reasonable classifications include specified job categories (e.g., managers), nature of compensation (e.g., salaried or hourly), geographic location, and other similar bona fide business criteria. A listing of employees by name (or other specific criteria having the same effect as a listing by name) is not considered a reasonable classification.

Regular time hours method: This equivalency method takes into account only *hours worked*; it does not take into account hours for which the employee did not perform any duties, such as vacation time or sick leave. It is not necessary to keep track of actual hours worked under this method. However, because the hours during which no duties are performed are excluded, employees would be given credit for fewer hours than under the actual hours method.

Rule of parity: A special break in service rule for determining participation, known as the rule of parity, applies if a participant is zero percent vested in his or her accrued benefits at the time the break in service begins. Under this rule, the plan may permanently disregard pre-break service if the employee's number of consecutive one-year breaks equals or exceeds the greater of five or the total years of pre-break service.

Shared employees: Shared employees are employees who perform services as an employee for more than one employer at shared business premises or common locations.

Snapshot variation of annual testing method: This method was originally designed for use by large companies that found it administratively difficult to track employees over an entire plan year. Under this method, a single testing date is chosen. Any date is allowed as long as it is reasonably representative of the work force and plan coverage for the plan year.

Three-year cliff vesting: A plan satisfies this schedule if a participant who has completed three years of service has a nonforfeitable right to 100% of the accrued benefit derived from employer matching contributions.

Vesting. The process by which the right to a participant's accrued benefit becomes nonforfeitable. The Internal Revenue Code and ERISA contain similar rules that govern vesting. The concepts of years of service and hours of service, which apply to eligibility and benefit accrual, also apply to vesting.

Year of service: A year of service is defined as a 12-consecutive-month period during which the employee completes at least 1,000 hours of service.

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COMPANION TO PPC'S GUIDE TO SMALL EMPLOYER RETIREMENT PLANS

COURSE 2

CONTRIBUTION LIMITS AND DEDUCTIONS (RETTG102)

OVERVIEW

COURSE DESCRIPTION: Tax law limits the amount of contributions that both the employer and the employee can make to a qualified retirement plan. Employers that maintain qualified plans are allowed deductions for contributions made to those plans in the current tax year. This course examines both contribution limits and deductions in more detail.

PUBLICATION/REVISION DATE: August 2010

RECOMMENDED FOR: Users of *PPC's Guide to Small Employer Retirement Plans*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of qualified retirement plans

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **August 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Complying With Limits on Contributions and Benefits

Completion of this lesson will enable you to:

- Identify Section 415 limits and assess related issues, including types of plans affected by the limits, and combining and aggregating plans.
- Determine a plan's limitation year and compensation applied to the Section 415 limits.
- Describe how Section 415 limits relate to defined benefit and defined contribution plans.
- Develop solutions to Section 415 violations for defined benefit and defined contribution plans.
- Summarize and deal with issues related to elective deferral limits, catch-up contributions, excess elective 401(k) plan deferrals, and forfeitures.

Lesson 2—Deducting Employer Contributions

Completion of this lesson will enable you to:

- Identify plan provisions and basic rules for employer plan contributions and deductions.

- Compute contribution deductions for defined benefit plans, defined contribution plans, money purchase pension plans, and when an employee is covered by more than one employer.
- Assess other issues related to plan administration, such as when deductions can be taken, contributing noncash property, excess contributions, and plan termination.

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Lesson 1: Complying with Limits on Contributions and Benefits

INTRODUCTION

The tax law limits the amount of contributions an employer and employee can make to a qualified retirement plan and the benefits the plan can provide. This lesson deals with the limits imposed on plan contributions at the individual participant level. Lesson 2 discusses the deduction limits that are imposed on a plan at the employer level.

Every type of qualified plan is subject to limitations set forth in IRC Sec. 415, which is referred to as the *Section 415 limit*. This limit dictates the amount of contributions that can be made for participants of defined contribution plans and the amount of benefits that can be accrued for and paid to participants of a defined benefit plan. A violation of the Section 415 limit can cause the plan to be disqualified. Depending on the circumstances that caused the violation, the plan may avoid disqualification by using one of several means of correction.

Qualified plans must comply with the IRC Sec. 415 limits, as well as several other Code sections that limit the benefits, deductions, and contributions that can be made to a qualified plan for participants. Several of these "limits" interact to further complicate the administration of qualified plans. The following chart identifies some of the limits, the applicable code section, and how the limit applies.

Limit on:	IRC Sec.	Applies to:
Annual Additions	IRC Sec. 415(c)	Individual participants
Pension Benefits	IRC Sec. 415(b)	Individual participants
Elective Deferrals	IRC Sec. 402(g)	Individual participants
401(k) Deferrals (ADP Limit)	IRC Sec. 401(k)	Highly compensated participants
401(m) Matching Contributions (ACP Limit)	IRC Sec. 401(m)	Highly compensated participants
Employer Contribution Deduction	IRC Sec. 404	Employer limit
Catch-up Contributions	IRC Sec. 414(v)	Individual participants age 50 and older by end of calendar year

In applying the Section 415 limits, all plans maintained by commonly owned businesses and affiliated service group members must be considered. The combining and aggregating of plans to apply the Section 415 limits is discussed in this lesson.

The limits are applied on an annual basis, and this lesson discusses which year the plan administrator must use to apply the limit. The Section 415 limits restrict the amount of contributions and benefits that a plan may provide based on participant compensation. This lesson provides a definition of compensation for Section 415 limitation purposes.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify Section 415 limits and assess related issues, including types of plans affected by the limits, and combining and aggregating plans.
- Determine a plan's limitation year and compensation applied to the Section 415 limits.
- Describe how Section 415 limits relate to defined benefit and defined contribution plans.
- Develop solutions to Section 415 violations for defined benefit and defined contribution plans.

- Summarize and deal with issues related to elective deferral limits, catch-up contributions, excess elective 401(k) plan deferrals, and forfeitures.

PLAN DOCUMENT GUIDANCE RELATED TO TESTING AND CORRECTING PLAN LIMIT VIOLATIONS

This lesson discusses general rules for testing contributions and benefits to ensure they meet the Section 415 limit. How these rules are applied to a particular plan is controlled, at least in part, by the plan document. Therefore, review the plan document and information in *PPC's Guide to Small Employer Retirement Plans* relating to the Section 415 limit and the nondiscrimination rules to determine if corrective action is necessary.

The following information will be needed to test participants' contribution or benefit limits. Most should be found in the plan document:

- Does the plan have a 401(k) feature?
- Does the plan provide for Designated Roth Accounts (DRAs)?
- Does the plan allow catch-up contributions?
- Does the plan have employer matching contributions?
- Does the plan allow Roth or after-tax employee contributions?
- What is the plan year to be used in testing?
- What is the limitation year for determining the Section 415 limit?
- If the plan year is not the calendar year, has the employer made the calendar year data election?
- How does the plan define highly compensated employees (HCEs)?
- Has the employer made a top-paid group election?
- What definition of compensation does the plan use for allocation and testing purposes?
- How are forfeitures to be handled?
- Does the plan have special provisions for defining compensation for disabled participants?
- Does the plan have special provisions for dealing with USERRA differential pay?

If any of the various contribution or benefit limits are exceeded in the operation of the plan, there are a number of allowable correction methods. Which method the plan can use is controlled by what is in the plan document.

The following items should also be found in the plan document. They will be needed only if it is determined that a limit violation has occurred and corrective actions are needed:

- Does the plan document provide for reallocating excess annual additions to other participants?
- Does the plan document provide for the refunding of excess employee deferrals to correct a Section 415 violation?
- Are excess annual additions to be used to reduce employer contributions? If so, is the reduction only for the affected participant or is it used to reduce the employer contributions for all participants?

- If the excess is produced by combining two plans, do the plans specify which plan is to reduce allocation first?
- Which is to be corrected first, the ADP or the ACP tests?
- How are matching contributions corresponding to elective deferrals and/or after-tax employee contributions that exceed the limitations handled?
- How are earnings on contributions that exceed the limitations handled?

SECTION 415 LIMITS ON CONTRIBUTIONS AND BENEFITS

The law limits the amount of contributions and benefits available to a participant through a qualified plan. This limit is found in IRC Sec. 415 and is commonly referred to as the Section 415 limit. It must be satisfied as a condition of a plan's qualified status. The Section 415 limit is separate from, but integrated with, the limit imposed on the amount the employer can contribute to the plan and deduct on its tax return. See Lesson 2 for a discussion of tax deduction limitations that apply to employer contributions.

The Section 415 limit is imposed on each plan participant. The type of plan determines whether the limit is imposed on amounts contributed on behalf of a participant or on benefits payable to a participant. For defined contribution plans, the limitation generally applies to employer and employee contributions and reallocated forfeitures (all referred to as *annual additions*). (The annual additions also include allocations to individual medical accounts and certain allocations of postretirement medical benefits to key employees, but these items are rarely seen in small employer plans and are not discussed here.) This is because defined contribution plans maintain separate accounts for each participant and allocate contributions to these accounts. For defined benefit plans, benefits are limited since employer contributions are not allocated to individual participants.

Qualified plan documents must contain provisions that preclude exceeding the Section 415 limits. Defined benefit plans must include provisions that automatically freeze or reduce the rate of benefit accrual to a level necessary to prevent exceeding the limit for any participant. Defined contribution plans should have similar provisions for the annual addition to any participant's account. Benefits provided by mandatory employee contributions are not limited. Voluntary employee contributions under a defined benefit plan are considered to have been made to a defined contribution plan and are subject to the Section 415 limits for that type of plan. Rollovers are not subject to the Section 415 limits.

Plans must comply with the Section 415 limits in operation as well as in plan design. A plan that violates this limit loses its tax-qualified status. As a result, (a) earnings become taxable, (b) the value of contributions made on behalf of the participant after the disqualification become taxable as vesting occurs, and (c) the employer's deduction for contributions is no longer determined under the rules relating to qualified plans. Instead, if the plan is a defined contribution plan, the employer's deduction coincides with the amounts and timing of the participants' inclusion in income. If the plan is a defined benefit plan, the employer's deduction may be permanently lost. However, in some circumstances, a failure to satisfy the Section 415 limits in a defined contribution plan can be self-corrected with a pre-specified correction method under the IRS program, EPCRS, to avoid disqualification. A submission under that program can mitigate the consequences of disqualification for defined benefit plans. Thus, it is important that the plan be appropriately monitored for compliance with the Section 415 limit each year.

COMPLIANCE WITH THE SECTION 415 LIMITS

The Section 415 limits apply to qualified defined benefit and defined contribution plans, including one-participant plans and church plans, whether or not they are electing plans under IRC Sec. 410(d). SIMPLE IRA plans are not subject to the Section 415 limits.

The limit does not apply to nonqualified retirement plans. Thus, many employers maintain supplementary plans for employees whose benefits under qualified plans are limited by IRC Sec. 415. These supplementary plans are sometimes referred to as *excess benefit plans*. Excess benefit plans provide benefits only to the extent that Section 415 limits apply—that is, they provide benefits that the employee would have received from the qualified plan

without the Section 415 limits. The employer may also maintain a plan for executives that provides benefits not necessarily related to Section 415 limits, such as nonqualified deferred compensation arrangements. These plans are usually known as supplemental executive retirement plans (SERPs), or *top hat* plans. Neither excess benefit plans nor SERPs qualify for the tax treatment that applies to contributions to and distributions from qualified plans.

The Section 415 limitations apply to all contributions (both employer and employee) made to a tax-qualified defined contribution plan, whether they are made in cash or property (i.e., noncash contributions). However, rollovers are not subject to the Section 415 limits, nor are catch-up contributions.

APPLYING THE SECTION 415 LIMITATIONS BY COMBINING AND AGGREGATING PLANS

The Section 415 limits apply to the benefits an employee receives under plans maintained by a single employer. For this purpose, the *employer* is defined the same as for purposes of the nondiscrimination rules.

The term *single employer* includes all businesses under common control, whether such businesses are corporations, partnerships, or sole proprietorships. However, for parent-subsidiary controlled groups, instead of the "at least 80%" controlling interest test that applies for the nondiscrimination rules, the controlling interest test for IRC Sec. 415 is "more than 50%." A second type of controlled group exists where the same person or persons own at least 80% of each of two corporations. This type of controlled group is referred to as a brother-sister group. For purposes of the Section 415 limit a controlling interest in a brother-sister group is defined as "at least 80%." Furthermore, in applying the Section 415 limits, a plan maintained by an organization that is a member of an affiliated service group, as determined under IRC Sec. 414(m), is aggregated with the plans maintained by other employers (and entities related to these employers) in the group.

Example 1-1: Combining plans for commonly owned businesses.

Mr. Big owns 85% of Diamonds Co., a retailer, and participates in its profit-sharing plan. Unrelated parties own the balance of Diamonds. He also serves on the boards of directors for several other unrelated companies and receives director's fees for these services as a self-employed individual. He has set up a profit-sharing Keogh plan as a self-employed individual to which he makes contributions based on these fees. In testing Mr. Big's Section 415 limits, Mr. Big's Keogh plan and Diamonds' profit-sharing plan must be combined, since he owns "more than 50%" of Diamonds and controls his trade or business of serving as a corporate director.

Section 415 Limit for Self-employed with Multiple Trades or Businesses

When a self-employed individual maintains more than one trade or business, the question arises as to whether the limit is based on the sum of earned income or loss from all trades or businesses under common control, or if only the trade or business maintaining the plan being tested is used. For purposes of the Section 415 limit, earned income for the self-employed individual is believed to be based on the earned income from the trade or business of the employer that maintains the qualified plan. However, IRS officials have informally taken a different standpoint on how to calculate compensation for Section 415 purposes for self-employed individuals with multiple trades or businesses.

Plans Maintained by Unrelated Companies Are Not Aggregated

Benefits available to an employee from a plan maintained by a separate, unrelated employer are not included in calculating the Section 415 limits. Thus, an individual participating in two defined contribution plans maintained by two unrelated employers could receive an allocation of up to the lesser of 100% of compensation earned or $49,000 under each plan for 2010. However, benefits provided by two unrelated employers under the same multiemployer plan must be combined (i.e., the plan limit is $49,000).

Example 1-2: Plans maintained by unrelated companies are not aggregated.

Ann works for General Keys, where she participates in the company's 401(k) plan. General Keys allows employees to acquire company stock through an employee stock option plan, and Ann has purchased stock

by exercising these options. She currently owns 5% of General Keys' outstanding shares. She also operates a bookkeeping business as a sole proprietor, and has set up a profit-sharing plan to which she makes contributions based on earnings from this activity. General Keys and the sole proprietorship are not an affiliated service group under IRC Sec. 414(m). In testing Ann's Section 415 limits, the two plans are not aggregated, since Ann does not own more than 50% of General Keys.

Note: The "at least 80%" ownership test for aggregating commonly controlled employers is replaced with a "more than 50%" test for use in applying the Section 415 limits.

Aggregating Similar Plans

For Section 415 purposes, all defined benefit plans ever maintained by an employer are considered to be a single plan. Similarly, all defined contribution plans ever maintained by an employer are considered as a single plan.

Example 1-3: Aggregating similar plans.

Lorrie works for Christmas Company, where she participates in a money purchase pension plan. Christmas has recently adopted a 401(k) plan as well, and Lorrie is now making salary reduction contributions to this plan. Since the money purchase pension plan and the 401(k) plan are both defined contribution plans, Christmas must aggregate them as a single plan when testing Lorrie's Section 415 limits.

A 403(b) plan is regarded as an individual account plan and treated as a defined contribution plan for Section 415 limits; therefore, aggregation will be required for an employer with multiple 403(b) contracts on one employee. In this case, all contracts, including those obtained through salary reduction contributions, will be aggregated as one plan to meet the individual's annual addition limit of $49,000 for 2010.

Combining a 403(b) Arrangement with a Qualified Plan

An employer making contributions on behalf of an employee to both a 403(b) plan and a qualified plan will generally not be required to aggregate the plans to meet Section 415 limits. The annual addition limit is applied to 403(b) plans as if the employee, and not the employer maintains the plan, this means the Section 415 limits will be applied separately to the qualified plan, with no regard to 403(b) contributions.

Example 1-4: Plan not required to be aggregated.

Dr. Sue works at Grey Hospital where she participates in both the 403(b) plan and profit-sharing plan for the limitation year. Last year Sue contributed $16,500 to the 403(b) plan, and the hospital matched $4,000. She also received a profit-sharing allocation from the hospital in the amount of $47,000. Though Dr. Sue's total allocations for the year are $69,500, she has not exceeded the Section 415 limits because the $49,000 contributed to the profit-sharing plan is considered the hospital's plan while the contribution of $20,500 to the 403(b) is considered as made to Sue's own plan.

If the participant *controls* an employer, aggregation of a 403(b) plan with all defined contribution plans maintained by the controlled employer, for the participant, will be required. Aggregation is required in this situation because the 403(b) plan is considered maintained by the employer, as opposed to the participant. A participant is considered *in control* of the employer if a plan maintained by that employer would have to be aggregated with a plan maintained by an employer that is 100% owned by the participant. For example, if a participant owns 60% of the common stock of a corporation, the participant is considered to be in control of that employer. This rule applies regardless of whether the controlled employer is the employer who maintains the 403(b) plan. If a 403(b) plan is aggregated with a qualified plan of a controlled employer, the plans must satisfy the limitations of Section 415(c) both separately and on an aggregate basis.

Example 1-5: Combining a 403(b) arrangement with a plan maintained by a company owned by the participant.

Belle is employed by a tax-exempt foundation that purchases a 403(b) annuity contract on her behalf for the limitation year. She also owns 100% of Bee Design, a service corporation that maintains a defined contribution plan in which Belle is a participant. Bee Design, as well as Belle, is considered to maintain the 403(b) contract. Therefore, the sum of annual additions to the defined contribution plan and 403(b) contract must, in the aggregate, meet the Section 415(c) limit on contributions.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which Internal Revenue Code (IRC) limit applies only to highly compensated participants?

    a. The limit on annual additions.

    b. The limit on pension benefits.

    c. The limit on 401(m) matching contributions.

    d. The limit on catch-up contributions.

2. The Bright Way Company's 401(k) plan failed to comply with the Section 415 limits in operation and, as a result, loses its tax-qualified status. Which of the following consequences will Bright Way face?

    a. The value of contributions made on behalf of participants becomes immediately taxable.

    b. Earnings become taxable.

    c. Bright Way's deduction is determined under the rules for qualified plans.

    d. Bright Way's deduction is permanently lost.

3. Hatfeld Enterprises maintains a qualified retirement plan for its employees. This plan is subject to the Section 415 limits. The company would like to provide all of its employees with the option of additional benefits. Establishing which of the following plans would help Hatfeld Enterprises meet this goal?

    a. An excess benefit plan.

    b. A top hat plan.

    c. A SIMPLE 401(k) plan.

4. In which of the following scenarios would the plans **not** be aggregated to test for the Section 415 limits?

    a. Lauren participates in a pension plan provided by Western Information and a stock ownership plan provided by Jamison, Inc. Western Information and Jamison, Inc. are unrelated employers. Lauren owns less than 1% of Jamison's outstanding shares.

    b. Adam receives benefits from the 403(b) plan maintained by the Sampson Academy and also participates in a plan maintained by the Dynamic Borders Company. Adam owns 57% of Dynamic Borders.

    c. Carole works as a bookkeeper for both Perfect Smiles and DeWalt & Macomb. She receives benefits from both employers. Perfect Smiles and DeWalt & Macomb both participate in the same multiemployer plan.

    d. Don works for Daysmith LLC and participates in its money purchase pension plan. The money purchase plan was scheduled for termination in 2011, and a 401(k) plan was established. In 2009, Don participated in both plans.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which Internal Revenue Code (IRC) limit applies only to highly compensated participants? **(Page 119)**

   a. The limit on annual additions. [This answer is incorrect. This limit applies to all participants, and it is found in IRC Sec. 415(c).]

   b. The limit on pension benefits. [This answer is incorrect. Information on this limit is found in IRC. Sec. 415(b), and the limit applies to all participants.]

   c. The limit on 401(m) matching contributions. [This answer is correct. This limit applies to highly compensated participants, as does the limit on 401(k) deferrals.]

   d. The limit on catch-up contributions. [This answer is incorrect. Catch-up contributions are covered by IRC Sec. 414(v), and the limit applies to all eligible participants. Individuals who are age 50 or older by the end of the calendar year are allowed to make catch-up contributions.]

2. The Bright Way Company's 401(k) plan failed to comply with the Section 415 limits in operation and, as a result, loses its tax-qualified status. Which of the following consequences will Bright Way face? **(Page 121)**

   a. The value of contributions made on behalf of participants becomes immediately taxable. [This answer is incorrect. The value of such contributions made after Bright Way's disqualification will become taxable as vesting occurs.]

   b. Earnings become taxable. [This answer is correct. Upon losing its tax-qualified status, earnings from Bright Way's 401(k) plan become taxable. This would happen whether Bright Way lost its qualified status because of a Section 415 limit violation in operation or in plan design. In limited circumstances, plans could find relief from harsh consequences such as this in the regulations.]

   c. Bright Way's deduction is determined under the rules for qualified plans. [This answer is incorrect. Bright Way's plan is a defined contribution plan; therefore, after its disqualification, the employer's deduction will coincide with the timing and amounts of participants' inclusion in income.]

   d. Bright Way's deduction is permanently lost. [This answer is incorrect. If Bright Way's employee benefit plan was a defined benefit plan, its deduction might be permanently lost under these circumstances; however, since Bright Way has a defined contribution plan, other measures will apply to the deduction.]

3. Hatfeld Enterprises maintains a qualified retirement plan for its employees. This plan is subject to the Section 415 limits. The company would like to provide all of its employees with the option of additional benefits. Establishing which of the following plans would help Hatfeld Enterprises meet this goal? **(Page 121)**

   a. An excess benefit plan. [This answer is correct. This type of nonqualified supplementary plan would not be subject to the Section 415 limits, and it would provide additional benefits that the employees would have received from the qualified retirement plan without the Section 415 limits. This plan would not qualify for the special tax treatment on contributions and distributions that apply to qualified plans.]

   b. A top hat plan. [This answer is incorrect. A top hat plan (otherwise known as a supplemental executive retirement plan or SERP) provides benefits that are not necessarily related to Section 415 limits (e.g., nonqualified deferred compensation arrangements). Top hat plans apply to executives and, thus, would not help Hatfeld meet its goal of providing the option of more benefits to all employees.]

   c. A SIMPLE 401(k) plan. [This answer is incorrect. SIMPLE 401(k) plans are subject to the Section 415 limits and other qualified plan rules (with the exception of top heavy rules). Because of this, a SIMPLE 401(k) would not meet Hatfeld Enterprises' needs in this scenario.]

4. In which of the following scenarios would the plans **not** be aggregated to test for the Section 415 limits? **(Page 122)**

   a. **Lauren participates in a pension plan provided by Western Information and a stock ownership plan provided by Jamison, Inc. Western Information and Jamison, Inc. are unrelated employers. Lauren owns less than 1% of Jamison's outstanding shares. [This answer is correct. If an employee earns benefits from separate, unrelated employers, the plans are not aggregated for calculating the Section 415 limits. In this scenario, Lauren could receive a benefit of up to $49,000 from each employer in 2010.]**

   b. Adam receives benefits from the 403(b) plan maintained by the Sampson Academy and also participates in a plan maintained by the Dynamic Borders Company. Adam owns 57% of Dynamic Borders. [This answer is incorrect. If an individual earns benefits from a 403(b) plan and also participates in a plan maintained by a company that the individual owns more than 50% of, aggregation of the plans is required. In this scenario, Adam, not his employer, is sponsoring the arrangement.]

   c. Carole works as a bookkeeper for both Perfect Smiles and DeWalt & Macomb. She receives benefits from both employers. Perfect Smiles and DeWalt & Macomb both participate in the same multiemployer plan. [This answer is incorrect. Benefits provided by two unrelated employers that both participate in the same multiemployer plan must be aggregated. In this scenario, Carole could receive a combined total of $49,000 in 2010.]

   d. Don works for Daysmith LLC and participates in its money purchase pension plan. The money purchase plan was scheduled for termination in 2011, and a 401(k) plan was established. In 2010, Don participated in both plans. [This answer is incorrect. All defined benefit plans ever maintained by an employer are considered a single plan, and the same is true for all defined contribution plans maintained by an employer. Since both of Don's plans are defined contribution plans, Daysmith must aggregate them as a single plan when testing the Section 415 limits.]

THE LIMITATION YEAR FOR APPLYING CONTRIBUTION AND BENEFIT LIMITS

The limits on contributions and benefits apply to a *limitation year*. The limitation year is a calendar year, unless the employer elects to use any other consecutive 12-month period. This election is frequently made by defining the limitation year in the plan document itself. However, the election may also be made by adopting a written resolution. The limitation year is distinguished from both the plan year and the employer's taxable year, even if any of these annual periods coincide.

Limitation Year for the Plan's First Year

A plan's first limitation year would normally be a 12-month period, even if the plan year consists of fewer than 12 months. The start of the limitation year can precede the plan's effective date, thus allowing a full 12-month period for the first limitation year.

Example 1-6: Limitation year for short plan year.

Carver, Inc. adopts a calendar year profit-sharing plan effective July 1, 2010. The plan document specifies the limitation year as the calendar year.

What is the plan's limitation year? The plan's limitation year begins January 1, 2010, and ends December 31, 2010, even though the plan itself has a short first year of July 1, 2010–December 31, 2010.

Changing the Limitation Year

The employer may change a limitation year by adopting a written resolution. The Section 415 limits are applied separately to the short limitation year (created by the change) and the new limitation year. Accordingly, the dollar limit applicable to defined contribution plans must be prorated for the short period.

Example 1-7: Changing the limitation year to a fiscal year.

In 2010, an employer with a qualified defined contribution plan using the calendar year as the limitation year elects to change the limitation year to a period beginning July 1 and ending June 30. The plan must satisfy the Section 415 limits for the period beginning January 1, 2010, and ending June 30, 2010. In applying the Section 415 limit for the short period, the amount of employee compensation may only include compensation paid during this period. Furthermore, the dollar limitation of $49,000 for 2010 must be multiplied by $^{6}/_{12}$ to equal a limit of $24,500 for the short period ending June 30, 2010.

A short limitation period normally does not affect the dollar limit under a defined benefit plan. This is because a particular year's contribution to a defined benefit plan is not a factor in computing the plan's limit for the pension payable to any plan participant.

Under the final Section 415 regulations, if a defined contribution plan is terminated effective as of a date other than the last day of the plan's limitation year, the plan is treated as if an amendment has been adopted to change the limitation year to the period ending on the plan termination date.

The limitation year is not the same as the plan year. A change in the plan year can affect many operational issues such as eligibility, the limitation year, and the contribution allocation. If the purpose of changing the *plan* year is to use payroll tax records to determine eligibility and contribution amounts but the *limitation* year is unchanged, the plan year change has not served the intended purpose. The limitation year (not the plan year) is used to determine whether the limitation on annual additions under IRC Sec. 415 have been exceeded.

DETERMINING COMPENSATION TO APPLY THE SECTION 415 LIMITS

Compensation for purposes of applying the limitations on contributions and benefits [Section 415(c)(3) compensation] is a complicated term at best. It is defined by the regulations under IRC Sec. 415. Basically, an employer may

choose one of three safe harbor methods of defining compensation. However, self-employed participants may only define compensation by using the *default definition* in *item c*. Section 403(b) plans must use a unique definition of *compensation*.

Following are the three safe harbor definitions of compensation for Section 415 purposes:

a. *Taxable Wages.* The plan may define compensation as taxable wages that must be reported under IRC Secs. 6041, 6051, and 6052. However, wages are 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 [such as the exception for agricultural labor in IRC Sec. 3401(a)(2)]. Also, wages must be grossed up to include salary reduction contributions to 401(k) plans, 403(b) plans, SARSEPs, SIMPLE IRA plans, cafeteria plans, and 457(b) plans. Wages also include elective salary reductions for qualified transportation benefits. This definition generally conforms to box 1 on Form W-2 plus the described salary reduction contributions, and is also referred to as the *W-2 definition* of compensation.

b. *Federal Income Tax Withholding (FITW) Wages.* The plan may define compensation as wages subject to federal income tax withholding as defined in IRC Sec. 3401(a). However, wages are 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 [such as the exception for agricultural labor in IRC Sec. 3401(a)(2)]. Also, wages must be grossed up to include salary reduction contributions to 401(k) plans, 403(b) plans, SIMPLE IRA plans, cafeteria plans, 457(b) plans, and SARSEPs. Wages also include elective salary reductions for qualified transportation benefits.

c. *Default Definition.* If the plan does not define compensation using items a. or b. above, compensation is defined by Reg. 1.415(c)-2(a).

    (1) Under this definition, compensation includes the following:

        (a) Remuneration for personal services, including wages, salaries, fees, commissions, tips, bonuses, and taxable fringe benefits. This includes foreign earned income as defined in IRC Sec. 911(b).

        (b) The earned income of a self-employed participant. This includes foreign earned income as defined in IRC Sec. 911(b). Earned income of a self-employed participant consists of the sum of earned income or loss from all trades or businesses under common control pursuant to Reg. 1.415-2(d)(6). The personal services of the participant must be a material income-producing factor. Further, the net income is determined after deducting contributions to the plan and after deducting half of the self-employment taxes attributed to the earned income. See Example 1-12 for the effect of these deductions on calculating the Section 415 limitations.

        (c) Income included in the employee's gross income for amounts received under accident and health plans and as compensation for injuries or sickness.

        (d) Amounts paid or reimbursed by the employer for moving expenses to the extent that, at the time of payment, it is unreasonable to believe the amounts are deductible by the employee (under IRC Sec. 217).

        (e) Income included in the employee's gross income for the value of a nonqualified stock option in the taxable year when it is granted.

        (f) Income includable under an IRC Sec. 83(b) election (i.e., an election to recognize income that would otherwise be deferred under a nonqualified deferred compensation arrangement) (whether or not the contributions are excludable from the employee's gross income).

        (g) Salary reduction contributions to 401(k) plans, 403(b) plans, SARSEPs, SIMPLE IRA plans, cafeteria plans, and 457(b) plans. Compensation for IRC Sec. 415 purposes also includes elective salary reductions for qualified transportation benefits.

(h) The final Section 415 regulations provide for certain post-severance payments to be included in compensation. Post-severance payments must be made by the later of 2½ months after the severance from employment or by the end of the limitation year that includes the date of severance from employment. Payments for vacation and sick leave and other leave that are paid within this time frame are not included in compensation for plan purposes unless the plan specifically includes the payments. The inclusion of compensation paid after severance is elective. Payments made prior to severance from employment which are regular compensation for services and that would have been paid to the employee prior to a severance from employment if the employment had continued must be included in compensation.

(2) However, compensation does not include the following:

(a) Amounts realized from the exercise of a nonqualified stock option.

(b) Amounts realized from the disqualifying disposition of stock acquired from the exercise of an incentive stock option.

(c) Amounts realized when a substantial risk of forfeiture lapses under IRC Sec. 83.

(d) Premiums for group term life insurance not included in income under IRC Sec. 79 (but only to the extent the premiums are not includable in the gross income of the employee).

(e) Distributions from a *funded* deferred compensation plan (whether qualified or nonqualified) are excluded for IRC Sec. 415 purposes, even though they are included in the employee's income. (An amount received by an employee from an *unfunded* nonqualified plan may be considered as compensation for Section 415 purposes if specifically included in the plan's definition of compensation.)

(f) Contributions made by an employer towards the purchase of an annuity contract described in IRC Sec. 403(b) (whether or not the contributions are excludable from the employee's gross income).

Including Accrued Compensation

The compensation actually paid or made available to a participant within the limitation year is that used to apply the Section 415 limits. Accrued compensation generally may not be considered. However, an employer may include *de minimis* amounts of accrued compensation earned during the limitation year but not paid because of the timing of pay periods and pay days, as long as the amounts are paid during the first few weeks of the next limitation year. This *de minimis* accrual must be uniformly and consistently included in Section 415 testing for all similarly situated employees, and none of the amounts can be included in more than one limitation period.

Including Post-severance Compensation

In general, severance pay, parachute payments under IRC Sec. 280G, and most unfunded nonqualified deferred compensation payments received following a severance from employment are not Section 415(c)(3) compensation. However, compensation for purposes of determining the Section 415 limit does include post-severance compensation if it is considered regular pay and is paid within 2½ months after the employee's separation from service or by the end of the limitation year that includes the date of severance from employment. *Regular post-severance pay* is payments that are regular compensation for services during the employee's workday (including overtime, commissions, and bonuses) and payments that would have been paid to the employee if he or she had continued employment with the employer maintaining the plan.

The regulations provide for a plan to include other types of post-severance payments, such as accrued leave cash-outs and certain deferred compensation, in the plan's definition of Section 415(c)(3) compensation. A play may, but is not required to, contain a definition of compensation that includes payments for unused bona fide sick, vacation, or other accrued leave if paid within 2½ months of severance or by the end of the limitation year that includes the date of severance. The leave-related severance payments can be included in compensation only if the participant could have used the leave had employment continued.

Including Differential Wage Payments

For tax years beginning in 2009, differential wage payments are treated as compensation for purposes of applying the Code, including IRC Sec. 415(c)(3) and Reg. 1.415-2(d), as added by the Heroes Earnings Assistance and Relief Tax Act of 2008 (Heroes Act). Any plan contributions and benefits provided are not required to, but may be based on differential wage payments received by the employee. An eligible employee may also make elective deferrals on the differential wages, and the employer will need to offer matching contributions and/or non-elective contributions, if applicable. Such payments are not required to be included in nondiscrimination testing. The employer must ensure any differential wage payments are made on a nondiscriminatory basis.

The Code defines *differential wage payment* as any payment that (a) is made by an employer to an individual for any period during which the individual is in the uniformed services while on active duty for a period of more than 30 days, and (b) represents all or a portion of the wages the individual would have received from the employer if the individual were performing service for the employer. Any individual receiving a differential wage payment is treated as an employee of the employer making the payment.

Employees with Less Than a Full Year of Participation

The plan must include the employee's compensation for the entire limitation year regardless of when during the year the employee begins participation.

Is Compensation Limited?

For limitation years beginning on or after July 1, 2007, Section 415 compensation is limited to the amount in effect under IRC Sec. 401(a)(17) ($245,000 for 2010).

Compensation for limitation years beginning prior to July 1, 2007, considered under IRC Sec. 415 was not limited by IRC Sec. 401(a)(17). This means there was no dollar limit on the amount of *compensation* used for IRC Sec. 415 tests.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Sunrise Productions must establish a limitation year for testing limits on contributions and benefits from its employee benefit plan. Which of the following most accurately reflects how Sunrise Productions should proceed?

   a. The limitation year must match the plan year.

   b. The limitation year must match Sunrise Productions' taxable year.

   c. The limitation year will always be the calendar year.

   d. The limitation year can be any consecutive 12-month period.

6. Janice is self-employed and has established a retirement plan. Janice earns foreign income as defined in IRC Sec. 911(b). Which of the following three methods must Janice's plan use to determine her compensation for the purposes of calculating plan contribution limitations?

   a. Taxable wages.

   b. Federal Income Tax Withholding (FITW) wages.

   c. The Reg. 1.415(c)-2(a) definition.

7. In which of the scenarios below has compensation been correctly attributed for application of the Section 415 limit?

   a. Holly's compensation is calculated based on amounts she has already been paid, as well as a significant amount of accrued compensation.

   b. Jake joined his employer's benefit plan in June 2010. Because the plan's limitation year is the calendar year, only compensation he earned from June to December of 2010 is included.

   c. Darrel's compensation is limited by IRC Sec. 401(a)(17) to $245,000 in 2010 for use in determining the Section 415 limit.

   d. Sam's employer includes a *de minimis* amount of accrued compensation earned in 2010 but paid in the first week of 2011.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Sunrise Productions must establish a limitation year for testing limits on contributions and benefits from its employee benefit plan. Which of the following most accurately reflects how Sunrise Productions should proceed? **(Page 128)**

   a. The limitation year must match the plan year. [This answer is incorrect. The limitation year must be distinguished from the plan year, even if the annual periods coincide; therefore, the limitation year is not required to match the plan year.]

   b. The limitation year must match Sunrise Productions' taxable year. [This answer is incorrect. The employer's taxable year, though it might coincide with the limitation year, is distinguished from the limitation year. Thus, Sunrise Productions' taxable year and the limitation year of its employee benefit plan are not required to match.]

   c. The limitation year will always be the calendar year. [This answer is incorrect. As a default, the limitation year will be the calendar year; however, it is not required that this always be the case.]

   d. The limitation year can be any consecutive 12-month period. [This answer is correct. Sunrise Productions can elect to use any consecutive 12-month period instead of the calendar year as its plan's limitation year. The election can be made by adopting a written resolution or defining the limitation year in the plan document.]

6. Janice is self-employed and has established a retirement plan. Janice earns foreign income as defined in IRC Sec. 911(b). Which of the following three methods must Janice's plan use to determine her compensation for the purposes of calculating plan contribution limitations? **(Page 128)**

   a. Taxable wages. [This answer is incorrect. Plans can define compensation as the taxable wages reported under IRC Secs. 6041, 6051, and 6052; however, this is not an option for a self-employed individual.]

   b. Federal Income Tax Withholding (FITW) wages. [This answer is incorrect. Self-employed individuals, such as Janice, do not have this option, which would define compensation as wages subject to federal income tax withholding as defined in IRC Sec. 3401(a).]

   c. The Reg. 1.415(c)-2(a) definition. [This answer is correct. All self-employed participants and any plan that does not define compensation in one of the other two ways must use this definition of compensation. Included under this definition is remuneration for personal services such as wages, salaries, fees, commissions, tips, bonuses, and taxable fringe benefits. Foreign earned income, as defined in IRC Sec. 911(b), is also included, among other things.]

7. In which of the scenarios below has compensation been correctly attributed for application of the Section 415 limit? **(Page 130)**

   a. Holly's compensation is calculated based on amounts she has already been paid, as well as a significant amount of accrued compensation. [This answer is incorrect. Generally, for purposes of the Section 415 limit, accrued compensation is not considered.]

   b. Jake joined his employer's benefit plan in June 2010. Because the plan's limitation year is the calendar year, only compensation he earned from June to December of 2010 is included. [This answer is incorrect. Though Jake has less than a full year of participation in the plan at the end of 2010, his compensation for the entire calendar-year limitation year must be included for purposes of the Section 415 limit.]

   c. Darrel's compensation is limited by IRC Sec. 401(a)(17) to $245,000 in 2010 for use in determining the Section 415 limit. [This answer is incorrect. There is no dollar limit on the amount of compensation used for testing the Section 415 limits; therefore, the IRC Sec. 401(a)(17) limits would not apply to Darrel's compensation.]

   d. Sam's employer includes a *de minimis* amount of accrued compensation earned in 2010 but paid in the first week of 2011. [This answer is correct. If the amount of accrued compensation is not significant and is not paid during the limitation year because of the timing of the pay period, it can be included in compensation if it is paid during the first few weeks of the next year. *De minimis* accrual must be dealt with on a uniform basis for all similarly situated employees.]

DEFINED BENEFIT PLANS AND THE SECTION 415 LIMIT

This section of the lesson discusses Section 415 limits as they pertain to a defined benefit plan. In addition to the guidance presented here, the practitioner may need to consult the plan's actuary to confirm that the limits have not been exceeded. The consequences of exceeding the IRC Sec. 415 limit for a defined benefit plan are discussed in the next section, along with a discussion of corrective measures.

IRC Sec. 415(b) limits the amount of the plan benefit to which a participant in a defined benefit plan is entitled. The indirect impact of the benefit limit is that the employer's deductions for contributions to the plan are also limited. The benefit limit prescribed applies to a benefit payable as either a straight-life annuity or a qualified joint and survivor annuity. If the plan benefit is not payable in the form of a straight-life annuity or a qualified joint and survivor annuity, the benefit is adjusted to the actuarial equivalent of a straight-life annuity for the purpose of applying the limits. Examples of benefits not in the form of a straight-life annuity or a qualified joint and survivor annuity are an annuity that includes a postretirement death benefit, an annuity providing for a guaranteed number of payments, or a lump sum. Because of the nature of a defined benefit plan, the limit is usually calculated by an actuary.

The following paragraphs discuss the general principles that apply to the defined benefit limit.

Defined Benefit Limit

The value of the participant's accrued straight-life annuity benefit may not, during the limitation year, exceed the lesser of either of the following (subject to adjustments as described in later paragraphs):

a. *Dollar Limit:* $195,000 for 2010 (adjusted annually in increments of $5,000 for cost-of-living increases prescribed by the IRS for the calendar year in which the limitation year ends).

b. *Compensation Limit:* 100% of the participant's average compensation for the highest three years. Compensation for this purpose is limited by IRC Sec. 401(a)(17) in effect for the high three years. This period must be the three consecutive years with the employer during which the participant had the greatest aggregate compensation. The three years need not be years during which the employee participated in the plan, or even years during which the employer maintained the plan. Further, the plan may use any 12-month period in making this determination, provided it is applied uniformly and consistently. Government and multi-employer defined benefit plans are exempt from the 100% of compensation limit. Also, multi-employer plans cannot be aggregated with single employer plans for purposes of satisfying the 100% of compensation limit.

Dollar Limit for Fiscal Limitation Years

The adjusted dollar limit ($195,000 for 2010) is effective as of January 1 of each calendar year and is applicable to limitation years that end during that calendar year. Note that the limitation year is not necessarily the same as the plan year.

Example 1-8: Determining the applicable adjusted dollar limit for a fiscal limitation year.

Zero Maintenance Corporation maintains a defined benefit plan with a fiscal limitation year ending in June.

What is the plan's adjusted dollar limit for its limitation year ending June 30, 2010?

The plan's adjusted dollar limit for its limitation year ending June 30, 2010 is $195,000, the adjusted dollar limit for the calendar year in which the limitation year ends.

General Rules for Calculating the Section 415 Limit

The Section 415 limitation is tested by comparing the limitation (the dollar or the compensation limit) as a life annuity against the distributable benefit also expressed as a life annuity. The compensation limit is 100% of the highest three year average of compensation determined as of the time of the distributable event. The dollar limit is

a life annuity at the Social Security retirement age. The dollar limit is reduced when benefits begin prior to age 62. The dollar limit is increased when benefits begin after age 65. No adjustment is required when a participant's benefit begins after age 62 and not later than age 65. These adjustments are discussed in Rev. Rul. 2001-51.

The determination of age-adjusted dollar limitations under the final regulations reflect the rules enacted in EGTRRA. The determination generally follows the same steps and procedures as those used in Rev. Rul. 98-1, except that the determination takes into account the increased defined benefit dollar limitation enacted by EGTRRA, and the adjustments for early or late commencement are no longer based on social security retirement age. The regulations apply rules similar to those that are used for determining actuarial equivalents among forms of benefits, generally using a plan's determinations for actuarial equivalents of early or late retirement benefits, but overriding those determinations where the use of the specified statutory assumptions result in a lower limit.

For a distribution with an annuity starting date after the participant attains age 65, the age-adjusted dollar limit is generally actuarial increased to equal an annual benefit that has the same actuarial present value as a straight-life annuity commencing at age 65, where annual payments under the straight-life annuity at 65 are equal to the dollar limit of IRC Sec. 415(b)(1)(A).

Some of the refinements that apply to the defined benefit limit are as follows:

a. *Annual Benefits Not Exceeding $10,000.* Annual benefits not exceeding $10,000 satisfy the Section 415 limit unless the employee has also participated in a defined contribution plan maintained by the same employer. The exception is available without regard to the form of distribution, as long as the annual benefit payable to the participant under all defined benefit plans maintained by the employer does not exceed $10,000.

b. *Less Than 10 Years of Service with the Employer.* The compensation limit and the $10,000 minimum-benefits limit are proportionately reduced for an employee with less than 10 years of service with the employer. The dollar limit of benefits pertaining to an employee with less than 10 years of plan participation is also limited under Item c.

c. *Less Than 10 Years of Plan Participation.* The dollar limit assumes that the employee has at least 10 years of participation in the plan. For an employee with less time, the dollar limit is reduced proportionately. This rule was intended to prevent an employer from deducting large amounts contributed to a recently adopted defined benefit plan that provided generous benefits for executives scheduled to retire in a few years. Grandfather rules protect benefits accrued prior to the effective date of TRA '86 changes to the Section 415 limitations.

d. *Grandfather Rules.* The Section 415 limits came into existence with ERISA in 1974. In general, those limits were reduced in 1983 by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and in 1987 by the Tax Reform Act of 1986 (TRA '86). These acts preserved the accrued benefit as of the close of the last limitation year preceding the effective date of the lower limit. The preserved accrued benefit, if larger, replaces the current Section 415 limit. For specifics refer to TEFRA, Act Sec. 235(g)(4) and TRA '86, Act Sec. 1106(i)(3). Also see IRS Notices 83-10 (as modified by IRS Notice 99-44) and 87-21.

e. *Section 401(a)(17) Application Changed.* The 2007 regulations under IRC Sec. 415 changed the rule with respect to the application of the IRC Sec. 401(a)(17) compensation cap ($245,000 for 2010). For limitation years ending prior to July 1, 2007, Section 415 compensation is not limited to the amount under IRC Sec. 401(a)(17), but for limitation years beginning on or after July 1, 2007, Section 415 compensation is required to take into account the Section 401(a)(17) cap and may not reflect compensation for a plan year that is in excess of the dollar limitation under IRC Sec. 401(a)(17).

Example 1-9: Calculating the Section 415 limit for a defined benefit plan.

Herman participates in B&B Corp.'s defined benefit plan, which has a calendar plan year and limitation year. The plan's benefit formula provides a benefit, payable for life at normal retirement (a straight-life annuity), equal to 1.75% of average annual compensation for the highest five consecutive years, multiplied by years of service, but limited to 50% of such average pay. The plan provides that the benefit will not exceed the Section 415 limit. Herman worked for B&B for 37 years, has a Section 415 retirement age of 65 (his normal retirement

age), and participated in the plan more than 10 years. His average pay for the highest five years was $130,000. His average pay for the three highest consecutive years was $145,000. Herman's benefit accrued through the 2010 plan year, to commence at age 65, is calculated as follows:

Benefit under the plan formula:

$130,000 (average pay for highest five years) × 1.75% = $2,275;
$2,275 × 37 years = $84,175;
limited to 50% of $130,000 = $65,000

Benefit limit under IRC Sec. 415:

Lesser of: (a) $195,000 (for 2010); or
(b) $145,000 (average pay for highest three years)

Herman's benefit is the lesser of the benefit provided under the plan's formula ($65,000) or the Section 415 limit ($145,000). Therefore, the annual pension benefit to commence at age 65 will be $65,000, payable monthly for life at a rate of $5,417 per month.

Example 1-10: Reduction of the Section 415 limit for an employee with fewer than 10 years of participation in the plan.

George has participated in Glass Company's defined benefit plan for four years. When calculating George's dollar limit (as of age 65) for the plan's 2010 calendar limitation year, that limit is $195,000 × 4/10, or $78,000.

In this example, the dollar limit at age 65 is currently less than the Section 401(a)(17) compensation limit. For distributions at a later age, the dollar limit, actuarially adjusted, could exceed the Section 401(a)(17) compensation limit. George would then be entitled to the larger benefit amount, provided that compensation used under the plan's pension formula (without regard to the Section 415 limit) did not exceed the Section 401(a)(17) compensation limit.

DEFINED BENEFIT PLANS AND SECTION 415 VIOLATIONS

The defined benefit plan document must include specific language that prevents the plan from accruing an annual benefit that exceeds the Section 415 limits discussed previously. Defined benefit plans also usually contain provisions that automatically freeze or reduce plan benefits to the extent necessary to remain within the Section 415 limits. Also, as a practical matter, the plan administrator uses the services of an enrolled actuary to determine the amount of contributions that must be made to the plan and to ensure such benefit accruals are within the Section 415 limits.

Despite the safeguards mentioned above, if a defined benefit plan violates the Section 415 limits, then it is subject to disqualification.

Alternatives to Plan Disqualification

Defined benefit plans may use the same programs as defined contribution plans to correct the failure without losing the plan's qualified status. These programs are discussed later in this lesson.

DEFINED CONTRIBUTION PLANS AND THE SECTION 415 LIMIT

Section 415 Limits the Annual Addition

Section 415(c) limits the amount of the *annual addition* that may be made to the account of a participant in a defined contribution plan. Before testing for compliance with the Section 415 limit, it is necessary to determine if any catch-up contributions were made for the year. Catch-up contributions are not annual additions for purposes of the Section 415 limit.

The annual addition for the 2010 limitation year cannot exceed the lesser of the following:

a. *Dollar Limit.* $49,000, adjusted annually for cost-of-living increases prescribed by the IRS; or

b. *Compensation Limit.* 100% of the participant's compensation.

What Is Included in the Annual Addition?

The annual addition includes all of the following:

a. Employer contributions. (This term includes employee pretax deferrals.)

b. Employee contributions, including after-tax contributions (except for rollovers, catch-up contributions, payments to buy back forfeited amounts, and loan repayments). (This includes *Designated Roth Account* contributions.)

c. Forfeitures allocated to participants' accounts.

Also treated as annual additions for the Section 415 dollar limit—but not the compensation limit—are (a) employer contributions allocated to an individual medical account as part of a pension or annuity plan; and (b) employer contributions attributable to postretirement medical benefits allocated to a key employee's separate account under a welfare benefit fund. However, as these items are rarely found in small employer plans, they are not discussed further in this course.

Plan earnings are not included in annual additions. Catch-up contributions and certain restorative payments are also not included in annual additions.

Restorative Payments. The IRS has ruled that certain restorative payments made by an employer are not annual additions subject to the limits under IRC Secs. 401(a)(4), 404, and 415. Restorative payments are those made by an employer to restore a plan's losses when the employer is under a reasonable risk of liability for those losses as a result of a fiduciary breach. The employer should specify that the contributions are to be treated as restorative payments. Employer contributions to a plan to make up for market fluctuations or losses that are not due to a reasonable risk of liability for breach of a fiduciary duty are not considered restorative payments and will generally be deemed an annual addition to the plan.

Calculating the Annual Addition

The following examples illustrate the calculation of a participant's annual addition to a defined contribution plan.

Example 1-11: Calculating the allowed annual addition to a participant's defined contribution account.

Bob participates in his employer's profit-sharing and 401(k) plan. His salary was $100,000 during the plan's 2010 limitation year. For 2010, XYZ contributed $6,000 on Bob's behalf. In addition, Bob made salary deferral contributions of $8,000 and after-tax contributions of $1,000. Plan forfeitures allocated to his account were $3,000. Bob's annual Section 415 addition limit is calculated as follows:

Annual addition:	
Employer contributions	$ 6,000
Salary deferral contributions	8,000
Bob's after-tax contributions	1,000
Forfeitures	3,000
Annual addition	$ 18,000

Since the annual addition to Bob's account ($18,000) is less than the lesser of $49,000 or 100% of Bob's annual compensation, the annual addition does not exceed the Section 415 limit for 2010 and, therefore, is properly credited to Bob's account.

Example 1-12: Calculating the allowed annual addition for 2010 to a self-employed person's defined contribution plan.

Jeanette is a self-employed computer consultant (age 35), and this is her only source of earned income or wages. She maintains a profit-sharing plan. Compensation for determining plan benefits is self-employment (SE) income net of both the SE tax deduction and qualified retirement plan deductions. For 2010, her SE income totaled $120,000 (from Schedule C of her Form 1040). This SE income is subject to SE taxes of $16,457.[a] SE income is first reduced by 50% of the tax (i.e., the deductible portion of the tax), leaving a net of $111,771 [$120,000 − (50% × $16,457)]. The net amount of $111,771 must then be reduced by the contribution made to the plan on Jeanette's behalf, as explained below.

What is the maximum annual addition that can be made to Jeanette's account for 2010? Jeanette's Section 415 limit is the lesser of—

1. $49,000, or
2. 100% × $111,771 = $111,771.

Thus, Jeanette's Section 415 limit for 2010 is $49,000. However, for 2010, her Section 415 limit will be greater than her deduction limit. As a practical matter, and to avoid the excise tax for non-deductible contributions, she will want to limit her contribution to the amount she can deduct, which is $22,354 (20% × $111,771).

Note:

[a] Computation of 2010 self-employment tax:

1. Social Security tax portion (OASDI): $106,800 × 12.4% = $13,243
2. Medicare tax portion (HI): ($120,000 × 92.35%) × 2.9% = $3,214
3. Total SE tax: $13,243 + $3,214 = $16,457
4. 1/2 SE tax = $8,229

Special Rule for the Disabled

A special rule applies for a participant who is not a highly compensated employee and who is totally and permanently disabled, as defined in IRC Sec. 22(e)(3). If provided for in the plan, the employer may elect to have the participant's compensation equal the compensation the person would have received for the year if paid at the rate of compensation in effect immediately before becoming disabled. Contributions made for the disabled employee must be nonforfeitable when made. If the plan document provides for the disability exception to apply to all participants for a fixed and determinable period, the exception may be applied to highly compensated employees as well.

When Annual Additions Are Credited

An annual addition is deemed credited to a participant's account for a particular limitation year if it is allocated to the participant's account under the terms of the plan on any date within that limitation year, provided the allocation is not dependent on plan participation after that date.

Employee Contributions. In the case of *employee* contributions, only those contributions actually made to the plan no later than 30 days after the close of the limitation year are credited as an annual addition for that year.

Employer Contributions—General Rule. In the case of employer contributions, this rule includes only those contributions actually made to the plan no later than 30 days after the due date (including extensions) of the employer's income tax return for its tax year with or within which the particular limitation year ends. [However, note that under IRC Sec. 404(a)(6), contributions made after the due date, including extensions, are not deductible for the current tax year.] Exceptions to the 30-day timing limit are discussed later in this lesson.

If the employer is exempt from federal income tax, contributions must be made to the plan no later than the 15th day of the tenth calendar month following the end of the calendar year or fiscal year (depending on the basis on which the employer keeps its books) with or within which the limitation year ends [Reg. 1.415(c)-1(b)(6)(i)(B)]. Therefore, for employer contributions made by a tax-exempt organization, the contribution due date for Section 415 purposes effectively governs when contributions must be made to be credited as an annual addition.

Example 1-13: Crediting annual additions made after the close of the limitation year.

InShape Corporation (a taxable entity) maintains a qualified profit-sharing plan. Its plan year and limitation year are the calendar year. The plan provides that employer contributions are allocated to participants' accounts as of the last day of the plan year. InShape's tax year begins June 1 and ends May 31. The company's income tax return for the year ended May 31, 2010, is due August 17, 2010. The company contributes to the plan on July 31, 2010, and allocates this contribution to participants' accounts as of December 31, 2009. Since the employer contribution is actually made to the plan no later than 30 days after the (extended) due date of InShape's tax return for its year ended May 31, 2010, and allocated to participants' accounts within the 2009 limitation year, the contributions are considered annual additions for the 2009 limitation year.

Example 1-14: Crediting annual additions made within the limitation year.

Assume the same facts as Example 1-13, except that InShape's plan year is a fiscal year beginning on April 1 and ending March 31. Under the terms of the plan, InShape's contribution made July 31, 2010, is allocated to participants' accounts as of March 31, 2010. Because the last day of the plan year is in the 2010 limitation year, which is a calendar year, and because employer contributions are allocated to participants' accounts as of the last day of the plan year, the contributions are considered annual additions for the 2010 calendar limitation year.

Employer Contributions—Special Timing Rules. In the following situations, special rules supersede the general rule described previously to determine the limitation year for which an employer contribution is deemed credited.

a. If, in a particular limitation year, an employer contributes an amount to a participant's account due to an erroneous forfeiture in a prior limitation year, or because of an erroneous failure to allocate amounts (either forfeitures or employer contributions) in a prior limitation year, the contribution is not considered an annual addition for the limitation year when it was made, but is an annual addition for the limitation year to which it relates.

b. For a defined contribution plan, such as a money purchase pension plan, to which the employer makes a contribution to reduce an accumulated funding deficiency under IRC Sec. 412(a), the contribution is considered an annual addition for the limitation year when the contribution was otherwise required to be made. An accumulated funding deficiency is the excess of the total amount that must be contributed under the plan formula over the total amount actually contributed. This rule applies only if the contribution is allocated to those participants who would have received an addition if the contribution had been made timely. Interest included as part of the funding deficiency contribution, if reasonable, is not considered part of the annual addition. Interest in excess of what is considered reasonable is an annual addition for the limitation year when the contribution was otherwise required to have been made. (See Example 1-16.)

Example 1-15: Crediting annual additions due to an error in a previous limitation year.

Nancy participates in Shellco's profit-sharing plan, which has a calendar plan year and limitation year. In 2011, Shellco discovers that it erroneously failed to properly credit an employer contribution to Nancy's account for the 2009 year. In 2011, it allocates an amount to correct this error. The amount is considered an annual addition for the 2009 limitation year. If Shellco also allocates an amount to take into account plan investment gains for 2010 and 2011, the amount attributable to these gains is not considered an annual addition for any limitation year.

Example 1-16: Crediting annual additions made to reduce an accumulated funding deficiency.

Desk Manufacturing maintains a money purchase pension plan. The plan year is a calendar year, as is the limitation year. Desk's tax year is also a calendar year. In 2007, Desk experienced severe cash flow problems, and was unable to make its required contribution to the plan. In 2010, Desk makes a contribution to make up the 2007 deficiency. The contribution is allocated to those persons who were participants on December 31, 2007. The contribution is considered an annual addition for the 2007 limitation year. The reasonable amount of interest included as part of the make-up contribution is not considered part of the annual addition. In addition, Desk will owe an excise tax on the funding deficiency for each plan year until a sufficient contribution is made to eliminate that funding deficiency.

DEFINED CONTRIBUTION PLANS AND SECTION 415 VIOLATIONS

Generally, a plan that has benefit accruals or annual additions exceeding the Section 415 limits loses its favored tax qualified status.

The Section 415 regulations do not contain the mechanisms included in the 1981 final regulations that could be used in certain circumstances to correct excess annual additions. The most commonly used mechanism provided for refunding elective deferrals to correct the excess. The more recent final regulations have eliminated these rules. After the effective date of the regulations, generally January 2008 for calendar-year plans, the excess annual additions must be corrected under the Employee Plans Compliance Resolution System (EPCRS).

Preventing Excess Annual Additions

Many plan documents contain fail-safe provisions to prevent Section 415 violations by automatically reducing allocations to the accounts of participants who would exceed the annual additions limit. The new regulations require that a fail-safe provision must operate without employer discretion to insure that the plan's definitely predefined allocation formula is not compromised.

In limited circumstances, the 1981 regulations offer some relief from the harsh result of plan disqualification by allowing excess annual additions to be corrected. The relief is available only to defined contribution plans and only if the excess annual addition results from one of the following:

a. The allocation of forfeitures.

b. A reasonable error in estimating a participant's annual compensation.

c. A reasonable error in determining the amount of salary deferrals the participant could make to a 401(k) plan within the Section 415 limits.

d. "Other limited facts and circumstances" that justify relief to the IRS's satisfaction.

Excess amounts resulting from any of these circumstances were not annual additions for the limitation year if treated in accordance with any of the alternatives provided by the regulations under IRC Sec. 415. The plan must specify the alternative(s) to be used. In general, the alternatives result in the excess amount being allocated to other participants and/or being held unallocated in a suspense account to be allocated in future years.

Correcting Excess Annual Additions for Plan Years Beginning after 2008

For plan years beginning after 2008, an excess annual addition is corrected under the following methods:

a. *Reduction of Account Balance Correction.* Under this method, the account balance of an employee is reduced by the excess amount (including earnings).

   (1) If the excess allocation would have been allocated to other employees in the year of the failure had the failure not occurred, then that amount (adjusted for earnings) is reallocated to those employees in accordance with the plan's allocation formula.

(2) If the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in a separate account that is not allocated on behalf of any participant or beneficiary established for the purpose of holding excess allocations (adjusted for earnings) to be used to reduce employer contributions (other than elective deferrals) in the current year or succeeding year(s). While such amounts remain in the unallocated account, the employer is not permitted to make contributions to the plan other than elective deferrals.

b. *Distribution of Elective Deferrals and After-tax Contributions.* If an excess allocation resulting from a Section 415 violation consists of annual additions attributable to both employer contributions and elective deferrals or after-tax employee contributions, then the correction of the excess allocation is completed by:

(1) first distributing the unmatched employee's after-tax contributions (adjusted for earnings) and then,

(2) the unmatched employee's elective deferrals (adjusted for earnings).

(3) If any excess remains, and is attributable to either elective deferrals or after-tax employee contributions that are matched, the excess is apportioned first to after-tax employee contributions with the associated matching employer contributions and then to elective deferrals with the associated matching employer contributions.

(4) Any matching contribution or nonelective employer contribution (adjusted for earnings) which constitutes an excess allocation is then forfeited and placed in an unallocated account established for the purpose of holding excess allocations to be used to reduce employer contributions in the current year and succeeding year(s). The unallocated account is adjusted for earnings. While such amounts remain in the unallocated account, the employer is not permitted to make contributions (other than elective deferrals) to the plan.

401(k) Plans and the Section 415 Limits

The plan may also provide for the distribution of employee contributions, whether voluntary or mandatory, and 401(k) elective deferrals that cause an annual addition to exceed the Section 415 limit. Any amounts so distributed are disregarded for purposes of the annual limit under IRC Sec. 402(g) on elective deferrals to a 401(k) plan, the actual deferral percentage test of IRC Sec. 401(k)(3), and the actual contribution percentage test of IRC Sec. 401(m)(2).

IRS Guidance on Corrective Distributions

Rev. Proc. 92-93 and Rev. Proc. 2008-50 provide guidance on reporting a distribution of elective deferrals and the return of employee contributions made to correct excess annual additions.

Treatment of Return of Excess Annual Additions. Excess annual additions may be corrected by distributing employee (after-tax) contributions or pretax elective deferrals. Such distributions are treated as corrective disbursements under Rev. Proc. 92-93. Thus, many of the requirements governing normal plan distributions do not apply to such distributions. The following rules apply:

a. Employee after-tax contributions returned as excess annual additions *are not* includable in gross income nor are they included in the employee's investment in the contract.

b. Employee elective deferrals returned as excess annual additions are includable in income in the year distributed. No part of the distribution may be treated as a return of investment in the contract under IRC Sec. 72.

c. Allocable gains distributed are includable in income in the year distributed. They may not be treated as including any return of investment in the contract.

d. The distribution is not subject to the additional tax on early distributions under IRC Sec. 72(t).

e. The distribution is not considered wages for FICA or FUTA purposes, but the federal income tax withholding requirements of IRC Sec. 3405 (i.e., voluntary income tax withholding) apply to the portion of the distribution includable in income.

f. No notice or consent (participant or spousal) is required under IRC Secs. 411(a)(11) and 417 for the distribution.

g. The distribution may not be treated as a required distribution for minimum distribution purposes.

h. The distribution is not an eligible rollover distribution.

A return of excess annual additions due to excess elective deferrals or employee after-tax contributions (and distribution of gains attributable to the contributions being returned) is reported on Form 1099-R. A separate Form 1099-R must be used to report this distribution. In general, no other distribution may be reported with this distribution [including a distribution of excess deferrals, excess contributions, or excess aggregate contributions 401(k) plan corrections].

Using the IRS Compliance Resolution Program to Correct the Error

The IRS has issued guidance on self-correcting plan errors, including the timing of corrective distributions, in its Employee Plans Compliance Resolution System (EPCRS). Under EPCRS, significant excess annual additions will generally not present a qualification problem as long as the plan distributes the excess by the end of the second year after the year the excess contribution was made. Insignificant excesses can be distributed at discovery even if this occurs after the two-year period expires.

Recommendations

The following are insights to correct excess contributions or excess deferrals:

a. The plan should be monitored carefully each year to be sure it complies with the Section 415 limits. If the limits are violated, the administrator should promptly take corrective steps as outlined in the plan, the Section 415 regulations, and the EPCRS guidance. These may include corrective disbursements as described previously and should include adoption of procedures to ensure that the problem does not recur.

b. The correction should be made and reported in the year it is discovered, which retroactively *cures* the qualification problem regarding IRC Sec. 415. On this basis, a correction can be made up to two years after the year the excess occurred. Some matters can be cured in later years as provided under the EPCRS guidance.

c. Investment gains on the excess after-tax employee contributions should either be distributed or remain in the plan, depending on the plan's provisions. If distributed, that should occur in the same year that the after-tax employee contributions are refunded. These investment gains are then taxable to the participant. If, however, the investment gains remain in the plan, they are considered an employee contribution (and thereby taxable to the employee) for the year the excess contribution was made (not necessarily the year it is returned). Obviously, the change of identity from investment gain to employee contribution makes the amount subject to the actual contribution percentage (ACP) test of IRC Sec. 401(m)(2).

   Treating the gain that remains in the plan as an employee contribution for the year the gain occurred (i.e., the year with respect to which the excess annual addition is being corrected) appears to create a further excess annual addition for the year the correction takes place. This practical problem is not specifically addressed in the regulations. Note that Reg. 1.415-6(b)(6) does say that following the correction guidance it spells out will not result in the excess amounts being annual additions for the limitation year to which the correction pertains. Hence, that statement may be construed to preclude the problem of the reclassification of investment gains as an employee contribution from itself being an excess annual addition. The better approach would be a plan amendment to permit the distribution of investment gains along with the distribution of the excess employee contributions to which these gains are allocable.

d. The regulations under IRC Sec. 415 deal with the treatment of investment gain on excess employee contributions and elective deferrals that can be corrected by distribution to the participants. No specific mention is made of investment losses allocable to those excess amounts. Apparently, investment losses are either retained in the participant's account or, where the plan so provides, allocated to a suspense account holding excess annual additions for later allocation to the participants in accordance with an approach acceptable under Reg. 1.415-6(b)(6). However, the correction principles described under the Employee Plans Compliance Resolution System state that corrective distributions need not be adjusted for losses. Further guidance as to the disposition of investment losses on corrective distributions is needed.

   Investment gains and losses may be allocated to a suspense account and, upon allocation to participants, are considered an annual addition. The treatment of any investment earnings distributed is similar to that of the gain on the return of employee contributions. The gain can be distributed or kept in the plan depending on what the plan document specifies. When the plan permits, the gain is distributed to the participant along with the excess matching contribution and is taxable to the employee.

e. A corrective distribution pertaining to a 401(k) plan would adjust the actual deferral percentage (ADP) discrimination test and/or the actual contribution percentage (ACP) test for the year the excess occurred.

f. Matching contributions attributed to excess elective deferrals and excess employee contributions because of a Section 415 violation must be forfeited. Therefore, the forfeiture of a corresponding matching contribution would also correct the excess annual addition and reduce the amount of elective deferrals or employee contributions that need to be distributed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. For the Section 415 limit to be applied, the defined benefit must be payable as which of the following?

   a. A straight-life annuity.

   b. An annuity including a postretirement death benefit.

   c. A lump sum.

   d. An annuity that provides a guaranteed number of payments.

9. Cammy accrues a straight-life annuity benefit of $195,000 as of December 31, 2010. Her employer's defined benefit plan uses a calendar-year limitation year. Using the dollar limit method, has Cammy exceeded the Section 415 limit?

   a. Yes.

   b. No.

   c. It depends on the annual cost-of-living increase allowed by the IRS.

   d. It depends on the average amount of total compensation Cammy earned in the past three years.

10. Under IRC Sec. 415, the annual addition to the account of a defined contribution plan participant for 2010 is limited to what amount?

    a. $45,000.

    b. $46,000.

    c. 100% of the participant's compensation.

    d. The lesser of $49,000 or 100% of the participant's compensation.

11. Lynne participates in a 401(k) plan maintained by Purrfect Prospects. Her salary for the plan's 2010 limitation year was $175,000. Purrfect Prospects contributed $8,800 to the plan on her behalf in 2010. Lynne contributed $17,500 to the plan in 2010, as well. During the course of the year, Lynne repays a $18,000 loan that she took out against her plan benefits in 2009. Plan forfeitures of $5,000 are allocated to her account during the year. Calculate Lynne's 2010 annual addition, and determine if she has exceeded the Section 415 limit.

    a. Her annual addition is $8,800, which does not exceed the Section 415 limit.

    b. Her annual addition is $26,300, which does not exceed the Section 415 limit.

    c. Her annual addition is $31,300, which does not exceed the Section 415 limit.

    d. Her annual addition is $49,300, which exceeds the Section 415 limit.

12. A defined contribution plan will correct excess annual additions by distributing employee after-tax contributions. Which of the following applies in this situation?

    a. The distribution is treated as a return on investment in the contract.

    b. The distribution will be considered wages for the purposes of FICA and FUTA.

    c. No notice or consent is required for the distribution.

    d. All of the rules that apply to normal plan distributions will govern this situation.

13. The law firm of Anderson, Wheeler & Tate maintains a money purchase pension plan for its employees. The plan's limitation, tax, and plan years are all the calendar year. In which of the following scenarios, could the firm's contribution be credited to participants' 2010 annual addition?

    a. In 2010, the firm discovers an error; it failed to credit an employer contribution to Sam's account during the 2007 year. In 2010, the firm allocates the amount to correct the error.

    b. The firm makes contributions to all participants' accounts as of January 1, 2011.

    c. The firm could not make required contributions to the plan in 2006. In 2010, the firm contributes amounts to employees who were plan participants in 2006 to make up the deficiency.

14. The defined contribution plan maintained by Columnar Industries made matching contributions to excess employee contributions in 2010. How should the matching contributions be treated after the Section 415 violation?

    a. They must be forfeited.

    b. They must remain in the plan.

    c. Corrective disbursements must be made.

    d. They will adjust the actual deferral percentage (ADP) discrimination test.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. For the Section 415 limit to be applied, the defined benefit must be payable as which of the following? **(Page 135)**

   a. A straight-life annuity. [This answer is correct. The limit would apply to a qualified joint and survivor annuity also. If the benefit is not payable in one of these two forms it will be adjusted actuarially to the equivalent of a straight-life annuity so the limit can be applied.]

   b. An annuity including a postretirement death benefit. [This answer is incorrect. The Section 415 limit cannot be calculated to a benefit payable as an annuity including a postretirement death benefit. The benefit will have to be adjusted to the actuarial equivalent of the correct form for the limit to be correctly applied.]

   c. A lump sum. [This answer is incorrect. The benefit must be adjusted to the actuarial equivalent of the correct form before the limit can be applied, because a benefit payable as a lump sum does not work in this case.]

   d. An annuity that provides a guaranteed number of payments. [This answer is incorrect. The limit cannot be calculated to a benefit payable as an annuity that provides a guaranteed number of payments. For the Section 415 limit to be correctly applied, the benefit must be adjusted to the actuarial equivalent of the correct form.]

9. Cammy accrues a straight-life annuity benefit of $195,000 as of December 31, 2010. Her employer's defined benefit plan uses a calendar-year limitation year. Using the dollar limit method, has Cammy exceeded the Section 415 limit? **(Page 135)**

   a. Yes. [This answer is incorrect. According to the Code, using the dollar limit method, Cammy has not exceeded the Section 415 limit with a benefit of this amount.]

   b. No. [This answer is correct. The 2010 dollar limit, including the annual $5,000 cost-of-living increase, is $195,000, so Cammy has not exceeded the limit.]

   c. It depends on the annual cost-of-living increase allowed by the IRS. [This answer is incorrect. The cost-of-living increase was determined by the IRS and effective January 1. Thus, the issue would not still be pending by the end of 2010 when Cammy's determination is made.]

   d. It depends on the average amount of total compensation Cammy earned in the past three years. [This answer is incorrect. An alternative way to determine if Cammy exceeded the limit would be to use the compensation limit, which would make Cammy's limit 100% of the average of her highest three consecutive years with the employer. The three years do not have to be the past three years or only years that Cammy participated in the plan, if this method is used.]

10. Under IRC Sec. 415, the annual addition to the account of a defined contribution plan participant for 2010 is limited to what amount? **(Page 138)**

    a. $45,000. [This answer is incorrect. This was the annual addition dollar limit for 2007. It has been adjusted for 2010.]

    b. $46,000. [This answer is incorrect. This is the correct dollar limit for 2008; however, there are other factors to consider, as well, when determining the annual addition.]

    c. 100% of the participant's compensation. [This answer is incorrect. This is one factor that must be considered when determining a plan participant's annual addition limit, but it is not the only factor.]

    d. The lesser of $49,000 or 100% of the participant's compensation. [This answer is correct. The annual addition cannot exceed the lesser of these two amounts. The dollar limit is adjusted annually by the IRS for cost-of-living increases.]

11. Lynne participates in a 401(k) plan maintained by Purrfect Prospects. Her salary for the plan's 2010 limitation year was $175,000. Purrfect Prospects contributed $8,800 to the plan on her behalf in 2010. Lynne contributed $17,500 to the plan in 2010, as well. During the course of the year, Lynne repays a $18,000 loan that she took out against her plan benefits in 2009. Plan forfeitures of $5,000 are allocated to her account during the year. Calculate Lynne's 2010 annual addition, and determine if she has exceeded the Section 415 limit. **(Page 138)**

    a. Her annual addition is $8,800, which does not exceed the Section 415 limit. [This answer is incorrect. This amount does not exceed the 2010 Section 415 limit; however, this amount only includes the contributions made on Lynne's behalf by Purrfect Prospects. Other amounts must also be included when calculating the annual addition.]

    b. Her annual addition is $26,300, which does not exceed the Section 415 limit. [This answer is incorrect. The amount only includes the contributions made by Lynne and those made by Purrfect Prospects on Lynne's behalf, which is not the total amount that should have been included in the annual addition. However, if this total had been the correct annual addition, it would not have exceeded the Section 415 limit for 2010.]

    c. Her annual addition is $31,300, which does not exceed the Section 415 limit. [This answer is correct. The annual addition would include contributions to the 401(k) plan by Lynne and by Purrfect Prospects on Lynne's behalf. Plan forfeitures would also be included. Lynne did not exceed the 2010 Section 415 limit of $49,000.]

    d. Her annual addition is $49,300, which exceeds the Section 415 limit. [This answer is incorrect. This amount does exceed the 2010 Section 415 limit; however, the $18,000 loan repayment should not have been included while calculating the annual addition.]

12. A defined contribution plan will correct excess annual additions by distributing employee after-tax contributions. Which of the following applies in this situation? **(Page 142)**

    a. The distribution is treated as a return on investment in the contract. [This answer is incorrect. Employee elective deferrals that are returned as excess annual additions are includable in income in the year they are distributed. No part of the distribution can be treated as a return of investment in the contract under IRC Sec. 72.]

    b. The distribution will be considered wages for the purposes of FICA and FUTA. [This answer is incorrect. The distribution would *not* be considered wages for the purposes of FICA and FUTA. However, the federal income tax withholding requirements under IRC Sec. 3405 apply to the portion of the distribution that is includable in income.]

    c. No notice or consent is required for the distribution. [This answer is correct. Neither participant nor spousal notice or consent is required for the distribution under IRC Secs. 411(a)(11) and 417.]

    d. All of the rules that apply to normal plan distributions will govern this situation. [This answer is incorrect. Many of the requirements that govern normal plan distributions will *not* apply in this case. The distributions in this scenario are treated as corrective disbursements under Rev. Proc. 92-93; therefore other rules apply.]

13. The law firm of Anderson, Wheeler & Tate maintains a money purchase pension plan for its employees. The plan's limitation, tax, and plan years are all the calendar year. In which of the following scenarios, could the firm's contribution be credited to participants' 2010 annual addition? **(Page 143)**

    a. In 2010, the firm discovers an error; it failed to credit an employer contribution to Sam's account during the 2007 year. In 2010, the firm allocates the amount to correct the error. [This answer is incorrect. The contribution would be considered part of annual addition for the 2007 limitation year, not the 2010 limitation year.]

    b. The firm makes contributions to all participants' accounts as of January 1, 2011. [This answer is correct. Employer contributions made to the plan no later than 30 days after the due date, including

extensions, for the employer's income tax return for the tax year in which the limitation year ends are included in the annual addition. Though the firm's contributions in this scenario were made in 2011, they would still be includable in the annual addition under this rule.]

c. The firm could not make required contributions to the plan in 2006. In 2010, the firm contributes amounts to employees who were plan participants in 2006 to make up the deficiency. [This answer is incorrect. The contributions would be considered part of the annual addition for the 2006 limitation year. A reasonable amount of interest included in the make-up contribution would not be considered part of the annual addition, and the firm would continue to owe excise tax on the funding deficiency for each plan year until the deficiency is eliminated.]

14. The defined contribution plan maintained by Columnar Industries made matching contributions to excess employee contributions in 2010. How should the matching contributions be treated after the Section 415 violation? **(Page 143)**

    a. They must be forfeited. [This answer is correct. The forfeiture of a corresponding matching contribution will correct the excess annual addition, reducing the amount of employee contributions that need to be distributed by the plan.]

    b. They must remain in the plan. [This answer is incorrect. Investment gains on excess after-tax employee contributions can remain in the plan, or they can be distributed. If they remain in the plan, they are considered an employee contribution and, thus, will be taxable to the employee per the Code.]

    c. Corrective disbursements must be made. [This answer is incorrect. If Section 415 limits are violated, the plan's administrator must take corrective steps promptly. Corrective disbursements could be one of the corrective steps per the Code.]

    d. They will adjust the actual deferral percentage (ADP) discrimination test. [This answer is incorrect. A corrective distribution pertaining to a 401(k) plan, not matching contributions, will adjust either the ADP test or the actual contribution percentage (ACP) test for the year that the excess occurred.]

COMPLIANCE ISSUES RELATED TO ELECTIVE DEFERRAL LIMITS AND IDENTIFYING CATCH-UP CONTRIBUTIONS

Contributions to 401(k) plans are subject to these types of limitations at the participant level:

a. *Statutory Limits.* These include the elective deferral limit under IRC Sec. 402(g), the annual additions limit under IRC Sec. 415(c), and the employer contribution deduction limit under IRC Sec. 404:

b. *Plan-imposed Limits.* A plan-imposed limit is any limit on the elective deferrals an employee is permitted to make that is contained in the plan document, but not required under the Internal Revenue Code. They include such things as a deferral limit that applies only to the highly compensated employees (HCEs) in a 401(k) plan and limits on the amount of compensation that is eligible for matching contributions. It is important to refer to the plan document to determine if there are any limits of this type that apply to the plan. Plan limits may be lower than statutory but they cannot exceed any of the statutory limits.

c. *Nondiscrimination Limits.* These limits are determined by application of the nondiscrimination rules to which a particular plan is subject. This type of limit includes the maximum deferral allowed for HCEs based on the ADP testing for a 401(k) plan and the amount of matching employer contributions and employee after-tax contributions allowed for ACP testing.

These limits are all interrelated. Catch up contributions are not subject to any limits other than the IRC Sec. 414(v) limit, but they must be identified to determine if the other limits are met and before the ADP testing can be completed. Catch-up contributions are defined to be elective deferrals that—

a. exceed an applicable limit,

b. are treated by the plan as catch-up contributions, and

c. do not exceed the annual catch-up limit under Reg. 1.414(v)-1(c).

Before any portion of a participant's elective deferrals can be treated as catch-up contributions, the participant must reach one of the other limits. This means that catch-up contributions cannot be determined until the end of the year. It also means that if a plan allows catch-up contributions, the catch-up contributions must be identified before determining if any of the other limits have been exceeded.

The following are the steps to take in applying the limits: (a) identify deferrals in excess of the employer-provided limit as catch-up contributions, (b) reduce the total deferrals by the catch-up amount, and (c) determine if the remaining deferrals exceed the other limits.

Apply the Statutory Limits

The Elective Deferral Limit. The annual elective deferral limit is $16,500 for 2010. This limit is applied on a per-individual basis with respect to a calendar year and applies to all elective deferrals (excluding catch-up contributions) that an individual makes to 403(b) plans, salary reduction simplified employee pension plans (SARSEPs), and SIMPLE IRAs, as well as 401(k) plans. These are combined for this limitation *regardless* of whether related or unrelated employers provide the plans.

One of the most popular features of a 401(k) plan is the ability of a participant to make salary reduction contributions (often referred to as elective deferrals). Such contributions are made pursuant to a salary reduction agreement whereby the employee elects to have the employer contribute an amount to the plan rather than to receive the amount in cash (or other taxable benefit). Although authorized by the employee, elective deferrals are treated as employer contributions for qualified retirement plan purposes.

Subject to certain limits, salary reduction contributions are excluded from the employee's income. To qualify for this exclusion, the contributions must be made pursuant to an election that usually takes the form of a salary reduction agreement. The election to make a salary reduction contribution can only be made for an amount unavailable to the

employee on the date of the election. Further, the election can only be made for amounts available after the later of (a) the date on which the employer adopts the 401(k) arrangement or (b) the date on which the 401(k) arrangement first becomes effective.

Example 1-17: Determining the maximum salary deferral amount for 2010 allowed under a 401(k) plan.

XYZ, Inc., adopts a profit-sharing plan with a 401(k) arrangement on November 30, 2010, with an effective date of January 1, 2010. Bob Smith, age 44, earns $6,000 per month during the year. His salary is paid on the last day of each month. The plan allows participants to defer up to 10% of their compensation for the plan year.

What amount of Bob's salary may he consider for deferral for 2010? The plan cannot permit elective deferrals of any compensation available to a given participant before the date the plan is adopted (November 30, 2010), as this date is later than the plan's effective date (January 1, 2010). Therefore, Bob may only consider the amount of his salary he will earn in December for deferral ($6,000).

What is the maximum amount of salary Bob can defer under the 401(k) plan for 2010? The maximum amount of elective deferral is the *lesser* of (a) the IRC Sec. 402(g) elective deferral limit of $16,500, (b) the 10% of salary plan limit of $6,200 (6,000 × 12 × 10%), or (c) the compensation earned after adoption of the plan of $6,000. Thus, the maximum elective deferral Bob can make for 2010 is $6,000. If Bob did this, he would have to defer all of his December salary, as he could not retroactively apply any portion of the elective deferral to salary earned before the adoption of the plan.

Increase for Catch-up Contributions. A plan that provides for employee deferrals may allow participants who have attained at least age 50 by the calendar year-end to make catch-up contributions. The otherwise applicable dollar limit on elective deferrals is increased. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, they aren't subject to applicable nondiscrimination rules. However, they must be available to all participants age 50 and older on an equal basis. An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules. The allowable catch-up contribution limit applicable to 401(k), 403(b), SARSEP, and 457(b) plans for 2010 is $5,500. This amount is increased for inflation. For SIMPLE IRA and SIMPLE 401(k) plans, the amount for 2010 is $2,500.

FICA and FUTA Taxes. Although salary reduction contributions are excluded from the employee's gross income for federal income tax purposes, they are included in the employee's wages for Social Security (FICA) and federal unemployment tax (FUTA) purposes. This means that the employer must withhold the employee's share of FICA on the salary reduction contribution at the time the contribution is made. Additionally, the employer must pay FUTA and its share of FICA on the contribution at the same time.

Example 1-18: Wages for FICA and FUTA purposes.

Sammy is an employee of ABC, Inc. During 2010, Sammy's salary is $20,000 and she contributes $1,000 to a 401(k) plan. Although Sammy's taxable wages for federal income tax purposes are $19,000 ($20,000 − $1,000), her wages for FICA and FUTA purposes are $20,000.

Exceeding the Elective Deferral Limit. At first, it may seem difficult to violate the $16,500 (for 2010) elective deferral limit in a 401(k) plan as many employers use payroll software or services that automatically stop elective deferrals when a participant reaches the limit. However, violating the elective deferral limit may be relatively easy for employers with plans that have liberal eligibility requirements or for employers with part-time employees. For example, an employer with a plan allowing immediate participation upon employment may hire a new employee during the last part of the year who has been participating in a previous employer's 401(k) plan during the year. The current employer's payroll system would continue to allow elective deferrals even though the combined elective deferrals for the two plans exceed the elective deferral limit. A similar situation may occur with part-time employees who participate in plans of different employers. Thus, employers should make certain that participant communications are clear on the nature of the annual limit on all elective deferrals and recommend that participants consult with their financial advisors as to how to handle any excess.

Example 1-19: Computing the elective deferral limit when participating in more than one plan.

Teddy Burk, age 42, is a participant in a 403(b) plan at the hospital where he works. He is also a participant in a 401(k) plan sponsored by another unrelated employer. During 2010, he made elective deferrals of $5,000 to the 403(b) plan. What is Teddy's elective deferral limit for the 401(k) plan for 2010?

Teddy's total elective deferral limit for 2010 is $16,500. Therefore, Teddy's elective deferral limit for the 401(k) plan for 2010 is $11,500 [$16,500 total elective deferral limit—$5,000 elective deferral made to the 403(b) plan].

EXCESS ELECTIVE DEFERRALS TO 401(k) PLANS

To maintain its qualified plan status, a 401(k) plan by its terms and operation must preclude participants from making excess deferrals (i.e., deferrals in excess of the elective deferral limit, $16,500 for 2010). However, a plan that (contrary to its terms) accepts an excess deferral can maintain its qualified status if the excess deferral is timely corrected.

When Excess Deferrals Must Be Distributed

Excess deferrals are timely corrected if they (plus their related earnings) are distributed (a) during the participant's same tax year in which they occurred, or (b) by April 15 following the participant's tax year in which the excess occurred.

A 401(k) plan must contain language permitting the distribution of excess deferrals for it to make such a distribution. If the plan does not contain such language, the plan could be amended to provide such language. If the plan so provides, an individual must designate the distribution as an excess deferral if the individual's elective deferrals under all of the plans of the employer or related employers exceed the elective deferral limit. A plan may require such designation to be given in writing. It may also require that the employee certify, or otherwise establish, that the designated amount is an excess deferral.

Correction of Excess Deferrals during the Participant's Tax Year. A plan may provide that an individual with excess deferrals for a tax year may receive a corrective distribution of those deferrals *plus their related earnings* during the same year. A corrective distribution may be made only if the following conditions are met:

a. The distribution is designated as an excess deferral by the individual and the plan.

b. The correcting distribution is made after the date when the plan received the excess deferral.

Correction of Excess Deferrals by April 15. A plan may provide for the distribution of excess deferrals (plus their related earnings) by April 15 following the participant's tax year when the excess occurred. The participant must allocate the amount of the excess deferrals among the plans under which the deferrals were made and notify each plan of its allocated portion by April 15 following the participant's tax year when the excess occurred. [The statute under IRC Sec. 402(g)(2)(A) specifies a March 1 deadline, but the IRS extended this deadline to April 15 in the regulations.] If the plan so provides, an individual may be deemed as notifying the plan of the excess deferrals if the individual's elective deferrals are under plans of the same employer or related employers. A plan may provide instead that the employer notify the plan on behalf of the individual under these circumstances.

Correction of Excess Deferral after April 15. If the corrective distribution is not made by April 15 following the participant's tax year when the excess occurred, the excess deferral may be distributed only after a qualifying event as permitted by IRC Sec. 401(k)(2)(B). When not timely corrected, the excess deferral may be subject to double taxation at the participant level. The excess deferral is includable in income during the tax year of deferral, and is included again when the excess deferral is distributed from the plan.

An EPCRS method of correction is available to prevent disqualification of a plan that fails to distribute an excess deferral by April 15. Under EPCRS, the employer corrects the violation by distributing the excess deferral and allocable earnings to the employee. However, this method does not eliminate the double taxation of the excess

deferral that results from the employee reporting the excess deferral as taxable income in both the year of deferral and the year of distribution.

How to Allocate Net Income to Excess Deferrals

The plan's net income allocable to excess deferrals is determined as either the allocable gain or loss for the individual's tax year or, if the plan so provides, allocable gain or loss for the tax year and the period between the end of the taxable year and the date of distribution (the *gap period*).

General Method of Allocating Net Income. Under the general rule of allocating income, a plan may use any reasonable method for computing the income allocable to excess deferrals (including gap period income) if the method (a) does not discriminate in favor of highly compensated employees, (b) applies consistently for all participants and for all corrective distributions under the plan, and (c) is used for allocating income to the participants' accounts.

Alternative Method of Allocating Net Income. Instead of using "any reasonable method," the regulations provide an allocation formula which the plan may use. Under this alternative method, income is allocated to excess deferrals by using the following formula:

$$\text{Net income for the period} \times \frac{\text{Excess deferrals}}{\text{Beginning balance plus deferrals for the period}}$$

The period is either the plan year or plan year plus the gap period as defined in the plan document. For tax years beginning after December 31, 2007, the adjustment for gains and losses may, but is not required to, include gains and losses that occur during the *gap period* (the period beginning immediately after the tax year and ending up to seven days before the distribution).

Example 1-20: Using an alternative method of allocating net income to an excess deferral.

The payroll software of Zinc, Inc. malfunctioned and allowed Tracy Young, age 42, to make an elective contribution of $30,000 to the 401(k) plan during 2010. The contribution was within Tracy's Section 415 limit, but drastically exceeded the 2010 $16,500 elective deferral limit, resulting in an excess deferral of $13,500. The plan document specifies that the alternative method be used to allocate income for the year and the gap period. Based on the following facts pertaining to Tracy's account, how much must be distributed to Tracy to fully correct the excess deferral?

Elective deferral account balance at beginning of the year	$	80,000
Net income for the plan year	$	15,000
Elective deferral account balance at end of the year ($80,000 + $30,000 + $16,500)	$	110,000
Tracy's elective deferrals for the plan year	$	30,000
Elective deferral limit for 2010	$	16,500
Tracy's excess deferral for 2010 ($30,000 – $16,500)	$	13,500

The net income to be distributed is calculated as follows:

$$\$15{,}000 \times \frac{\$13{,}500}{(\$80{,}000 + \$30{,}000)} = \$1{,}841$$

A total distribution of $15,341 ($13,500 + $1,841) must be made to correct Tracy's excess deferral.

Safe Harbor for Allocating Income to Excess Deferrals for the Gap Period. The regulations provide a safe harbor method for allocating gap period (i.e., the period between the end of the tax year and the date of distribution) income to excess deferrals. Under this method, net income on excess deferrals for the gap period equals 10% of the net income allocable to excess deferrals for the period (calculated under the alternative method of allocating net income described previously). This 10% amount is then multiplied by the number of calendar months in the gap

period. In making this calculation, a corrective distribution made on or before the 15th day of the month is treated as made on the last day of the preceding month, whereas, a distribution made after the 15th day of the month is treated as made on the 1st day of the next month.

Example 1-21: Using the 10% safe harbor method of allocating gap period income to an excess deferral.

Assume the same facts of Example 1-20, except that gap period income is computed pursuant to the 10% safe harbor method as prescribed by the plan document. The gap period income allocable to the excess deferral is $368 [10% of $1,841 multiplied by the number of months (two) between the end of the year and the date of the corrective distribution]. The total income allocable to the excess deferral using the 10% safe harbor method in conjunction with the alternative method is $2,209 ($1,841 + $368). Accordingly, the amount that must be distributed is $15,709 ($13,500 excess deferral plus $2,209 income).

Tax Treatment of Distributions of Excess Elective Deferrals and Related Income or Loss

A corrective distribution of excess deferrals is includable in gross income for the employee's tax year of the deferral when it is distributed by April 15th of the year following the year of deferral. However, the income or loss allocable to excess deferrals is treated as earned and received in the employee's gross income for the tax year in which the income or loss is distributed. A corrective distribution of excess deferrals (and income) is not subject to the IRC Sec. 72(t) early distribution tax.

Reporting Distributions of Excess Deferrals and Related Income or Loss

Distributions of excess deferrals and their related income are reported to participants on Form 1099-R.

Example 1-22: Reporting an excess deferral and related income distributed after the year of the deferral.

Tom Smith has a $1,000 excess deferral in his employer's 401(k) plan for the 2010 calendar plan year. The amount of income allocable to the excess deferral is $100. The excess deferral and the allocable income are distributed to Tom on April 1, 2011.

How is the excess deferral and allocable income reported to Tom? As the excess deferral and allocable income were distributed following the calendar year of the deferral, they are reported to Tom using two 2011 Forms 1099-R. One is used to report the $1,000 excess deferral indicating it is taxable in the year of the deferral (2010) by using distribution code "P" in Box 7. The other Form 1099-R reports the distribution of the $100 income allocated to the excess deferral indicating it is taxable in the year of distribution (2011) by using distribution code "8" in Box 7.

Example 1-23: Reporting an excess deferral and related income distributed during the year of the deferral.

Tom Smith has a $1,000 excess deferral in his employer's 401(k) plan as of October 15, 2010, for the 2010 calendar plan year. The amount of income allocable to the excess deferral is $100. The excess deferral and the allocable income are distributed to Tom on October 17, 2010.

How is the excess deferral and allocable income reported to Tom? As the excess deferral and allocable income were both distributed during the calendar year of the deferral, they are reported to Tom using one 2010 Form 1099-R. The Form 1099-R reports the combined excess deferral and related income amounts ($1,100 total) and indicates they are taxable in the year received (2010) by using distribution code "8" in Box 7.

If a loss is allocable to an excess deferral, the excess deferral is reported *net* of the loss on Form 1099-R. The participant reports such a loss as a bracketed amount on the "Other Income" line of Form 1040 for the year when the corrective distribution of the excess deferral occurs, even though the entire excess deferral (unadjusted for the loss) is reported on Form 1040 for the year of the deferral. Only one Form 1099-R is required in this situation, no

matter if the corrective distribution occurs during the deferral year or the following year by April 15th. Thus, the employer should include with the Form 1099-R given to the participant a separate statement showing the amount of the loss and explaining that the excess deferral, unadjusted for the loss, is reportable on the "Wages, salaries, tips, etc." line of Form 1040, for the year of deferral, and the loss may be reported as a bracketed amount on the "Other Income" line, Form 1040, for the distribution year.

Example 1-24: Reporting an excess deferral and related loss distributed after the year of the deferral.

Tom Smith has a $1,000 excess deferral in his employer's 401(k) plan for the 2010 calendar plan year. The amount of loss allocable to the excess deferral is $100. The excess deferral less the allocable loss ($900) is distributed to Tom on April 1, 2011.

How is the excess deferral and allocable loss reported to Tom? The 2011 Form 1099-R reports the distribution of the excess deferral amount net of the allocable loss in both the gross distribution box and taxable amount box and uses distribution code "P" in Box 7. In addition, Tom's employer must include a statement indicating the amount of the loss and explaining that the excess deferral, unadjusted for the loss, is reportable on the "Wages, salaries, tips, etc." line of Form 1040 for the year of deferral (2010), and that the loss may be reported as a bracketed amount on the "Other Income" line, Form 1040, for the distribution year (2011).

Coordinating Distributions of Excess Deferrals with Distributions of Excess Contributions

The amount of excess deferrals that may be distributed as corrective distributions on behalf of an employee for a taxable year is reduced by any excess contributions under the actual deferral percentage (ADP) test previously distributed or recharacterized for the employee for the plan year beginning with, or within, the employee's taxable year. The amount of excess contributions includable in the gross income of the employee and reported by the employer as a distribution of excess contributions is reduced by the amount of the reduction. This rule treats distributions of excess amounts first as excess deferrals since these are not includable in the participant's income when distributed, but are instead includable in income for the year of the deferral.

Example 1-25: Coordinating distributions of excess deferrals with distributions of excess contributions.

Tim Johnson makes elective deferrals to his employer's 401(k) plan in the amount of $17,500 for 2010. Thus, he has an excess deferral of $1,000 includable in his 2010 gross income. The plan administrator determines that Tim also has excess contributions of $2,000 as a result of the ADP test. The plan distributes the $2,000 on March 1, 2011, with allocable income. Normally, Tim would report the $2,000 of excess contributions as 2011 income. However, $1,000 of the $2,000 is treated as a distribution of the excess deferral (which is already included in Tim's 2010 income). Thus, Tim will report the remaining $1,000 of the excess contributions (plus the allocable income on the $2,000) as 2011 income.

Effect of Community Property Laws and Spousal Consent on Excess Deferrals

Community property laws are not considered in determining the tax treatment of excess deferrals. The consent of an employee, or the employee's spouse, is not required before a corrective distribution of excess contributions and allocable income may be made pursuant to the terms of the plan.

Corrective Distribution Impact on Minimum Distribution Requirements

A corrective distribution of excess deferrals (and income) is not treated as a distribution when determining whether the plan meets the minimum distribution requirements of IRC Sec. 401(a)(9).

CORRECTING EXCESS CONTRIBUTIONS

Excess contributions are the excess of total employer contributions paid on behalf of highly compensated employees (HCEs) over the maximum amount of contributions allowable under the ADP test. Any excess contributions may cause the plan to become disqualified, unless properly corrected. The regulations allow for the correction

of excess contributions by (a) distributing the excess contributions plus any earnings to the employee, (b) making qualified nonelective contributions (QNECs) or qualified matching contributions, or (c) allowing the employee to recharacterize the excess contribution.

FORFEITURES

The portion of a participant's accrued benefit in a qualified retirement plan that is not 100% vested according to the plan's vesting schedule will be forfeited when the participant terminates employment or at a later date as specified by the plan document. The forfeited benefits are known as forfeitures. What happens to these forfeitures depends on whether the plan is a defined benefit plan or a defined contribution plan. If a terminated employee returns to employment, benefits previously forfeited may have to be restored.

What Happens to Forfeitures in a Defined Benefit Plan?

A defined benefit plan must expressly provide that forfeitures arising from severance of employment, death, or any other reason, must not be reallocated to other participants in the plan. Instead, the plan may provide that forfeitures be used first to reduce the administrative expenses of the plan, with any remainder being applied to reduce employer contributions. Alternatively, the plan may provide that forfeitures be used only to reduce employer contributions.

What Happens to Forfeitures in a Defined Contribution Plan?

A defined contribution plan [e.g., profit-sharing plan, 401(k) plan, money purchase pension plan, etc.] may provide that forfeitures either be (a) reallocated to the accounts of other participants in a nondiscriminatory manner, or (b) used to reduce future employer contributions or administrative costs.

Forfeitures Reallocated Based on Compensation. One method of reallocating forfeitures to other participants in a defined contribution plan is based on compensation, just as employer contributions are allocated. For example, the plan may provide that forfeitures be reallocated to individuals, based on their relative compensation, who were participants on the last day of the plan year in which the forfeiting employee terminated employment.

Forfeitures Reallocated Based on Account Balances. Another method of reallocating forfeitures to other participants in a defined contribution plan is based on account balances. For example, the plan may provide that forfeitures be reallocated based on the ratio that each remaining participant's account balance bears to the total account balances for all remaining participants. To use this method, the plan must be able to annually show that such reallocations of forfeitures are nondiscriminatory. The plan may have difficulty proving nondiscrimination because highly compensated employees will typically have the largest account balances. Therefore, basing forfeiture allocation on account balances will generally disproportionately favor the highly compensated employees.

Per Capita Reallocation of Forfeitures. Forfeitures may be allocated as a fixed dollar amount to each eligible participant in the plan. This type of allocation helps the plan pass the ADP test.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Tom turned 56 in 2010 and is a highly compensated employee. He plans to make catch-up contributions to his 401(k) account this year. Which of the following statements will apply?

    a. Tom must identify his catch-up contributions as he makes them throughout the year.

    b. The total amount of Tom's catch-up contributions cannot exceed the limits found in IRC Sec. 402(g) and IRC Sec. 415(c).

    c. Any catch-up contributions that Tom makes will be included in the ADP test.

    d. To apply the elective deferral limits, Tom's catch up contributions must first be deducted from the total deferrals.

16. What is the annual elective deferral limit for 2010?

    a. $2,500.

    b. $5,500.

    c. $16,500.

17. Melinda is employed by Honest Eugene's and makes an annual salary of $30,000. In 2010, she contributes $2,500 to Honest Eugene's 401(k) plan. Calculate the amount of wages for FICA and FUTA purposes.

    a. $2,500.

    b. $27,500.

    c. $30,000.

    d. $32,500.

18. Derek participates in his employer's 401(k) plan. In 2010, he has excess deferrals of $500. Which of the following scenarios best illustrates appropriate consequences for the excess deferrals?

    a. Derek will forfeit the $500.

    b. The plan can provide for distribution of excess deferrals and related earnings in 2010.

    c. The plan can provide for distribution of excess deferrals and related earnings by March 1, 2011.

    d. The plan will lose its qualified status.

19. Pier 52's payroll software allowed Harrison to make an elective contribution of $20,000 to the 401(k) plan, which exceeds the 2010 elective deferral limit of $16,500. Pier 52's plan document specifies that the net income for excess deferrals must be allocated using the following formula:

$$\text{Net income for the period} \times \frac{\text{Excess deferrals}}{\text{Beginning balance plus deferrals for the period}}$$

Match this formula with the allocation method it applies to.

 a. The general method of allocating net income.

 b. The alternative method of allocating net income.

 c. The safe harbor for allocating income to excess deferrals for the gap period.

20. Leslie has a $500 excess deferral in her employer's 401(k) plan for the 2010 plan year (which runs on the calendar year). Fifty dollars of income is allocable to the excess deferral. Leslie receives a distribution of $550 on March 31, 2011. How is this reported to Leslie?

 a. On two 2011 Forms 1099-R.

 b. On one 2010 Form 1099-R.

 c. On a 2011 Form 1099-R accompanied by a separate statement.

 d. On a 2011 Form 1040.

21. Guy's Auto Parts maintains a 401(k) plan. When Mark's employment in the company is terminated before he is 100% vested in the plan, how would the plan typically reallocate the forfeiture to other plan participants?

 a. Based on compensation.

 b. Based on account balances.

 c. As a fixed dollar amount to each eligible participant.

 d. Forfeitures cannot be allocated to other plan participants.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Tom turned 56 in 2010 and is a highly compensated employee. He plans to make catch-up contributions to his 401(k) account this year. Which of the following statements will apply? **(Page 150)**

    a. Tom must identify his catch-up contributions as he makes them throughout the year. [This answer is incorrect. Tom must reach one of the other elective deferral limits before contributions can be treated as catch-up contributions; therefore, catch-up contributions cannot be determined until the end of the year.]

    b. The total amount of Tom's catch-up contributions cannot exceed the limits found in IRC Sec. 402(g) and IRC Sec. 415(c). [This answer is incorrect. These statutory limits do not apply to catch-up contributions. Catch-up contributions are defined as (1) exceeding an applicable limit, (2) being treated by the plan as catch-up contributions, and (3) not exceeding the annual catch-up limit found in Reg. 1.414(v)-1(c).]

    c. Any catch-up contributions that Tom makes will be included in the ADP test. [This answer is incorrect. Tom's catch-up contributions are not part of the ADP test; however, they must be identified before the ADP testing can be completed.]

    d. To apply the elective deferral limits, Tom's catch up contributions must first be deducted from the total deferrals. [This answer is correct. When applying the limits to Tom's elective deferrals, the following steps will be taken: (1) deferrals in excess of the employer-provided limit will be identified as catch-up contributions, (2) total deferrals will be reduced by the catch-up amount, and (3) the remaining deferrals will be tested to see if they exceed the other limits.]

16. What is the annual elective deferral limit for 2010? **(Page 150)**

    a. $2,500. [This answer is incorrect. This is the allowable catch-up contribution limit for SIMPLE IRAs and SIMPLE 401(k) plans in 2010.]

    b. $5,500. [This answer is incorrect. This is the allowable catch-up contribution limit for 401(k), 403(b), SARSEP, and 457(b) plans in 2010.]

    c. $16,500. [This answer is correct. The annual elective deferral limit is applied per individual with respect to a calendar year. All elective deferrals (except for catch-up contributions) for 403(b) plans, 401(k) plans, SARSEPs, and SIMPLE IRAs are combined for this limitation, whether the plans are maintained by related or unrelated employers.]

17. Melinda is employed by Honest Eugene's and makes an annual salary of $30,000. In 2010, she contributes $2,500 to Honest Eugene's 401(k) plan. Calculate the amount of wages for FICA and FUTA purposes. **(Page 151)**

    a. $2,500. [This answer is incorrect. The $2,500 that Melinda contributed to the 401(k) plan is not the total amount subject to FICA and FUTA.]

    b. $27,500. [This answer is incorrect. This is the amount of Melinda's salary that is taxable for federal income tax purposes.]

    c. $30,000. [This answer is correct. All of Melinda's 2009 salary is considered wages for FICA and FUTA purposes, even though it is not all taxed for federal income tax purposes.]

    d. $32,500. [This answer is incorrect. Melinda would not have to pay additional FICA or FUTA taxes based on the $2,500 that she contributed to the 401(k) plan.]

18. Derek participates in his employer's 401(k) plan. In 2010, he has excess deferrals of $500. Which of the following scenarios best illustrates appropriate consequences for the excess deferrals? **(Page 152)**

    a. Derek will forfeit the $500. [This answer is incorrect. There is no penalty in the regulations that says a participant forfeits the amount of the excess deferral, so Derek will not lose the $500 in this scenario per the IRS.]

    b. The plan can provide for distribution of excess deferrals and related earnings in 2010. [This answer is correct. If certain conditions are met, the excess can be distributed during the participant's tax year, which corrects the error and allows the plan to keep its qualified status.]

    c. The plan can provide for distribution of excess deferrals and related earnings by March 1, 2011. [This answer is incorrect. This is the date specified under the Internal Revenue Code, but the IRS extended the deadline to April 15 in the regulations.]

    d. The plan will lose its qualified status. [This answer is incorrect. According to the IRS, there are methods for correcting such an error that will help the plan avoid losing its qualified status.]

19. Pier 52's payroll software allowed Harrison to make an elective contribution of $20,000 to the 401(k) plan, which exceeds the 2008 elective deferral limit of $15,500. Pier 52's plan document specifies that the net income for excess deferrals must be allocated using the following formula:

$$\text{Net income for the period} \times \frac{\text{Excess deferrals}}{\text{Beginning balance plus deferrals for the period}}$$

    Match this formula with the allocation method it applies to. **(Page 153)**

    a. The general method of allocating net income. [This answer is incorrect. The general rule of allocating net income allows a plan to use any reasonable method for computing the income allocable to excess deferrals if the method (1) does not discriminate in favor of highly compensated employees, (2) applies for all participants and all corrective distributions under the plan consistently, and (3) is used for allocating income to the participants' accounts.]

    b. The alternative method of allocating net income. [This answer is correct. The plan may use this allocation formula instead of using "any reasonable method." The formula is provided in the regulations.]

    c. The safe harbor for allocating income to excess deferrals for the gap period. [This answer is incorrect. Under the safe harbor, net income on excess deferrals for the gap period equals 10% of the net income allocable to excess deferrals for the period. The net income would be calculated using the formula for the alternative method. The 10% amount then must be multiplied by the number of calendar months in the gap period to complete the safe harbor calculation.]

20. Leslie has a $500 excess deferral in her employer's 401(k) plan for the 2010 plan year (which runs on the calendar year). Fifty dollars of income is allocable to the excess deferral. Leslie receives a distribution of $550 on March 31, 2011. How is this reported to Leslie? **(Page 154)**

    a. On two 2011 Forms 1099-R. [This answer is correct. One Form 1099-R is used to report the $500 excess deferral indicating that it is taxable in 2009 (the year of deferral), and one reporting the distribution of $50 income indicating that it is taxable in 2010 (the year of distribution).]

    b. On one 2010 Form 1099-R. [This answer is incorrect. One Form 1099-R would be used if the distribution was made to Leslie in 2010.]

    c. On a 2011 Form 1099-R accompanied by a separate statement. [This answer is incorrect. If the $50 in this scenario was loss instead of income, a 2011 Form 1099-R would be used to report the deferral amount

net of the loss, and a separate statement would be included by the employer to indicate how the deferral and loss would be reported on the 2010 Form 1040.]

d. On a 2011 Form 1040. [This answer is incorrect. An employer would not issue a Form 1040 to an employee to report a distribution of an excess deferral. A Form 1040 is an individual income tax return prepared by an individual taxpayer.]

21. Guy's Auto Parts maintains a 401(k) plan. When Mark's employment in the company is terminated before he is 100% vested in the plan, how would the plan typically reallocate the forfeiture to other plan participants? **(Page 156)**

a. Based on compensation. [This answer is correct. The compensation-based method is the method most typically used by defined contribution plans. Employer contributions are based on compensation, as well.]

b. Based on account balances. [This answer is incorrect. If this method is used, the plan must be able to show that the reallocations of the forfeitures are nondiscriminatory for each year. And this may be difficult to prove, as highly compensated employees will typically have the largest account balances.]

c. As a fixed dollar amount to each eligible participant. [This answer is incorrect. Though this is not the most typical method, it can help the plan pass the ADP test.]

d. Forfeitures cannot be allocated to other plan participants. [This answer is incorrect. Since a 401(k) plan is a defined contribution plan, forfeitures may be reallocated to other plan participants or used to reduce future employer contributions or administrative costs.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (RETTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Qualified retirement plans must comply with limits found in the Internal Revenue Code (IRC). Match the following IRC sections with the limit they cover.

1. IRC Sec. 415(c)	i. Pension benefits
2. IRC Sec. 415(b)	ii. Annual additions
3. IRC Sec. 402(g)	iii. Catch-up contributions
4. IRC Sec. 414(v)	iv. Elective deferrals

   a. 1., iv.; 2., iii.; 3. i.; 4., ii.

   b. 1., ii.; 2., i.; 3., iv.; 4., iii.

   c. 1., i.; 2., iv.; 3., ii.; 4., iii.

   d. 1., ii.; 2., iv.; 3., iii.; 4., i.

2. Which of the following most accurately illustrates how the Section 415 limit on contributions available to a participant is imposed?

   a. On each participant in the plan.

   b. On the employer contributions for each plan participant.

   c. On all highly compensated employees.

   d. On each plan maintained by the employer.

3. Which of the following plans must comply with the Section 415 limit?

i. SIMPLE 401(k) plans	iv. Qualified defined contribution plans
ii. SEPs	v. Qualified defined benefit plans
iii. SIMPLE IRA plans	vi. Excess benefit plans

   a. i. and iii.

   b. iv. and v.

   c. i., ii., iv., and v.

   d. i., ii., iii., and vi.

4. Joe owns 60% of a chain of grocery stores and participates in the chain's profit-sharing plan. Unrelated parties own the rest of the grocery store chain. Joe also receives director's fees for services he performs as a self-employed individual serving as a director on the boards of several unrelated companies. Joe makes a contribution to a profit-sharing Keogh plan as a self-employed individual based on these fees. How will Joe's holdings be tested for the Section 415 limit?

   a. Only the grocery profit-sharing Keogh plan must be tested.

   b. Only the self-employed profit-sharing Keogh plan must be tested.

   c. The plans must be combined and then tested because they meet the ownership requirements under Section 415.

   d. The plans must not be combined because they do not meet the ownership requirements under Section 415.

5. The Smelt Corporation adopts a defined benefit plan in June 2010. The plan document specifies that the plan year will run from May 1 through April 30. What is the plan's limitation year for 2010?

   a. January 1 – December 31, 2010.

   b. May 1, 2010 – April 30, 2011.

   c. June 1, 2010 – December 31, 2010.

   d. June 1, 2010 – April 30, 2011.

6. Assume the same details as in the question above. In May 2011, the Smelt Corporation decides to change its limitation year to be the calendar year. How will the plan's dollar limit most likely be affected?

   a. The start of the limitation year can precede the plan's effective date, so there will not be a short limitation period to affect the dollar limit.

   b. The Section 415 limit will be applied separately to the short limitation year and the new limitation year, so the dollar limit will be prorated for the short period created by the change.

   c. The contribution of a particular year is not a factor in computing the plan's limit for each plan participant so the dollar limit will not be affected.

   d. IRC Sec. 415 would not allow Smelt to make the change described in the above scenario.

7. The definition of compensation found in Reg. 1.415(c)-2(a) includes which of the following?

   a. Amounts realized from exercising a nonqualified stock option.

   b. Salary reduction contributions to 401(k) plans.

   c. Amounts realized when a substantial risk of forfeiture lapses under IRC Sec. 83.

   d. Premiums for group term life insurance not included in income under IRC Sec. 79.

8. Which of the following statements most accurately describes how the Section 415 limit affects a defined benefit plan?

   a. It limits the amount a plan participant can contribute to the plan.

   b. It limits the amount that the plan can contribute on behalf of a plan participant.

   c. It limits the benefits for a plan participant if the benefits are payable as a straight-life annuity, a postretirement death benefit, or as a lump sum.

   d. It limits the amount of plan benefit a participant is entitled to and the employer's deductions for contributions.

9. Which of the following scenarios best illustrates one of the refinements to the defined benefit limit?

   a. Luke retires at age 62; therefore, the exception to the Section 401(a)(17) limit applies.

   b. Darrel has been with his company for 10 years and has participated in the company's defined benefit plan for 7 years; therefore, his dollar limit is proportionally reduced.

   c. Callie belongs to her company's defined benefit plan. The benefit will be settled as a lump sum. Because Callie's annual benefits are only $9,075, the Section 415 limit is satisfied.

   d. Do not select this answer choice.

10. Which of the following elements are included in the annual addition when calculating the Section 415 limit for a defined contribution plan participant?

    i. Employer contributions

    ii. Employee pretax deferrals

    iii. Forfeitures allocated to participants' accounts

    iv. Catch-up contributions

    v. Employee contributions

    vi. Plan earnings

    vii. Loan repayments

    viii. Rollovers

    a. i., v., and vi.

    b. i., ii., iii., and v.

    c. i., iii., iv., v., vii., and viii.

    d. i., ii., iv., v., vi., and viii.

11. Home Harmony maintains a 401(k) plan with a calendar-year limitation year. In 2010, Home Harmony contributes $6,000 on behalf of Mike, who has been employed by Home Harmony for 25 years. Mike's salary for 2010 is $200,000, and he contributes salary deferral contributions of $20,000, plus an additional $5,000 to the plan during the year. Mike is 57 years old, and he makes catch-up contributions of $5,000 to the plan. A rollover amount of $3,000 is added to Mike's plan benefit during the year, as is a plan forfeiture of $2,000. Mike also repays a loan he took out against his benefit in 2010, which adds $12,000 to his account. Calculate Mike's 2010 annual addition and determine if it exceeds the Section 415 limit.

    a. Mike's annual addition is $26,000, which does not exceed the Section 415 limit.

    b. Mike's annual addition is $33,000, which does not exceed the Section 415 limit.

    c. Mike's annual addition is $48,000, which does not exceed the Section 415 limit.

    d. Mike's annual addition is $53,000, which exceeds the Section 415 limit.

12. The Bread Company maintains a defined contribution plan and uses the calendar year as the limitation year and plan year. The company's 2010 income tax return is due March 15, 2011. The return will not be extended. In which of the following scenarios would the contribution be included in the 2010 annual addition for Section 415 purposes?

    i. Steve makes a contribution to the plan on January 15, 2011.

    ii. Bread Company makes a contribution to the plan for Sarah on June 1, 2011.

    iii. Joan makes a contribution to the plan on February 1, 2011.

    iv. Bread Company makes a contribution to the plan for Joe on March 15, 2011.

    a. i. and iv.

    b. ii. and iii.

    c. i., ii., and iv.

    d. i., ii., iii., and iv.

13. Explosions of Fun maintains a defined contribution plan. When estimating Peter's annual compensation in 2009, a reasonable error is made, which results in the plan exceeding its Section 415 limit. The plan satisfies the requirements for self-correction of *significant operational failures* under the most recent EPCRS revenue procedure. Select the scenario below that most accurately illustrates what will happen to the company now.

    a. The company will lose its favored tax qualified status.

    b. The company can allocate Peter's excess annual addition to other plan participants, as long as no other Section 415 limits are exceeded.

    c. The excess annual additions can be used to reduce employer contributions for all plan participants.

    d. The company can correct the error by one of two methods, depending on what is specified in the plan document.

14. The 401(k) plan established by Corner Minders had excess annual additions during its 2009 limitation year. Under the Employee Plans Compliance Resolution System (EPCRS) established by the IRS, when must the plan distribute the excess to avoid a qualification problem?

    a. 2009.

    b. 2010.

    c. 2011.

    d. 2012.

15. Match the following 401(k) plan limitations with the correct definition.

1. Statutory limits	i. Any limit on elective deferrals an employee may make that is contained in the terms of the plan but not required under the Internal Revenue Code.
2. Plan-imposed limits	ii. Any limit on the elective deferrals an employee is permitted to make that is contained in the plan document but not required under the Internal Revenue Code.
3. Nondiscrimination limits	iii. Any limit that includes the maximum deferral allowed for HCEs based on the ADP testing for a 401(k) plan and the amount of matching employer contributions and employee after-tax contributions allowed for ACP testing.

   a. 1., ii; 2., iii; 3., i.

   b. 1., ii; 2., i; 3., iii.

   c. 1., i; 2., ii; 3., iii.

   d. 1., iii; 2., i; 3., ii.

16. The firm of Duke & Dias adopts a 401(k) plan on October 30, 2010. The plan effective date is January 1, 2010. Sandra earns $7,000 a month and elects to participate in the plan when it is adopted. The plan allows participants to defer up to 10% of their compensation for the plan year. Sandra is not old enough to make catch-up contributions. What amount of Sandra's salary can she consider for deferral in 2010?

   a. $7,000.

   b. $14,000.

   c. $21,000.

   d. $84,000.

17. Assume the same details as in the previous question. What is the maximum amount of salary that Sandra can defer under the 401(k) plan for 2010?

   a. $1,400.

   b. $8,400.

   c. $14,000.

   d. $15,500.

18. George works part-time for Mercy Hospital, where he participates in a 403(b) plan. He also works part-time at the Hillside Free Clinic, which is unrelated to the hospital. George participates in a 401(k) plan maintained by the clinic. If George contributed $8,000 to the 403(b) plan in 2010, calculate his elective deferral limit for the 401(k) plan for the year.

   a. $8,000.

   b. $8,500.

   c. $9,000.

   d. $9,500.

19. Assume the same details as in the question above. If George miscalculates and ends up with an excess elective deferral, which of the following scenarios best describes how a distribution of the deferral will be treated for tax purposes?

    a. The corrective distribution is includable in George's gross income for 2010 only if it is made by December 31, 2010.

    b. Any income allocable to the deferral will be treated as earned and received in George's gross income for the tax year in which the income is distributed.

    c. The distribution will be subject to the early distribution tax found in IRC Sec. 72(t).

    d. If the 10% safe harbor method is used, George will not have to pay taxes on his excess elective deferral or any allocable income or loss.

20. Kathryn makes $18,000 of elective deferrals to the Matrix Company's 401(k) plan in 2010, which gives her an excess deferral of $1,500. The administrator of the company's plan determines that, after the ADP test, Kathryn has excess contributions of $2,500. How would Kathryn report these excesses?

    a. As $2,500 of 2010 income.

    b. As $2,500 of 2011 income.

    c. As $1,500 of 2010 income and $2,500 of 2011 income.

    d. As $1,500 of 2010 income and $1,000 of 2011 income.

21. Megan resigns from Gumdrops, Inc., before she is fully vested in its employee benefit plan. The plan document specifically states that forfeitures cannot be reallocated to other participants per the Internal Revenue Code. What type of plan does Gumdrops, Inc., maintain?

    a. A defined benefit pension plan.

    b. A profit-sharing plan.

    c. A 401(k) plan.

    d. A money purchase pension plan.

Lesson 2: Deducting Employer Contributions

INTRODUCTION

Employers that maintain qualified plans are allowed deductions for contributions to those plans in the current tax year as well as for contributions made on or before the extended due date of the current-year return. However, if the plan is a defined benefit or money purchase pension plan, the contribution may have to be made earlier than the extended due date of the employer's tax return to satisfy the minimum funding standard set forth in IRC Sec. 412. This rule applies even though benefits provided by these plans are taxable to plan participants in the year in which the benefits are distributed, rather than in the year in which their contributions are made.

This lesson discusses requirements that must be met for contributions to be deductible.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify plan provisions and basic rules for employer plan contributions and deductions.
- Compute contribution deductions for defined benefit plans, defined contribution plans, money purchase pension plans, and when an employee is covered by more than one employer.
- Assess other issues related to plan administration, such as when deductions can be taken, contributing noncash property, excess contributions, and plan termination.

THE EFFECT OF PLAN PROVISIONS ON LIMITS AND TIMING OF DEDUCTIONS OF EMPLOYER PLAN CONTRIBUTIONS

Certain plan document provisions must be reviewed before calculating the employer contribution required or allowed to be made to a plan. When the contributions must be funded may also be affected by information contained in the document. The document should answer most of the following questions:

- What type of plan is it? (Profit-sharing, money purchase, defined benefit?)
- Does the plan limit the contributions by reference to the maximum allowed employer tax deduction under the Code or to a lesser amount?
- Does the plan have a 401(k) feature?
- Does the plan have matching contributions?
- Does the plan allow after-tax employee contributions?
- Is there a required contribution?
- What is the plan year?
- What is the sponsor's taxable year?
- How does the plan handle forfeitures?
- Are there any commonly controlled businesses to be considered? (This information should be reviewed with the sponsor. Plan documents may not include this information, or may not reflect current information.)
- Are there multiple plans that are required to be aggregated? (This may also need to be reviewed with the sponsor.)
- Can excess annual additions be used to reduce employer contributions? If so, is the reduction only for the affected participant or are the reductions to be used to reduce the employer contributions for all participants?

BASIC RULES FOR EMPLOYER CONTRIBUTION DEDUCTIONS

Key Deduction Rules

IRC Sec. 404 contains the key rules for deducting contributions to qualified plans. These rules differ based on the type of plan (e.g., profit-sharing, stock bonus, money purchase, or defined benefit plan).

The basic rule is that contributions otherwise deductible as business expenses under any other Code Section must be deducted under IRC Sec. 404. In other words, IRC Sec. 404 preempts other Code Sections when determining the extent to which plan contributions are deductible. The purpose of this rule is to ensure that contributions are subject to the limitations on deductibility set forth in IRC Sec. 404.

This does not mean that if IRC Sec. 404 applies, the requirements of other Code Sections can be ignored. Instead, it means that if a deduction would be allowed under another section of the Code, IRC Sec. 404 works to potentially limit that deduction.

Ordinary and Necessary Requirement for Deductibility. An example of the interaction of IRC Sec. 404 with other Code requirements is the requirement that expenses be ordinary and necessary. IRC Sec. 162 provides that expenses incurred to maintain a trade or business must be ordinary and necessary to be deductible. IRC Sec. 212 provides that, in the case of an individual, expenses for the production of income are deductible if they are ordinary and necessary.

The IRC Sec. 162 ordinary and necessary requirement that has the broadest application in the area of contribution deductions is the one that requires compensation to be reasonable in amount. A deduction for a contribution to a plan for the benefit of an employee is not allowed under IRC Sec. 404(a) unless that contribution, together with the employee's other compensation, constitutes reasonable compensation for services actually rendered.

Thus, to be deductible at all, contributions to plans must first be ordinary and necessary under IRC Sec. 162 and/or IRC Sec. 212. They are then subject to limitations under IRC Sec. 404.

Certain Restorative Payments Not Subject to Limits. The final Section 415 regulations specify that a restorative payment allocated to a participant's account is not subject to the Section 415 limits and treated as a business expense under IRC Sec. 162 for purposes of IRC Sections 415 and 404. The regulations state that generally payments to a defined contribution plan are restorative payments only if the payments are made in order to restore some or all of the plan's losses due to an action or failure to act that creates a reasonable risk of liability for breach of fiduciary duty.

The IRS has privately ruled that proposed payments designed to compensate participants for surrender charges did not constitute restorative payments where: (a) the rate of return under the contracts exceeded the guaranteed rate of return; (b) each participant's account was invested according to the participant's direction; (c) actual surrender charges were not more than 5 percent of the contract value; and (d) the payments were not to be made pursuant to an order or judgment of the DOL, an arbitrator, or a court of competent jurisdiction.

Deduction for Administrative and Overhead Expenses. An employer can deduct, without limit, recurring administrative or overhead expenses, such as trustee's fees and actuary's fees, that are not paid from plan contributions to the extent that such expenses are ordinary and necessary business expenses. The deductibility is not affected by whether the employer pays the expenses directly or reimburses the plan's trust for its payment of expenses (although the plan and/or trust document must provide for such payment). Doing so will allow employers to increase their tax deduction associated with the plan, as these amounts are not limited by the Section 404 deduction limit. (These amounts are also not considered for nondiscrimination testing.)

Timing of Deduction. For the contributions to be deductible, the contributions must actually be "paid" to the plan by the due date (including extensions) of the employer's tax return for the year of the contribution. The plan must be written, communicated to employees, and in effect by year end. Employers subject to the uniform capitalization rules may not be able to deduct the full Section 404 limit. A part of the Section 404 limit may be required to be allocated to production or inventory costs, which are capitalized and not immediately deductible.

The remainder of this lesson discusses the IRC Sec. 404 deduction limits applicable to different types of qualified plans.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Internal Revenue Code (IRC) Sec. 404 includes the key rules for deducting employer contributions to qualified plans. How does the guidance found in IRC Sec. 404 relate to the rest of the Code?

    a. Contributions that would otherwise be deducted as a business expense under another Code Section must be deducted under IRC Sec. 404 instead.

    b. If other Code Sections apply to the contributions, they will supersede the effects of IRC Sec. 404 and IRC Sec. 404 must be ignored.

    c. If IRC Sec. 404 applies in the situation, the requirements found in other Code Sections are superseded and must be ignored.

    d. How the Code is applied must be determined on a case-by-case basis using professional judgment.

23. In which of the following scenarios would the employer's contributions generally be fully deductible?

    a. Carmichael Construction maintains a 401(k) plan and makes regular contributions on the behalf of its employees. The company is subject to the uniform capitalization rules.

    b. Life Books makes contributions to its employees' profit-sharing-plan accounts, and the contributions are deemed ordinary and necessary under IRC Sec. 162.

    c. Donner Donuts pays an actuary for services related to its pension plan from the plan's trust.

24. During its 2009 plan year, the profit-sharing plan maintained by Fiction Ltd. had investment losses due to a breach in fiduciary duty. In 2010, the company made contributions totaling $200 to all plan participants to restore accounts to their previous balances. Based on the final Section 415 regulations, how should Fiction Ltd. treat these contributions?

    a. The contributions are deductible as long as the Section 404 limits have not been exceeded.

    b. The contributions are deductible as long as the Section 415 limits have not been exceeded.

    c. The contributions are treated as business expenses under IRC Sec. 162.

    d. Because the contributions fall outside of normal contributions, they cannot be deducted.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. Internal Revenue Code (IRC) Sec. 404 includes the key rules for deducting employer contributions to qualified plans. How does the guidance found in IRC Sec. 404 relate to the rest of the Code? **(Page 170)**

    a. Contributions that would otherwise be deducted as a business expense under another Code Section must be deducted under IRC Sec. 404 instead. [This answer is correct. When determining the extent that plan contributions are deductible, IRC Sec. 404 preempts other Code Sections. This ensures that contributions are subject to the limitations on deductibility that IRC Sec. 404 sets forth.]

    b. If other Code Sections apply to the contributions, they will supersede the effects of IRC Sec. 404 and IRC Sec. 404 must be ignored. [This answer is incorrect. Because IRC Sec. 404 contains important guidance related to employee benefit plans, it cannot be ignored, even if other Code Sections apply.]

    c. If IRC Sec. 404 applies in the situation, the requirements found in other Code Sections are superseded and must be ignored. [This answer is incorrect. The other Code Sections should not be ignored. The rules specify what employer contributions are deductible as a business expense.]

    d. How the Code is applied must be determined on a case-by-case basis using professional judgment. [This answer is incorrect. There are specific guidelines for how rules found in IRC Sec. 404 apply when other Code Sections apply to the contribution deduction, as well.]

23. In which of the following scenarios would the employer's contributions generally be fully deductible? **(Page 170)**

    a. Carmichael Construction maintains a 401(k) plan and makes regular contributions on the behalf of its employees. The company is subject to the uniform capitalization rules. [This answer is incorrect. Since Carmichael Construction is subject to the uniform capitalization rules, it may not be able to deduct the entire Section 404 limit, because part of that limit could be allocated to production or inventory costs, which are capitalized and not deductible immediately.]

    b. Life Books makes contributions to its employees' profit-sharing-plan accounts, and the contributions are deemed ordinary and necessary under IRC Sec. 162. [This answer is correct. Contributions that are ordinary and necessary under IRC Sec. 162 are deductible by the employer; however, the Section 404 limit must also be applied.]

    c. Donner Donuts pays an actuary for services related to its pension plan from the plan's trust. [This answer is incorrect. Administrative and overhead expenses, such as this one, are deductible by the employer; however, because the payments made by Donner Donuts are not considered contributions, this scenario does not meet the qualifications of this question per the Code.]

24. During its 2009 plan year, the profit-sharing plan maintained by Fiction Ltd. had investment losses due to a breach in fiduciary duty. In 2010, the company made contributions totaling $200 to all plan participants to restore accounts to their previous balances. Based on the final Section 415 regulations, how should Fiction Ltd. treat these contributions? **(Page 170)**

    a. The contributions are deductible as long as the Section 404 limits have not been exceeded. [This answer is incorrect. Section 404 applies to deducting contributions to qualified plans. Because Fiction Ltd. is making restorative payments, different guidance applies.]

    b. The contributions are deductible as long as the Section 415 limits have not been exceeded. [This answer is incorrect. Because the payments described in the scenario above are restorative, they are not subject to the Section 415 limits.]

    c. The contributions are treated as business expenses under IRC Sec. 162. [This answer is correct. Because Fiction Ltd.'s payments were made to restore losses to a defined contribution plan for a breach in fiduciary duty, they would be classified as restorative payments. Therefore, the payments would be treated as business expenses under IRC Sec. 162.]

    d. Because the contributions fall outside of normal contributions, they cannot be deducted. [This answer is incorrect. Based on IRS guidance, Fiction Ltd. can treat these payments as restorative payments, and treat them as indicated by the final Section 415 regulations.]

PROFIT-SHARING AND STOCK BONUS PLAN CONTRIBUTION DEDUCTIONS

Understanding Limits for Defined Contribution Plans and How They are Related

Generally defined contribution plans sponsored by single employers (not included in a controlled group) are subject to several limits that are interrelated and require careful consideration in determining the employer deduction limit.

a. *Employer Deduction Limits.* The employer deduction limit determines the amount an employer can deduct for contributions made to a qualified plan.

b. *The Annual Addition Limit.* The annual addition limit is the amount of contributions that can be added to an individual participant's plan account. This limit includes the employer and employee contribution as well as reallocated forfeitures allocated to the account of the participant.

c. *Employee Deferral Limit.* This limit applies to employee deferrals on a per-individual basis with respect to a calendar year. These deferrals are included in the annual addition limit (item b.) but not in the employer deduction limit (item a.).

d. *Catch-up Contributions.* Catch-up contributions can be made by individuals that are age 50 and over by the calendar year-end if the plan allows. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying the nondiscrimination rules. For 2010, the catch-up limit is $5,500 for qualified plans and $2,500 for SIMPLE plans.

To understand the limits, one must know what is being limited and to whom the limit applies. The employer deduction limit applies to the employer and limits the amount of employer contributions the employer can deduct. It does not include employee deferrals or catch-up contributions. The annual addition limit, the employee deferral limit, and the catch-up contribution limits are applied at the individual level and limit the amount that can be added to an individual's account but can reduce the employer's deduction limit if the individual limits are exceeded. This relationship makes a simple limit rather complex in certain situations.

Qualified Compensation Defined

There are several definitions for compensation that can be used for various purposes. It is important to understand which definition to use for which purpose. Compensation for the purpose of determining the employer deduction limit will be referred to as *qualified compensation* in the following discussion. A plan may cover both employees and owner-employees who are self-employed participants. Qualified compensation for self-employed participants is determined by earned income and adjusted by half of the self-employment tax and the participant's deductible contribution to the plan. The overall deduction limit for defined contribution plans is based on the total qualified compensation of all participants (including both employees and owner-employees).

Complying with the Annual Compensation Limitation. For purposes of the deduction limit, compensation is defined as the amount paid or accrued during the tax year to plan participants, not including deductible contributions to a qualified plan. Qualified plan compensation is not reduced by employee elective deferrals to 401(k) plans or employee elective contributions to cafeteria plans. This definition of compensation must be used to determine the deduction for employer contributions regardless of the plan definition of compensation used for contribution allocation purposes. The annual compensation for an individual employee that is taken into account to determine the deduction limit cannot exceed $245,000 for 2009 and 2010. Thus, the compensation for determining plan benefits of an employee with gross pay of $260,000 and employee elective deferrals of $16,500 is limited to $245,000.

Example 2-1: Computing the annual compensation limit.

Flight Services, Inc.(FSI) maintains a profit-sharing plan with a 401(k) arrangement. Randy, a 45-year-old participant in the plan, has compensation of $300,000 and elective deferrals of $16,500 for 2010. Thus,

Randy's taxable income is $283,500. FSI also makes an employer contribution of $10,000 to the plan on Randy's behalf. In applying the IRC Sec. 404 deduction limit, Randy's 2010 qualified compensation is $245,000 (unreduced by the elective deferrals of $16,500). If Randy were FSI's only employee, FSI's deduction limit for 2010 would be $61,250 (25% of $245,000). However, the maximum amount FSI can deduct is $49,000, which is Randy's IRC Sec. 415 annual addition limitation for 2010.

Compensation of Disabled Individuals. If provided for in the plan, an electing employer may treat the compensation of a non-highly compensated participant who is totally and permanently disabled as equal to the amount the individual would have received for the year if paid at the rate of compensation immediately before becoming disabled. Contributions relating to this compensation must be nonforfeitable when made. Such pay is also included in the definition of compensation.

Military Differential Pay. Under the Heroes Earnings Assistance Relief Tax Act (HEART), differential pay (the difference between the individual's pay from the employer and his or her military pay) paid after December 31, 2008, must be treated as compensation for retirement plan purposes. Plans may provide full or partial benefit accruals or contributions for the period for plan participants who die or become disabled.

Understanding the Deduction Limitation

The deduction for employer contributions to profit-sharing and stock bonus plans may not exceed the *greater* of:

a. 25% of the *total* qualified compensation paid or accrued during the employer's tax year to *all* participants to whom the contributions are allocated under the terms of the plan.

b. The amount the employer is required to contribute to a SIMPLE 401(k) under IRC Sec. 401(k)(11).

Amounts exceeding the deduction limitation can be carried forward under the rules discussed later in this lesson in the "Using a Contribution Carryover" paragraph. However, such excess is subject to a 10% excise tax for nondeductible contributions.

Example 2-2: Computing the deduction limit.

Pluscorp's profit-sharing plan calls for an annual contribution of 11% of profits. In 2010, its profits were $750,000. Based on the 11% rate, its contribution for 2010 would be $82,500. Its employees received qualified compensation of $300,000; 25% of that compensation was $75,000. Thus, the corporation's contribution deduction is limited to $75,000. The $7,500 ($82,500 − $75,000) excess is carried over to succeeding tax years. In addition, Pluscorp must pay a 10% excise tax ($750) on the excess.

If a company has two profit-sharing plans covering two entirely separate employee groups, the 25% limit of IRC Sec. 404 applies to the aggregate compensation of the two groups, no matter how the contribution is split between the two groups.

Example 2-3: Computing deduction limit when there are two plans.

Corporation X has two profit-sharing plans, one covering hourly employees and one covering salaried employees. The hourly and salaried groups each have $500,000 of total qualified compensation. The contribution to the hourly employees is $200,000 (40% of the total of qualified compensation for the group), while the contribution to the salaried employees is $25,000 (5% of qualified compensation). Looking at the two plans together, the total contribution of $225,000 divided by the total qualified compensation of $1,000,000 is 22.5% and does not exceed 25% on an aggregate basis; thus, the deduction limit is satisfied.

Profit-sharing and Stock Bonus Plans

The term *profit-sharing plan* is used throughout this lesson for easy reference; however, the same rules generally apply to a stock bonus plan.

A plan intended to qualify as a profit-sharing plan must indicate so in the plan document.

Are Profits Required? Contributions to profit-sharing plans can be made without regard to the employer's current or accumulated profits. To allow a contribution in a year in which the employer has a loss, the plan may specify a definition of profits that allows for a contribution even if the employer has no current or accumulated profits. Alternatively, the plan may merely specify that contributions are completely discretionary—to be determined annually by the employer without regard to whether the employer has any profits.

Limiting Contributions to 401(k) Plans

The deduction limit for the employer can be reduced because of the individual's annual addition limit which is applied at the individual level. The limits are interrelated. In some cases, the benefits must be aggregated. Similar plans of the employer and any related employer must be aggregated in determining the limits. If the employee receives benefits from unrelated employers there is a separate annual addition limit for each unrelated employer.

Example 2-4: Annual additions from unrelated employers.

Jim Beam works for Jack Daniel Distributing Company (JDDC) earning $200,000 yearly. He receives an employer contribution of $49,000 for 2010 in the JDDC profit-sharing plan. Jim also has unrelated self-employment income of $300,000 from Jim's Gold Mine (JGM). This provides Jim with the opportunity to contribute $49,000 to the JGM profit-sharing plan. Jim will not exceed the IRC Sec. 415 limit in this case.

Aggregation rules for the deferral limit and the catch-up limit are different. Each individual has a deferral limit of $16,500 for 2010 ($22,000 for 2010 for individuals age 50 and over by the calendar year end). This limit includes all deferrals made to any plan regardless of whether the sponsors are related.

Example 2-5: Annual deferral limit with multiple plans.

Sally Sue is 30 years old and works for two companies. She earns $70,000 from A-1 Services and $80,000 from B-2 Bomber Co. Each company has a 401(k) plan. She defers $10,000 to the A-1 Service 401(k) plan and $8,000 to the B-2 Bomber plan.

Does she have a limit problem? Yes, even though the two companies are unrelated, Sally must combine the salary deferrals made to both plans in determining her deferral limit. She has deferred a total of $18,000. She must inform one or both employers that she has exceeded her IRC Sec. 401(g) limit of $16,500 for 2010 and receive a total refund of $1,500 from the plan(s).

Generally, a 401(k) arrangement is part of a profit-sharing or stock bonus plan, and as such, the rules discussed in this section apply.

Treatment of Elective Deferrals. Elective deferrals are contributions an employer makes to a plan (instead of paying cash to the employee) pursuant to an employee election. The amounts contributed to the plan because of the employee's election are excludable from the employee's gross income and are not subject to income tax by the federal government or by most states [unless the participant designated them as Roth 401(k) contributions], but instead are subject to income tax when distributed to the participant or beneficiary. Elective deferrals must be fully vested from the time of contribution; in addition, they are subject to restrictions on withdrawal.

When determining whether the limitations on contributions are exceeded, elective deferrals to a 401(k) plan are not treated as employer contributions. Also, compensation as determined for the deduction limit is not reduced by the participant's pre-tax contributions to a 401(k) plan, cafeteria plan under IRC Sec. 125, a 457, or a 132(f) qualified transportation fringe benefit plan.

Amounts contributed to the plan that were currently available to the employee at the time of the contribution (and, thus, subject to income tax at that time) are not treated as employer contributions. Rather, they are treated as after-tax employee contributions.

Contribution and Allocation Formulas Distinguished

A contribution formula and an allocation formula are two different things and are defined in the following paragraphs.

Contribution Formula. A profit-sharing plan may have a contribution formula that requires a specific amount to be contributed to the plan. Such a definite contribution formula (e.g., a fixed percentage of net profits or a specified percentage of the compensation of the participating employees) is allowed (but not required). However, most profit-sharing plan documents allow the employer complete discretion in setting its annual contribution formula.

If the plan does contain a contribution formula, that formula must be complied with when determining the contribution amount each year.

Allocation Formula. The allocation formula establishes how the employer's contribution is allocated to each participant.

Unlike contribution formulas which may be discretionary, no discretion is allowed as to whether to provide an allocation formula in the plan documents. Profit-sharing plans must provide a definite predetermined formula for allocating employer contributions among the participants. An example of such a formula is one providing for the allocation of contributions in proportion to the participants' compensation.

The allocation formula requirement is a qualification requirement. If the plan does not contain such a formula, it will not constitute a qualified plan under IRC Sec. 401.

Staying within the Section 415 Annual Addition Limit

In addition to, but separate from, the deduction limit discussed in this lesson, the annual addition to a participant's account for 2010 is limited to the lesser of the following:

a. $49,000 (adjusted annually for cost-of-living increases), or

b. 100% of the participant's compensation.

Thus, in addition to the deduction limit discussed previously (which is based on aggregate employee compensation), the employer's contribution combined with elective 401(k) deferrals, allocated forfeitures, and employee after-tax contributions may not exceed the Section 415 annual addition limit (which limits amounts contributed to each participant). The Section 415 annual addition limit does not include catch-up contributions.

A failure to stay within the annual addition limit will result in an excess contribution known as an excess annual addition.

Example 2-6: Complying with the Section 415 annual addition limit.

Billy Kid.com, Inc. maintains a profit sharing plan for its employees. The plan allows discretionary contributions up to the maximum deductible amount allowed and does not affect employee contributions by forfeitures. For 2010, the corporation wishes to contribute 14% of each employee's compensation (limited to $245,000 for each employee). In the prior year, one employee terminated employment and forfeited $30,000. The plan document provides that the forfeited amount is to be allocated in the year following termination. The maximum amount Billy Kid.com, Inc. can deduct for 2010 is $93,000 ($372,000 × 25%).

Participant	Plan Compensation	14% Contribution to Allocate	$30,000 Forfeitures to Allocate	Total Allocation	Section 415 Annual Addition Limit
Billy Kid	$ 245,000	$ 34,300	$ 19,758	$ 54,058	$ 49,000
Betsy Smith	50,000	7,000	4,032	11,032	40,000
Jane Davis	32,000	4,900	2,823	7,723	25,000
Alisa Barker	42,000	5,880	3,387	9,267	28,000
Totals	$ 372,000	$ 52,080	$ 30,000	$ 82,080	$ 139,000

In this example, if the employer contributes $52,080 (14% of qualified compensation), the allocation of employer contributions of $52,080 plus forfeitures of $30,000 will exceed Billy's Section 415 limit of $49,000 by $5,058. Depending on how the plan document handles forfeitures and excess allocations, the employer must either reduce the amount contributed to the plan to 11.9355% to bring Billy's total allocation to $49,000, allocate the $5,058 to the other participants, or carry the excess amount to the next year. Reg. 1.415-6(b)(6) provides methods for correcting excess annual additions under certain circumstances.

Using a Contribution Carryover

Contributions actually paid in a taxable year, that are in excess of the deduction limit are carried over to succeeding tax years in order of time. However, the total amount deductible in each succeeding tax year cannot exceed the deduction limit for that year. In other words, the carryover cannot increase the limit in a year to which it is carried to an amount in excess of the deduction limit for that year.

The following rules apply to the carryover:

a. If the succeeding tax year ends with or within a plan year when the plan is qualified, the excess is deductible in any succeeding tax year in which contributions are less than the deduction limitation for that year. The total deduction for that succeeding year cannot exceed the lesser of: (1) the deduction limit, or (2) the sum of the succeeding year's contribution plus the carryover.

b. If the succeeding tax year ends with or within a plan year when the plan is not qualified (or if the succeeding tax year ends after termination of the plan), the amount deductible cannot exceed the lesser of the deduction limit or the nondeductible prior years' contributions.

c. The excise tax discussed later in this course applies to excess contributions that are carried over to succeeding years.

Example 2-7: Use of carryovers.

Jones, Inc. exceeded the deduction limitation on contributions to its profit-sharing plan in years 2005 through 2009, resulting in contribution carryovers. The plan maintained its qualified status throughout. The schedule below illustrates the use of those carryovers.

	2005	2006	2007	2008	2009
Prior year carryover	$ —	$ 5,000	$ 8,000	$ 5,000	$ 4,000
Current year contribution	80,000	93,000	90,000	96,000	99,000
Total contribution subject to limit	80,000	98,000	98,000	101,000	103,000
Deduction limit	(75,000)	(90,000)	(93,000)	(97,000)	(98,000)
Nondeductible Contributions[a]	$ 5,000	$ 8,000	$ 5,000	$ 4,000	$ 5,000

Note:

[a] Carryforward to next tax year.

Jones, Inc. must pay a 10% excise tax on the nondeductible contribution amount occurring in each year. Thus, the excise tax would be $500 for 2005, $800 for 2006, and so on. If Jones, Inc.'s contribution is made after the close of the plan year, the nondeductible portion may be designated as a contribution for the next year to the extent that such a designation is not contrary to the contribution formula under the plan and the resolution resolving to make the contribution. Also, note that forfeitures allocated under a profit-sharing plan do not reduce the employer's Section 404(a)(3) deduction limit, although forfeitures are annual additions under IRC Sec. 415.

Using Contributions by Affiliates

Members of an affiliated group with a common profit-sharing plan in which contributions are based on profits, can shift contributions and the deductions for those contributions among the group members. Accordingly, if a plan

established by an affiliated group has a group member that cannot make a contribution because it has no profits, the group members with profits may make the contribution for the employees of the group member with no profits. In addition, if a group member's contribution is limited because earnings are less than the contribution that it would otherwise have been able to make, the group members with profits may make otherwise disallowed contributions on that member's behalf.

Special Limits for Employee Stock Ownership Plan (ESOP) Contributions

Special limits apply to contributions to Section 4975(e)(7) employee stock ownership plans (ESOPs). These limits depend on whether the contributions are used by the plan to repay principal or interest on a loan incurred for the purpose of acquiring qualified employer securities:

a. *Principal.* Contributions used to repay principal may exceed the usual deduction limit; however, the deduction for any year may not exceed 25% of the compensation otherwise paid or accrued during the tax year to employees covered by the ESOP.

b. *Interest.* Contributions used to pay interest on such a loan are deductible without limit.

To qualify for this exception, the contributions must be applied toward the payment of principal and/or interest no later than the due date of the corporation's extended income tax return. Also, the special limits do not apply to S corporations.

All other limitations applying to profit-sharing/stock bonus plans apply to contributions to an ESOP.

Contributions for Self-employed Individuals

For purposes of the rules regarding profit-sharing plans, self-employed individuals with earned income are considered employees. Thus, contributions can be made on their behalf based on the same rules that apply to other employees. However, qualified compensation for plan purposes is defined slightly differently for self-employed individuals. The definition begins with earned income and is then reduced for half of the SE tax and the self-employed participant's deductible contribution to the plan.

The deduction for contributions on behalf of self-employed individuals are considered to satisfy the ordinary and necessary requirements of IRC Secs. 162 and 212 if the contributions do not exceed that individual's earned income derived from the trade or business for which the plan was established. In other words, contributions made on behalf of self-employed individuals are limited to their earned income from that trade or business and, therefore, the deduction cannot create a net operating loss.

Qualified Compensation for Self-employed Individuals

The self-employed individual's compensation is considered to be the earned income from the trade or business for which the plan was established. There are different earned income requirements based on the type of self-employment. The following paragraphs discuss these requirements.

Sole Proprietors and Partners. The earned income requirement for sole proprietors and partners means that personal services must be performed and must be a material income-producing factor. The following rules apply in determining earned income for these individuals:

a. Distributions to a limited partner are not considered earned income from self employment.

b. Guaranteed payments to a limited partner are considered earned income if personal services are performed to or for the partnership.

c. Inactive investors do not have earned income from the business and, thus, are not self-employed.

d. Liquidating distributions received by terminating partners for their capital interests are not earned income.

e. Partners may not maintain a qualified plan independent of the partnership that is based on pass-through income. For qualified plan purposes, the partnership is the employer of the individual partner.

Calculating Compensation for Allocation Purposes for Self-employed Individuals with Multiple Businesses. A self-employed individual that is involved in more than one trade or business must consider each trade or business separately for purposes of determining deductible contributions. For example, if a plan has been established for one trade or business but not the other, then the individual will be considered an employee only if earned income is received from the trade or business maintaining the qualified plan. Only the earned income from the trade or business with the plan may be taken into account to determine the deductible contribution. The IRC Sec. 164(f) deduction for one-half of self-employment tax must also be allocated to the net self-employment earnings of each business.

Example 2-8: Allocation of compensation and the Section 164(f) deduction.

Bernie, a self-employed designer, maintains two separate businesses. He has self-employment income of $70,000 and has established a qualified plan through Rockets Corp. From his second business, Torpedo Inc., he has self-employment income of $30,000. When computing the earned income used to determine qualified plan contributions for Rockets Corp, only his self-employment income from this business may be used. In addition, Bernie's IRC Sec. 164(f) deduction must be apportioned between the two businesses in order to determine the earned income allocable to Rocket's plan.

If Bernie wishes to have his earned income from both businesses used to determine the maximum contribution deduction then Torpedo Inc. would need to adopt the plan as well.

If one trade or business of a self-employed individual with multiple trades or businesses has a net loss for the year, then, presumably, the result would be virtually the same. However, this is an area that has not had clear formal guidance as to the IRS's position. In the IRS question and answer session at the 2005 annual conference of ASPPA, in Q&A-61, the IRS took the approach demonstrated in Example 2-9 that only the earned income of the adopting entity is used in calculating the compensation for *allocation* purposes for plans maintained by self-employed individuals with multiple businesses even in the instance when one business has a net loss.

Example 2-9: Calculating compensation for allocation purposes when a loss is involved.

Company A, LLC and Company B, LLC are owned 100% by the same person. This person performs management functions for both entities. Company A has rank and file employees; Company B has no rank and file employees. A defined contribution plan is set up that covers the employees of Company A. The owner receives $100,000 in earned income from Company A (after the contribution for the employees of Company A). However, he incurs a loss of $100,000 from Company B. For purposes of allocating contributions in the Company A plan, is his compensation considered to be $100,000 or $0?

According to Reg. 1.401-10(b)(3) and the IRS's informal guidance in Q&A-61 of the 2005 annual ASPPA conference, compensation of $100,000 is used to allocate contributions in the Company A plan.

S Corporation Shareholders. S corporation shareholders are not treated as self-employed individuals for this purpose, and any pass-through income is not earned income. S corporation shareholders are employees of the corporation and thus, may be covered by the corporation's qualified plan. However, an S corporation shareholder cannot separately establish a qualified plan based on pass-through income received from the corporation.

Limited Liability Companies (LLCs). To date, there have been no rulings pertaining specifically to LLCs and qualified retirement plans. However, in general, the rules that apply depend on whether the LLC elects to be classified for federal income tax purposes as a disregarded entity, a partnership, or an association taxed as a corporation.

If the LLC is taxed as a disregarded entity or a partnership, the rules discussed previously apply. The potential contributions of LLC members to a qualified plan are limited to their self-employment income from the trade or business conducted by the LLC. If a member of the LLC taxed as a partnership is not subject to self-employment (SE) tax, that member cannot participate in the qualified plan. Earned income is the member's allocable share of self-employment income derived from the LLC's business (line 14 of Schedule K-1, Form 1065).

If the LLC is taxed as a corporation, the member is an employee of the LLC and taxable compensation derived from personal services performed is compensation for plan purposes.

Adjusting Earned Income for Self-employed Individuals. When computing the deduction limit, the qualifying compensation for a self-employed participant is generally the individual's earned income determined after (a) deducting half of the SE tax (b) deducting the self-employed participant's deductible contribution to the plan, and (c) applying the annual compensation limit. This latter reduction requires the use of a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income). This reduced percentage is referred to in this discussion as the recalculated percentage.

The actual percentage that may be contributed on behalf of the self-employed person depends on whether the compensation limit ($245,000 for 2010) comes into play and, if so, how the plan defines compensation.

Generally, the self-employed individual's recalculated contribution percentage (net of SE tax) is 20% if a 25% profit-sharing contribution (the maximum percentage allowed for employer deductions in 2010) is used for the other employees. If less than 25% is contributed for the other employees, the following formula can be used to compute the self-employed owner's maximum percentage:

$$\text{Owner } \% = \frac{\text{Employee } \%}{1 + \text{Employee } \%}$$

Example 2-10: Calculating a self-employed's profit-sharing contribution.

Gary, a self-employed individual, maintains a profit-sharing plan and employs two other individuals that are eligible to participate in the plan. Gary maintains no other qualified plans. For 2010, the eligible employees' total compensation is $40,000 and Gary has net income of $70,000 (before any plan contributions for himself or the employees). Gary wishes to contribute for himself and the employees the maximum amount deductible for 2010.

How is the contribution calculated? The employees' contribution is $10,000 ($40,000 × 25%). Gary's contribution is calculated as follows:

Net income before plan contributions	$ 70,000
Less contribution for employees	(10,000)
	60,000
Less 1/2 SE tax ($60,000 × .9235 × .153 × .5)	(4,239)
	55,761
Recalculated percentage	× 20%
Gary's contribution	$ 11,152

The calculation of Gary's contribution can be tested as follows:

Net income before plan contributions	$ 70,000
Less employee contributions	(10,000)
Less 1/2 SE tax	(4,239)
Less Gary's contribution	(11,152)
Gary's earned income	44,609
Contribution percentage	× 25%
Gary's contribution	$ 11,152

What if Gary also owned an 85% interest in a partnership under which he was allocated an $80,000 loss for the year? Although Gary's deduction limit would still be $11,152, the annual contributions to his account would be limited under IRC Sec. 415 to the lesser of $49,000 or 100% of his net earnings from the controlled group, which includes the sole proprietorship and the partnership (as he owns more than 80% of this brother-sister controlled group). Because Gary has a combined loss of $10,000 from both businesses, he cannot make a contribution for the year for his benefit. (If Gary had owned 50% or less of the partnership, his earned income for Section 415 purposes would not have included the partnership loss, and the Section 415 limit would not apply.) The contribution limits for his employees would not be affected by Gary's ownership interest.

The IRS has issued examination guidelines for deduction limitations of self-employed individuals.

Effect of the $245,000 Compensation Limit

If the self-employed individual's earnings for 2010 are to be limited by the $245,000 compensation limit and the amount contributed is less than the 25% maximum, it is important to check the specific language in the plan document to learn how contributions are determined for the self-employed participant. Plans typically satisfy the requirement for the reduced owner's contribution percentage by using one of the following methods:

a. *Gross Earnings Method.* The plan provides a contribution formula for owners (the self-employed individuals) that specifies the reduced owner percentage. This reduced percentage is applied to the owner's plan-year compensation, defined by the plan as net profit from self-employment minus the deduction for half of the self-employment tax.

b. *Net Earnings Method.* The plan provides a contribution formula of a stated rate (which is the same for all employees) of plan-year compensation. The plan defines plan-year compensation for self-employed individuals as earned income within the meaning of IRC Sec. 401(c)(2) (i.e., net profit from self-employment less the self-employment tax deduction and the deduction for the plan contribution on behalf of the self-employed participant).

Calculating the Maximum Contribution Deduction. A seven-step process can be used to calculate the maximum deductible 2010 contribution for a self-employed individual.

Example 2-11: Contribution limit using the gross earnings method.

Pam Hye is a self-employed attorney with a net Schedule C income of $300,000. Pam maintains a defined contribution plan that annually allocates 16.6667% of plan-year compensation to eligible self-employed individuals and 20% of plan-year compensation to eligible employees. Compensation for self-employed individuals is defined in the plan document as the individual's net profit from self-employment less the deduction for half of the self-employment taxes. This results in 13.6667% of the net schedule C income as adjusted.

The maximum 2010 contribution Pam may make to the plan on her own behalf is $40,833, calculated as follows:

1. Net earnings from self-employment	$ 300,000
2. Less half the SE tax liability ($21,277 × 1/2)[a]	(10,639)
3. Compensation before plan contribution	$ 289,361
4. Reduced owner's contribution percentage	16.6667 %
5. Compensation multiplied by contribution rate ($289,361 × 16.6667%)	$ 48,227
6. $245,000 compensation limit multiplied by the separate contribution rate specified in the plan for self-employed individuals; or, if none is specified, the contribution rate applicable to all participants, including the owners (unreduced) ($245,000 × 16.6667%)	$ 40,833
7. Maximum deductible contribution (smaller of $49,000, line 5, or line 6)	$ 40,833

Note:

[a] Pam's 2010 self-employment tax liability is calculated as follows:

1. Social security tax portion: $106,800 × 12.4% = $13,243
2. Medicare portion: ($300,000 × 92.35%) × 2.9% = $8,034
3. Total: $13,243 + $8,034 = $21,277

Example 2-12: Contribution deduction using the net earnings method.

Assume the same facts as in the previous example, except the plan provides a contribution formula of 20% of plan-year compensation for all participants and defines compensation for self-employed individuals as Section 401(c)(2) earned income (i.e., net profit from self-employment less the self-employment tax deduction and the deduction for the plan contribution on behalf of the self-employed participant). Under this scenario, Pam's maximum deductible contribution increases by more than $7,400, to $48,227, calculated as follows:

1.	Net earnings from self-employment	$ 300,000
2.	Less half the SE tax liability ($21,277 × 1/2)	(10,639)
3.	Compensation before plan contribution	$ 289,361
4.	Reduced owner's contribution percentage	16.6667 %
5.	Compensation multiplied by contribution rate ($289,361 × 16.6667%)	$ 48,227
6.	$245,000 compensation limit multiplied by the separate contribution rate specified in the plan for self-employed individuals; or, if none is specified, the contribution rate applicable to all participants, including the owners (unreduced) ($245,000 × 20%)	$ 49,000
7.	Maximum deductible contribution (smaller of $49,000, line 5, or line 6)	$ 48,227

DEFINED BENEFIT PLAN CONTRIBUTION DEDUCTIONS

This section contains limited information regarding defined benefit plans. The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Thus, an actuary must compute the deduction limit. The maximum deduction is based in part on the benefits provided by the plan and assumptions employed by the actuary, such as interest, mortality, and turnover. Service providers need to have a basic understanding of the concepts involved to facilitate communication between clients and actuaries.

Deductible Limit

The deduction limit for defined benefit plans (other than multiemployer plans) for taxable years beginning after 2007 is the greater of:

a. the sum of the unfunded amount that is actuarially determined under IRC Sec. 404(o), or

b. the minimum funding requirement under IRC Sec. 430.

The plan's minimum funding requirement and the *maximum deductible contribution* use the same actuarial assumptions and funding method. However, there are special adjustments and accounting requirements that distinguish the two. Normally, it is expected that the minimum funding requirement will be less than the *maximum deductible contribution*. However, should it exceed the calculated *maximum deductible contribution*, the minimum funding requirement becomes the deductible contribution limit.

The full funding limit under IRC Sec. 412(c)(7)(A)(i) no longer exists.

Understanding the Minimum Funding Standard Rule

The minimum funding standards are contained in IRC Sec. 412 and ERISA Sec. 302. IRC Sec. 430 contains the minimum required contribution rules for single-employer plans (and all other plans that are not multiemployer plans) subject to the minimum funding standards. Multiemployer plans are subject to the funding rules of IRC Sec.

431. The standards of IRC Sec. 412 apply to qualified pension plans while the standards of ERISA Sec. 302 apply to qualified and nonqualified pension plans. The purpose of the standards is to provide a system of financing the benefits of pension plans to better enable the plans to meet their future benefit obligations. Most plans will be subject to a single set of funding rules.

The required contribution is based on a comparison of the value of the plan's assets to the plan's funding target and target normal cost. The value of the plan assets are actuarially determined using the fair market value or asset smoothing. *Asset smoothing* is the averaging of fair market values over a period of not more than 24 months and that does not result in a determination of value that is less than 90% or more than 110% of the fair market value at the time. When using asset averaging, the amounts must be adjusted for contributions, distributions and expected earnings (to be actuarially determined).

The adjustment for expected earnings made to the fair market value of plan assets for a determination date equals the sum of the expected earnings, separately determined for each period between the determination date and the valuation date. *Expected earnings* are equal to the assumed rate of return (for 12 months) multiplied by the fair market value of assets as of the determination date that is the beginning of the period, adjusted to reflect any contributions, benefits, and administrative expenses paid during the period (other than contributions for a plan year that ends with, or prior to, the determination date).

The contribution determination is not solely in the actuary's hands. Roles must be played by the participating employers, the plan administrator, and the trustee, all of whom are plan fiduciaries. The actuary is a catalyst, taking the input from the plan fiduciaries to arrive at the appropriate contribution level. The actuary has the responsibility of choosing the actuarial assumptions, while the choice of funding method belongs to the plan administrator. Basically, the funding method determines how quickly the liabilities of the plan will be funded. The actuarial plan assumptions reflect the economic and demographic expectations of the plan, mortality tables (issued or approved by the IRS), revised funding rules of the Pension Protection Act of 2006 (PPA), and investment changes that may be triggered by the PPA. The assumptions are the measurement of the value of benefits, which, when applied under the funding method chosen by the plan administrator, produces the plan's annual contribution requirements and the deduction limit for income tax purposes.

The rules regarding use of the generally applicable mortality tables set by the IRS are provided in IRC Sec. 430(h)(3). These tables are based on actual experience of pension plans and projected trends and should be used for determination of any present value calculation necessary under Section 430 [Reg. 1.430(h)(3)-1]. However, a plan sponsor may request the use of a substitute mortality table as long as the applicable requirements are met. The current static mortality tables, for use in determining the funding target, and other present value calculations for dates occurring during calendar years 2009–2013 are available in IRS Notice 2008-85.

The economic assumptions employed in calculating the funding amount reflect the expected investment earnings of the plan and, if the benefits of the plan are a function of the wages of the covered employees, the potential growth of those wages to normal retirement. The employee and employer demographics reflect the probability of remaining employed to collect benefits and the potential growth or stability of the employee population to satisfy the staffing needs of the employer's business. The actuary cannot choose the appropriate assumptions in a vacuum; the assumptions are dependent upon the input provided by the plan fiduciaries and the periodic review of that information as circumstances warrant.

The interest rate used to determine the present value of liabilities under ERISA Sec. 303(h)(2) (added by the PPA) is based on a modified yield curve of investment grade corporate bonds of varying maturities that are rated AAA, AA, and A and published by the Treasury Department. The change begins in 2008 and is phased in over three years, although a plan sponsor may make a one-time election to opt out of the phase-in rules.

Minimum Required Contribution for Defined Benefit Plans after 2007

Effective for plan years beginning in 2008, the PPA replaced the funding standard account requirement with a single minimum required contribution (MRC) calculation for plans other than multiemployer plans. Although actuaries will be required to deal with the details of the law changes and the transition rules, the practitioner may need a basic understanding of the following terms contained in the new rules:

a. *Funding Target.* The present value of all benefits accrued or earned under the plan as of the beginning of the plan year is the funding target that is used to determine if the plan has a funding shortfall.

b. *Target Normal Cost.* The present value of benefits expected to be accrued or earned during the current plan year is the target normal cost.

c. *Funding Shortfall.* If the plan's funding target for the year exceeds the value of the plan assets, the plan has a funding shortfall for the year.

d. *Shortfall Amortization Installment.* The shortfall amortization installment is the amount necessary to amortize the shortfall amortization base for any plan year over a 7-plan-year period using specified interest rate rules.

e. *Waiver Amortization Base.* The waiver amortization base for a plan year is the amount of waived funding deficiency.

For taxable years beginning after 2007, the minimum required contribution (MRC) depends on whether the plan has a funding shortfall for the plan year and is determined as follows:

a. If the plan has a funding shortfall, the MRC is the sum of:

(1) the shortfall amortization charge, plus

(2) the waiver amortization charge, if any.

b. If the plan has no funding shortfall, the MRC is:

(1) the target normal cost for the plan year, reduced by certain credits allowed for any prefunding balance or funding standard carryover balances.

Includible Contributions. A special rule under Reg. 1.404(a)-14(e)(1)(ii) provides that if amounts required under IRC Sec. 412 were paid for the preceding year but not deducted solely because they were not timely paid for IRC Sec. 404 purposes, these amounts are "includible contributions" and are deductible under IRC Sec. 404(a)(1)(A)(i) for the current year. However, total deductions under IRC Sec. 404(a)(1)(A)(i) are subject to the applicable funding limit.

Example 2-13: Special rule for "includible contributions."

The Paylate Corporation maintains a defined benefit plan. Both the corporate and plan year ends are December 31. The employer timely made the required minimum funding contribution of $10,000 for 2009 within 8$^{1}/_{2}$ months of the plan year end ($8,000 on March 15, 2010, and $2,000 on September 15, 2010. However, only $8,000 was deductible for 2009 because $2,000 was paid subsequent to the tax filing of March 15, 2010 and therefore is not deductible for 2009. Assuming that the full funding limitation does not otherwise limit the deduction, this $2,000 is deductible as an "includible contribution" in 2010, even though when added to the 2010 required minimum funding contribution of $11,000, it causes the deduction to exceed the minimum funding requirement for 2010. Although the 2009 contribution was $10,000 and the 2010 contribution was $11,000, the deduction for 2009 was $8,000 and the 2010 deduction was $13,000.

The shorter automatic extension period does not affect the due date for contributions to defined benefit or money purchase plans. The minimum funding standards set the due date for such contributions (generally to 8$^{1}/_{2}$ months after the year-end). The due date for contributing employee elective deferrals is also not impacted. Such contributions must generally be deposited as soon as reasonably possible, but no later than 15 business days (30 days for SIMPLE IRA elective deferrals) following the month in which the contributions were paid by employees or withheld from their wages.

Additional Funding Based Limits. For plan years beginning after 2007, IRC Sec. 436, added by the PPA, imposes funding-based limits on unpredictable contingent event benefits. Certain benefit distributions and benefit accruals

will not be required under plans with funding percentages of less than 60% (or that would be less than 60% taking into account the contingent event's occurrence). An *unpredictable contingent event benefit* is any benefit payable solely by reason of (a) a plant shutdown (or similar event, as IRS determines), or (b) an event other than the attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of death or disability.

Changes in Benefits. Minimum funding standards are based upon the terms of the plan in effect on the first day of the plan year. In developing a minimum funding contribution, changes in the benefits effective, whether or not retroactively, in a future plan year or that become effective during the current plan year after the first day of the plan year, cannot be anticipated. Prohibited considerations under a reasonable funding method are (a) anticipated future benefits and (b) anticipated future participants.

Amendments to Benefit Structures. Amendments made for minimum funding purposes within 2½ months after the close of the plan year, effective as of the first day of the plan year, may be considered in the determination of the minimum funding standard and the corresponding relationship to the deduction limitations under IRC Sec. 404.

Plans Exempt from the Minimum Funding Standards. Generally, all defined benefit plans sponsored by small business employers are subject to the minimum funding standards. However, the following plans are exempt from the minimum funding standards of ERISA for both tax and regulatory purposes:

a. A plan that at no time after the date of enactment of ERISA (September 2, 1974) has provided for employer contributions.

b. A plan funded exclusively through the purchase of insurance contracts.

c. A profit-sharing, 401(k), or stock bonus plan. This also includes an ESOP to the extent it is not a money purchase plan.

d. A governmental plan.

e. A church plan not electing ERISA coverage under IRC Sec. 410(d).

f. A plan of a fraternal organization or employee beneficiary association that is tax-exempt under IRC Sec. 501(c)(8) or (9), and to which no employer contributions are made.

g. An unfunded plan designed to provide deferred compensation to a select group of management or highly compensated employees (a "top-hat" plan).

h. An unfunded excess benefit plan.

i. A plan funded with IRAs.

Funding Standard Account Requirement. Each plan subject to the minimum funding standards is required to maintain a funding standard account in order to determine whether the minimum funding standard has been met for the plan year. If contributions to a plan are not sufficient to satisfy the funding standards, the funding standard account will reveal an accumulated funding deficiency at the end of the plan year. An accumulated funding deficiency is the excess of (a) total charges (normal cost, amortization of past service costs, etc.) to (b) the funding standard account for all plan years (beginning with the first plan year the funding standards were applicable), over (c) total credits to the account (contributions, etc.) for such years. Meeting the minimum funding requirement does not insure that the plan will have sufficient assets to satisfy benefit liabilities as they become due, as this depends upon how quickly the chosen funding method amortizes the liabilities.

Excise Tax on Accumulated Funding Deficiency. A two-tier excise tax is imposed on an accumulated funding deficiency—an initial 10% tax and an additional 100% tax. Funding deficiencies (failures to make the required contributions to a plan subject to IRC Sec. 412) cannot be corrected through the correction programs offered by the Employee Plans Compliance Resolution System (EPCRS). The two-tier excise tax is discussed in the following paragraphs.

Initial Excise Tax. An employer who maintains a defined benefit plan that has an accumulated funding deficiency for any year, must pay an excise tax equal to 10% of that deficiency for each tax year until the accumulated funding deficiency is corrected. The initial excise tax is payable annually and is computed and paid with Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans). The IRS has no authority to grant a waiver of the initial tax.

Example 2-14: Excise tax on funding deficiency.

Farther Behind, Inc. (FBI) has a funding deficiency of $10,000 in its defined benefit plan's minimum funding standard account for the plan year ended December 31, 2010.

What is the amount of the excise tax? FBI must pay an excise tax on its funding deficiency in the amount of $1,000 ($10,000 × 10%). FBI's employer identification number and "Form 5330 Section 4971" should be indicated on the accompanying payment.

For the purpose of an accumulated funding deficiency, Form 5330 is due the later of (a) the last day of the seventh month after the end of the employer's tax year in which the plan year ends (July 31 for a calendar year employer), or (b) 8½ months after the last day of the plan year that ends with or within the employer's tax year (September 15 where the plan and employer have a calendar tax year). The period for filing Form 5330 may be extended up to six months by filing Form 5558 (Application for Extension of Time to File Certain Employee Plan Returns).

Additional 100% Excise Tax. If the funding deficiency is not corrected by the time the initial tax is assessed or by the time the IRS mails a tax deficiency notice, the employer is liable for an additional excise tax of 100% of the amount of the funding deficiency, unless it is waived by the IRS. Payment of the 100% excise tax does *not* void the funding deficiency; it is still owed to the plan. The 100% additional tax is not imposed if the accumulated funding deficiency is corrected within the taxable period. The taxable period means the period beginning with the end of the plan year (in which there is an accumulated funding deficiency) and ending on the earlier of (a) the date on which a notice of deficiency regarding the 10% excise tax is mailed, or (b) the date on which the 10% excise tax is assessed.

Waiver of the 100% Excise Tax. An employer or an employer's representative (e.g., accountant, attorney, etc.) may make a request for the waiver of the additional 100% excise tax under Rev. Proc. 81-44. Generally, evidence must be furnished showing that the imposition of the 100% tax under IRC Sec. 4971(b) would be a substantial business hardship and adverse to the interests of the plan participants in the aggregate. Exactly what constitutes appropriate evidence depends on the facts and circumstances of each case.

Waiver of the Minimum Funding Standards. The IRS may grant a waiver of the minimum funding standards if the required contribution to the plan would cause a temporary substantial business hardship on the employer and harm the interests of the plan participants. For single employer plans, three waivers are allowed in a 15-year period and the waived funding deficiency is amortized or paid back, over five years (15 years for multiemployer plans) in equal annual payments.

In order to obtain a waiver, the hardship must be temporary. The following factors are taken into account to determine if a temporary substantial business hardship exists:

a. if the employer is operating at an economic loss,

b. if there is substantial unemployment or underemployment in the trade or business and the industry of the employer,

c. if the sales and profits of the industry are declining or depressed, and

d. if it is reasonable to expect the plan will be continued only if the waiver is granted.

The procedure for obtaining a waiver of the minimum funding standards is quite extensive and is contained in Rev. Proc. 2004-15. A waiver request must be submitted within 2½ months (24 months for multiemployer plans) following the close of the plan year for which the waiver is requested. Also, a user fee of $14,500 ($10,000 if the waiver request is less than $1 million) must be paid.

Minimum Funding Standards for Restored Pension Plans. The PBGC may restore a terminated pension plan in situations where it determines such action to be necessary and appropriate.

The minimum funding standards under IRC Sec. 412 apply to a terminated defined benefit plan that has been restored by the PBGC. When the PBGC restores such a plan, the funding standard account required by IRC Sec. 412 must be reestablished and maintained for all subsequent plan years. The restoration of a terminated plan retroactively reinstates benefit accruals [except with respect to non-top-heavy accruals which were previously frozen in accordance with ERISA Sec. 204(h)] under the plan because the statute requires restoration of the plan to its pretermination status. Since the plan will have been underfunded upon plan termination, and since the plan sponsor will ordinarily not have made any contributions to the plan while it was being administered as a terminated plan, the plan is likely to be even more underfunded on restoration. This underfunding will be significantly increased if the plan has been administered as a terminated plan for an extended period.

A special funding method called the *restoration method*, must be used by plans that have been or are being terminated and restored by the PBGC. The restoration method provides for the funding of a restored plan under a restoration payment schedule ordered by the PBGC. This schedule specifies the timing and amount of contributions required to amortize plan liabilities arising before the first valuation date following restoration. The regulations also contain minimum standards designed to ensure that plan underfunding does not increase while the restoration payment schedule is in effect, and that the employer makes systematic progress toward funding the outstanding liabilities of the plan while it is under the PBGC restoration payment order.

Changing Funding Methods

The funding method used to determine the minimum funding contribution generally cannot be changed without IRS approval. Rev. Proc. 2000-41 provides the specific procedure by which this approval can be obtained.

A funding method change not only refers to the procedure for amortizing the cost of benefits, but also to a change in any of the following:

a. The annual date to value benefit liabilities and assets ("valuation date").

b. The method of valuing assets for determining the actuarial contribution.

c. The method of valuing ancillary benefits (e.g., death and disability benefits) if different from the method of valuing retirement benefits.

d. Any other aspect of the actuarial determination that is not merely a change of the actuarial assumptions used in the determination.

Automatic Approval for Funding Method Changes. Rev. Proc. 2000-40 specifies in detail those funding method changes for which the IRS will grant automatic approval. Generally, the approval is granted only if (1) all the conditions for those changes are followed by the actuary, and (2) the plan sponsor or administrator consents to the funding method change. However, under certain circumstances [outlined in Rev. Proc. 2000-40, Sec. 6.01(2)], explicit consent is not required as long as the plan administrator (or sponsor) is made aware of the change. In most cases, an automatic funding method change will not be allowed if a similar change has been made in any of the four preceding plan years. A change in a plan's funding method, or the adoption of any actuarial assumptions, for the first plan year in which IRC Sec. 430 applies to the plan that is not inconsistent with the requirements of IRC Sec. 430 is granted automatic approval by the IRS.

A change in a plan's valuation date that is required by IRC Sec. 430 (that is, a change to the first day of the plan year as the valuation date by a plan that is not a small plan) is also deemed to have been approved by the IRS.

Automatic Approval for Take-over Plans and Valuation Software Changes. For plan years beginning after 2009, single-employer defined benefit plans are granted automatic approval for a change in the funding method in take-over plans and valuation software changes. The change in funding method must result from either a change in the valuation software used to determine plan liabilities or to a new enrolled actuary and business organization for actuarial services (take-over plans) where certain conditions must be met.

For take-over plans, the new method must be essentially the same as the method used by the prior actuary and consistent with the method reported in the prior valuation report or prior Schedule SB of Form 5500. For plan years beginning after 2010, the funding target and target normal cost for the prior plan year (without taking into account adjustments for employee contributions and plan-related expenses) and the actuarial value of plan assets for the prior plan year determined by the new actuary should come within 5% of the respective values determined by the prior actuary.

For a change in the funding method that results from a change in the valuation software that is used to determine plan liabilities, there must have been either no changes in the actuary or business organization providing actuarial services, or a change in either (but not both). The underlying method must be unchanged and consistent with the prior valuation report or prior Schedule SB of Form 5500 (except to the extent automatic approval was obtained for a change in funding method other than this change). The new software should be that generally used by the actuary for single-employer plans that the actuary provides services to. Using different software or modifying the computations in existing software must not produce results that are less accurate than those produced before the change. For plan years beginning after 2010, under the new valuation software, the funding target and target normal cost for the prior plan year (without taking into account adjustments for employee contributions and plan-related expenses) and the actuarial value of plan assets for the prior plan year determined by the new actuary should come within 2% of the respective values determined by the prior actuary.

If the plan sponsor or administrator fails to give the required consent or is not made aware of the change when applicable, the change does not apply for that plan year. Accordingly, the actuary must advise the plan sponsor and administrator that a funding method change is contemplated, detailing the significance of the change and why it is necessary. The actuary would then request approval of the plan sponsor (or administrator) as appropriate.

Deducting Amounts in Excess of the Minimum Funding Standard

Two alternatives to the minimum funding standard rule are available. These alternatives can be used if they provide a greater deduction than those provided by the minimum funding standard rule.

Using the Straight-line Rule. Under this rule, the employer's deduction is an amount actuarially necessary to fund the plan costs for all employees. This is determined as if the remaining unfunded cost of their past and current service credits is distributed over the remaining future service of each employee as a level amount, or a level percentage of compensation.

If more than 50% of the unfunded cost is attributable to any three individuals, the straight-line rule must be computed by distributing the unfunded cost for those individuals over at least five tax years.

Using the 10-year Rule. Under this rule, the deduction is an amount equal to the plan's normal cost plus an amount necessary to amortize the unfunded costs (if past service or other pension or annuity credits are provided by the plan) over 10 years rather than the amortization periods customarily used for the minimum funding standard account.

Carryover of Excess Contributions

Any amount paid in a tax year that exceeds the deductible limits can be carried over and deducted in succeeding tax years. This rule applies to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for that year. However, contributions on behalf of self-employed individuals in excess of their earned income are not considered as deductible carryovers.

Multiemployer Plan Special Funding Rules

For plan years beginning after 2007, the minimum funding rules for multiemployer plans are found in IRC Sec. 431. All multiemployer plans that are subject to the minimum funding requirements must maintain a funding standard account. The plan's funding standard account is maintained through the application of charges and credits to the account as specified in IRC Secs. 431(b)(2) and 431(b)(3). The balance in the funding standard account then establishes whether the plan has an accumulated funding deficiency for the plan year.

A multiemployer plan with an accumulated funding deficiency will not meet the IRC Sec. 412 minimum funding rules for the plan year, and is subject to the excise tax. The accumulated funding deficiency of a multiemployer plan for any plan year is defined as the amount, determined at the end of the plan year, equal to the excess, if any, of the total charges to the funding standard account of the plan over the total credits to the account for all plan years. However, for a multiemployer plan that is in reorganization for a plan year, the accumulated funding deficiency must be determined under ERISA Sec. 4243.

Impact of the Full Funding Limitation on Multiemployer Plans. The full funding limitation is the maximum amount that can be deducted in a tax year for contributions to the defined benefit pension plan.

The full funding limitation is defined as the excess, if any, of:

a. the accrued liability (including normal cost) of a plan over

b. the lesser of the fair market value of the plan's assets, or the value of the assets as determined under IRC Sec. 431(c)(2).

A 20% addition to tax is imposed on a tax underpayment that is attributable to a substantial overstatement of pension liabilities. A substantial overstatement exists if the actuarial determination of the liabilities considered for purposes of computing the deduction for the contribution to the plan is 200% or more of the amount determined to be correct.

The addition to tax will not be imposed if the portion of the tax underpayment attributable to the substantial overstatement is $1,000 or less. If a gross valuation misstatement exists, the addition to tax is increased to 40%. A gross valuation misstatement exists if 400% is substituted for 200% in the previous calculation.

Multiemployer Plans in Endangered or Critical Status. Multiemployer plans in endangered or critical status have to meet additional funding requirements under IRC Sec. 432, for plan years beginning after 2007. The additional rules require that a plan actuary make an annual certification to the IRS by the 90th day of each plan year as to whether the plan is in an *endangered status* or a *critical status*.

If a plan is in endangered status it must adopt a funding improvement plan under IRC Sec. 432(c) within 240 days after the due date of the actuarial certification to the IRS. A multiemployer plan is in *endangered status* for a plan year if the funded percentage for the year is less than 80% or the plan has an accumulated funding deficiency as defined under IRC Sec. 431 (or is projected to have an accumulated funding deficiency for any of the six succeeding plan years).

The plan sponsor of a plan in critical status is required to adopt a rehabilitation plan under IRC Sec. 432(e) to improve the plan's funded percentage. A multiemployer plan is in critical status for a plan year if the funded percentage for the year is less than 65% and the sum of the fair market value of plan assets plus the present value of reasonably expected employer contributions for the current year and the six succeeding plan years is less than the present value of nonforfeitable benefits projected to be payable in the next six plan years.

Contributions for Self-employed Individuals

Deductions can be taken for contributions made on behalf of self-employed individuals under rules similar to those discussed above regarding profit-sharing plans. Although IRC Sec. 404(a)(8) prohibits a defined benefit deduction beyond the self-employed's earned income, the minimum funding requirement must be met even if that requirement exceeds the earned income. The excess is neither deductible nor a carryforward. The 10% excise tax of IRC Sec. 4972(a) does not apply to this excess.

MONEY PURCHASE PENSION PLAN CONTRIBUTION DEDUCTIONS

The Economic Growth and Tax Relief Reconciliation Act of 2001 changed the deduction rules for money purchase pension plans by providing that defined contribution plans subject to the funding standard of IRC Sec. 412 are

treated like profit-sharing or stock bonus plans for deduction purposes under IRC Sec. 404(a)(3). Thus, an employer may deduct contributions to a money purchase pension plan in an amount not to exceed the greater of:

a. 25% of compensation paid or accrued during the tax year to beneficiaries of the plan, or

b. the amount that the employer is required to contribute to the trust for the year for a SIMPLE plan.

In spite of this, the employer's funding liability to a money purchase pension plan (including a target benefit plan) is established by the plan's benefit formula and is still subject to the minimum funding standards of IRC Sec. 412. A single-employer plan subject to the minimum funding standards must meet the IRC Sec. 430 minimum required contribution rules, while a multiemployer plan is subject to the funding rules of IRC Sec. 431. Additional minimum funding requirements found in IRC Sec. 432 may also be required for a multiemployer plan that is in endangered or critical status. Even though the employer is subject to the 25% contribution limit under IRC Sec. 404(a)(3), only the required contribution, as determined by the plan's contribution formula, may be contributed to the plan each year. Because a money purchase plan is a pension plan, it is required to provide *definitely determinable benefits* to the participants. An employer with a required contribution of less than the maximum permissible deduction under IRC Sec. 404(a)(3) cannot make an additional discretionary contribution to reach the maximum available unless the plan was amended to provide for a larger contribution. On the other hand, if the minimum funding requirements established by the plan's contribution formula require a contribution in excess of the 404(a)(3) limit, the employer could be in a excess contribution penalty situation. However, the Treasury has authority under IRC Sec. 404(a)(3)(A)(v) to create exceptions.

Deduction Limitations

These plans are subject to the same deduction limits as profit-sharing and stock bonus plans. However, when these rules are applied to money purchase pension plans, as discussed in the following paragraphs, the 100% of compensation and $49,000 (for 2010) limitations under the Section 415 annual addition rules apply as with all defined contribution plans of the employer. Like all defined contribution plans, money purchase plans maintain individual account balances. However, they are also pension plans. The employer's annual contribution to a money purchase plan is a fixed obligation that must be funded regardless of the employer's financial condition. It is usually stated as a percentage of the employee's annual compensation. Money purchase plans were often used in combination with a profit-sharing plan to reach the maximum deductible contribution percentage of 25% of compensation allowed under pre-2002 law for combinations of such plans. However, the 2001 Tax Act increased the maximum deductible contribution percentages of simplified employee pensions (SEPs) and profit-sharing plans to 25% starting in 2002, virtually eliminating the need for money purchase plans. Since many money purchase plans are, however, still in existence, the specific tax-law provisions that apply to them are discussed in the following paragraphs.

Minimum Funding Standard Rule. The purpose of the minimum funding standards with regard to a money purchase pension plan is to ensure the required contributions to the plan are actually made. Thus, the funding requirement of a money purchase pension plan is the contribution called for by the plan document. Failure to meet this funding requirement will negatively impact the accrued benefit as well as the plan's ability to distribute individual account benefits. Money purchase and target benefit plans are subject to the same limits on deductible employer contributions as profit-sharing plans, which is 25% of compensation. The amount of deductible employer contributions to money purchase and target benefit plans is limited not only by the 25% of compensation limit, but also by the amount needed to fund the plan's contribution formula (i.e., the minimum funding cost of the plan for the plan year).

Example 2-15: Timing of contributions to money purchase pension plan.

Joan Drew, a calendar year sole proprietor, has a calendar year money purchase pension plan. Under the terms of the plan, Joan is required to make a $10,000 contribution for 2010. Joan's 2010 Form 1040 has been extended until October 15, 2011.

When must Joan make the $10,000 contribution and when can she deduct it? Technically, if Joan makes the contribution by October 15, 2011, she can claim the $10,000 deduction on her 2010 tax return. However, for minimum funding purposes, Joan must make the contribution by September 15, 2011.

Accumulated Funding Deficiencies. Failure to timely meet the minimum funding requirement results in an accumulated funding deficiency, which may negatively impact the accrued benefit as well as the plan's ability to distribute individual account benefits.

The excise tax on accumulated funding deficiencies applying to defined benefit plans also applies to money purchase pension plans. Some employers may be able to obtain a waiver from the minimum funding standards, or a waiver from the additional 100% excise tax.

A money purchase pension plan has met the funding requirements for a plan year (i.e., it does not have a funding deficiency) if the required contribution is made by the end of the plan year. However, if the contribution is made within 8½ months after the close of the plan year, it is deemed to have been made on the last day of the plan year.

The Section 415 Contribution Limit

The Section 415 annual addition limit applies to money purchase pension plans.

The Annual Compensation Limit

The annual compensation ($245,000 for 2010) limit applies when computing the contribution for a money purchase pension plan. The amount is indexed for increases in cost-of-living.

Carryover of Excess Contributions

Generally, the rules applying to the carryover of excess contributions apply to money purchase pension plans, as does the excise tax on nondeductible contributions.

Contributions for Self-employed Individuals

For purposes of money purchase pension plans, self-employed individuals are considered employees.

Deductions can be taken for contributions made on behalf of self-employed individuals under rules similar to those discussed in the section about profit-sharing plans. Although IRC Sec. 404(a)(8) prohibits money purchase pension plan deductions beyond the self-employed's earned income, the minimum funding requirement must be met even if that requirement exceeds the earned income. The excess is neither deductible nor a carryforward. However, the 10% excise tax of IRC Sec. 4972(a) does not apply to this excess.

HOW TO DEDUCT CONTRIBUTIONS WHEN THE SAME EMPLOYEE IS COVERED BY MORE THAN ONE EMPLOYER PLAN

When an employer has both a profit-sharing plan and either a money purchase or target benefit plan covering at least one common employee, there is an overall deduction limitation of 25% of covered compensation, limited to $245,000 for 2010. The Pension Protection Act of 2006 amended IRC 404(a)(7) to apply the combined plan limit only if the employer contributions to one or more DC plans exceeds 6% of participant compensation for the year. IRS guidance clarifies employer contributions to which the rule applies are equal only to the employer contributions in excess of 6% of applicable participant's compensation contributed to the defined contribution plan or plans.

A somewhat similar limit applies when an employer has both a defined benefit and a defined contribution plan covering at least one common employee. The combined limit on deductions for contributions to defined benefit plans and defined contribution plans with overlapping coverage is the greater of:

1. 25% of compensation,
2. or the contributions to the defined benefit plan or plans to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard for the defined plans.

Exception to the Combined Limit. The 25% combined limit does not apply if the only amounts contributed to the defined contribution plan are employee elective deferrals.

Example 2-16: Exception to the combined plan limit.

Deuce Corp. maintains two qualified retirement plans: a defined benefit pension plan and a defined contribution elective deferral 401(k) plan. For the 2010 plan year, Deuce makes no contributions to the defined contribution plan. The only contributions made to that plan in 2010 are elective deferrals by employees. Thus, the combined plan deduction limit of 25% of compensation does not apply for 2010. Rather, each plan is subject only to the deduction limits applicable to that plan.

Excise Tax on Nondeductible Contributions

When the limitation applying to employers with both a defined benefit and defined contribution plan is exceeded, an excise tax applies.

Exceptions to the Excise Tax. There are exceptions to the excise tax for plans exceeding the combined plan limits.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Jim, age 33, earns an annual salary of $100,000 from Amsler & Hanson. The firm has a defined contribution plan to which Jim made elective deferrals of $10,000 in 2010. The firm contributes $2,000 to the plan on Jim's behalf during the same plan year. Calculate the annual addition limit for Jim in 2010.

    a. $12,000.

    b. $25,000.

    c. $49,000.

    d. $90,000.

26. Butterfield International runs a profit-sharing plan for its employees. In 2010, Butterfield has no current or accumulated profits. How will this affect the plan?

    a. Butterfield will not contribute to the plan in 2010.

    b. Butterfield must make a contribution to the plan in 2010 despite the lack of profit.

    c. Butterfield can determine whether or not to make a contribution on an annual basis.

    d. The plan document will outline how Butterfield can address this issue.

27. Jessica works for two unrelated companies, Hardware Heaven and Wrenches 'R Us. In 2010, she made $60,000 at Hardware Heaven and made elective deferrals of $6,000 into its 401(k) plan. During the same year, Jessica earned $120,000 from Wrenches 'R Us and made elective deferrals of $12,000 into its stock bonus plan. Hardware Heaven made $800 of matching contributions on Jessica's behalf, while Wrenches 'R Us made $3,600 of matching contributions. Which of the following statements is true in this scenario?

    a. Jessica has a limit problem and must receive $1,500 to correct it.

    b. Jessica has a limit problem and must forfeit the difference to correct the violation.

    c. Because the two employers are unrelated, Jessica has no limit problems.

    d. Because her Section 415 limit of $49,000 has not been exceeded, Jessica has no limit problems.

28. Which of the following accurately defines the term *contribution formula*?

    a. Contributions an employer makes to a plan, instead of paying cash to the employee, pursuant to an employee election.

    b. A formula that requires a specific amount to be contributed to the plan (e.g., a fixed percentage of net profits).

    c. A formula that establishes how the employer's contribution is allocated to each participant.

29. The Dillon Corporation maintains an employee stock ownership plan (ESOP). In which of the following circumstances, can contributions to the ESOP be deducted without limit?

    a. The corporation has no profit during the plan year, so another member of the affiliated group with profits can make its contribution for that year.

    b. The contributions are used to repay principal on a loan incurred for the purpose of acquiring qualified employer securities.

    c. Contributions do not exceed earned income derived from the trade or business for which the plan was established.

    d. The contributions are used to repay interest on a loan that was incurred so that qualified employer securities could be purchased.

30. Which of the following terms is defined as a contribution formula of a stated rate (the same for all employees) of plan-year compensation?

    a. Gross earnings method.

    b. Net earnings method.

    c. Minimum funding standard rule.

    d. Straight-line rule.

31. Mandolins Limited maintains a defined benefit plan. The plan year end and the corporate year end are December 31. The company made a timely required minimum funding contribution of $20,000 for 2009 within 8½ months of the plan year end—$15,000 on March 15, 2010, and $5,000 on September 15, 2010. The company made the 2010 minimum funding contribution of $9,000 on December 15, 2010. Calculate the amount that Mandolins Limited can deduct as an "includable contribution" in 2010.

    a. $9,000.

    b. $14,000.

    c. $15,000.

    d. $20,000.

32. In which of the following scenarios would the plan be exempt from the ERISA portion of the minimum funding standards?

    a. The plan is funded exclusively through the purchase of insurance contracts.

    b. The plan's minimum funding standard account has an accumulated funding deficiency at year end.

    c. The plan amends its minimum funding purposes two months after the close of the plan year, and changes are effective as of the first day of the plan year.

    d. The plan's reasonable funding method includes anticipated future benefits.

33. The Garden Outlet maintains a defined benefit plan, and in 2010 the company claims actuarial plan liabilities of $100,000 for computing the deduction for the contribution to the plan, when in actuality only $50,000 of liabilities should have been claimed. Which of the following consequences would apply?

    a. This is a substantial overstatement, so a 20% addition to tax is imposed on the tax underpayment.

    b. This is a gross valuation misstatement, so a 40% addition to tax is imposed on the tax underpayment.

    c. The amount of the tax underpayment in this case is beneath the minimum required for an addition to the tax to be imposed.

34. Based on the guidance found in the Economic Growth and Tax Relief Reconciliation Action of 2001, employers can deduct contributions to money purchase pension plans in an amount that does not exceed the greater of one of two options. Which of the following is one of those options?

    a. The amount established by the plan's benefit formula.

    b. The amount the employer is required to contribute to the trust for the year for a defined contribution plan.

    c. 25% of compensation paid or accrued to plan beneficiaries during the tax year.

    d. The amount established by the Treasury, which has authority under IRC Sec. 404(a)(3)(A)(v).

35. The TGBT Company maintains both a defined benefit and a defined contribution plan, and a significant number of its employees participate in both plans. TGBT's contributions to the defined contribution plan equal 5% of participant compensation for 2010. Which of the following scenarios applies?

    a. $245,000 is TGBT's deduction limit for 2010.

    b. The combined deduction limit is the greater of contributions to the defined benefit plan or 25% of compensation.

    c. No combined deduction limit applies to TGBT Company under these circumstances.

    d. An excise tax applies to the contributions of all employees that contribute to both plans.

36. Dog Walkers, Inc., (DWI) maintains a defined benefit pension plan and a defined contribution elective deferral 401(k) plan for its employees. A number of employees participate in both plans. In which of the following scenarios would DWI qualify for the combined plan limit exception?

    a. DWI contributes only $10,000 to both plans during the plan year.

    b. DWI makes no contributions to the defined benefit plan during the plan year.

    c. DWI makes no contributions to the defined contribution plan during the plan year.

    d. DWI decides to terminate its defined contribution plan at the conclusion of the plan year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Jim, age 33, earns an annual salary of $100,000 from Amsler & Hanson. The firm has a defined contribution plan to which Jim made elective deferrals of $10,000 in 2010. The firm contributes $2,000 to the plan on Jim's behalf during the same plan year. Calculate the annual addition limit for Jim in 2010. **(Page 173)**

    a. $12,000. [This answer is incorrect. This is the amount of Jim's elective deferrals plus the amount of the firm's contributions on his behalf.]

    b. $25,000. [This answer is incorrect. If Jim were Amsler & Hanson's only employee, the firm's 2010 deduction limit under IRC Sec. 404 would be 25% of Jim's qualified compensation ($100,000).]

    c. $49,000. [This answer is correct. The maximum amount the firm can deduct for Jim is his 2010 Section 415 limit of $49,000.]

    d. $90,000. [This answer is incorrect. This is the amount of Jim's taxable income (his annual salary less his elective deferrals).]

26. Butterfield International runs a profit-sharing plan for its employees. In 2010, Butterfield has no current or accumulated profits. How will this affect the plan? **(Page 175)**

    a. Butterfield cannot contribute to the plan in 2010. [The answer is incorrect. Profits are not required to be eligible to contribute to the plan per the IRS.]

    b. Butterfield must make a contribution to the plan in 2010 despite the lack of profit. [The answer is incorrect. Making a contribution is not a requirement when the employer has no current or accumulated profits per the IRS.]

    c. Butterfield can determine whether or not to make a contribution on an annual basis. [The answer is incorrect. According to the IRS, discretionary contributions are not permitted without the proper authority.]

    d. The plan document will outline how Butterfield can address this issue. [The answer is correct. The plan document can indicate a definition of profits that allows Butterfield to contribute in a year with no profit, or it can specify that contributions are discretionary.]

27. Jessica works for two unrelated companies, Hardware Heaven and Wrenches 'R Us. In 2010, she made $60,000 at Hardware Heaven and made elective deferrals of $6,000 into its 401(k) plan. During the same year, Jessica earned $120,000 from Wrenches 'R Us and made elective deferrals of $12,000 into its stock bonus plan. Hardware Heaven made $800 of matching contributions on Jessica's behalf, while Wrenches 'R Us made $3,600 of matching contributions. Which of the following statements is true in this scenario? **(Page 175)**

    a. Jessica has a limit problem and must receive $1,500 to correct it. [This answer is correct. Jessica has exceeded her 2010 elective deferral limit of $16,500, so she must tell one or both employers. She will need a $500 refund to correct the problem.]

    b. Jessica has a limit problem and must forfeit the difference to correct the violation. [This answer is incorrect. There are ways that limit problems can be corrected. If Jessica did have a limit violation, she would not have to forfeit the excess funds per the Code.]

    c. Because the two employers are unrelated, Jessica has no limit problems. [This answer is incorrect. Whether the employers are unrelated does not matter when determining a participant's elective deferral limit per the Code.]

    d. Because her Section 415 limit of $49,000 has not been exceeded, Jessica has no limit problems. [This answer is incorrect. The elective deferral limit must be considered in this scenario along with the Section 415 limit per the Code.]

28. Which of the following accurately defines the term *contribution formula*? **(Page 176)**

    a. Contributions an employer makes to a plan, instead of paying cash to the employee, pursuant to an employee election. [This answer is incorrect. This definition applies to the term *elective deferrals*. Elective deferrals are not treated as employer contributions when determining if contribution limits have been exceeded.]

    b. A formula that requires a specific amount to be contributed to the plan (e.g., a fixed percentage of net profits). [This answer is correct. A profit-sharing plan may have a contribution formula. If the plan has one, it must be adhered to each year; however, most profit-sharing plans allow the employer complete discretion in setting its annual contribution formula.]

    c. A formula that establishes how the employer's contribution is allocated to each participant. [This answer is incorrect. This is the definition of *allocation formula*. A plan document must provide an allocation formula; no discretion is allowed.]

29. The Dillon Corporation maintains an employee stock ownership plan (ESOP). In which of the following circumstances, can contributions to the ESOP be deducted without limit? **(Page 178)**

    a. The corporation has no profit during the plan year, so another member of the affiliated group with profits can make its contribution for that year. [This answer is incorrect. This is an example of how members of an affiliated group with a common profit-sharing plan can shift contributions among group members.]

    b. The contributions are used to repay principal on a loan incurred for the purpose of acquiring qualified employer securities. [This answer is incorrect. In these circumstances, the deduction for any year may not exceed 25% of the compensation otherwise accrued or paid during the tax year to employees who are covered by the ESOP per Section 4975 (e)(7).]

    c. Contributions do not exceed earned income derived from the trade or business for which the plan was established. [This answer is incorrect. Deductions for contributions on behalf of self-employed individuals meet the ordinary and necessary requirements of IRC Secs. 162 and 212 if they meet this requirement.]

    d. The contributions are used to repay interest on a loan that was incurred so that qualified employer securities could be purchased. [This answer is correct. Under these circumstances, the contributions are deductible without limit. To qualify for the exception, contributions must be applied no later than the due date of the corporation's extended income tax return.]

30. Which of the following terms is defined as a contribution formula of a stated rate (the same for all employees) of plan-year compensation? **(Page 181)**

    a. Gross earnings method. [This answer is incorrect. This method is used to calculate a self-employed business owner's compensation limit for a defined contribution plan. If it is used, the plan will provide a contribution formula for owners (the self-employed individuals) that specifies the reduced owner percentage.]

    b. Net earnings method. [This answer is correct. This is one of two methods used to calculate a self-employed business owner's compensation limit for a defined contribution plan. When using this method, the plan will define plan-year compensation for the self-employed individuals as earned income under IRC Sec. 401(c)(2).]

    c. Minimum funding standard rule. [This answer is incorrect. The purpose of these standards is to provide a financing system for the benefits of pension plans to better enable the plans to meet future benefit obligations. They pertain to defined benefit plans.]

    d. Straight-line rule. [This answer is incorrect. This rule says that the employer's deduction is an amount actuarially necessary to fund the plan costs for all employees. It pertains to defined benefit plans.]

31. Mandolins Limited maintains a defined benefit plan. The plan year end and the corporate year end are December 31. The company made a timely required minimum funding contribution of $20,000 for 2009 within 8½ months of the plan year end—$15,000 on March 15, 2010, and $5,000 on September 15, 2010. The

company made the 2010 minimum funding contribution of $9,000 on December 15, 2010. Calculate the amount that Mandolins Limited can deduct as an "includable contribution" in 2010. **(Page 184)**

a. $9,000. [This answer is incorrect. The $9,000 contributed in 2010 would be the regular deduction for 2010.]

b. $14,000. [This answer is correct. The $5,000 that was contributed after the company's tax filing was not deductible in 2009 and can be deducted in 2010 as an "includable contribution" even though it causes the 2010 deduction to exceed the minimum funding requirement. The $9,000 regular deduction for 2010 is also timely made and deductible in 2010.]

c. $15,000. [This answer is incorrect. The $15,000 was deducted in time to include in the 2009 deduction.]

d. $20,000. [This answer is incorrect. The entire $20,000 minimum funding contribution for 2009 would not be deducted as an "includable contribution" in 2010.]

32. In which of the following scenarios would the plan be exempt from the ERISA portion of the minimum funding standards? **(Page 185)**

a. The plan is funded exclusively through the purchase of insurance contracts. [This answer is correct. A plan funded this way would be exempt from the minimum funding standards of ERISA for both tax and regulatory purposes. Another plan that would qualify for this exemption is one that has not provided for employer contributions since September 2, 1974 (the date of the enactment of ERISA).]

b. The plan's minimum funding standard account has an accumulated funding deficiency at year end. [This answer is incorrect. This would not exempt the plan from the minimum funding standards under ERISA. All plans subject to the minimum funding standards must maintain a funding standard account to determine if the standard has been met for the plan year.]

c. The plan amends its minimum funding purposes two months after the close of the plan year, and changes are effective as of the first day of the plan year. [This answer is incorrect. The ERISA exemption is not related to plan amendments. Amendments of this type made within two and a half months after the close of the plan year that are effective as of the first day of the plan year may be considered when determining the minimum funding standard and the corresponding relationship to Section 404 deduction limitations.]

d. The plan's reasonable funding method includes anticipated future benefits. [This answer is incorrect. This element of plan funding is not related to the ERISA exemption. Two prohibited considerations under the reasonable funding method are anticipated future benefits and participants. Changes cannot be anticipated per Reg. 1.412(c)(3)-1(d).]

33. The Garden Outlet maintains a defined benefit plan, and in 2010 the company claims actuarial plan liabilities of $100,000 for computing the deduction for the contribution to the plan, when in actuality only $50,000 of liabilities should have been claimed. Which of the following consequences would apply? **(Page 189)**

a. This is a substantial overstatement, so a 20% addition to tax is imposed on the tax underpayment. [This answer is correct. A substantial overstatement is defined as an overstatement of 200% or more.]

b. This is a gross valuation misstatement, so a 40% addition to tax is imposed on the tax underpayment. [This answer is incorrect. A gross valuation misstatement would exist only if the overstatement is 400% or more.]

c. The amount of the tax underpayment in this case is beneath the minimum required for an addition to the tax to be imposed. [This answer is incorrect. If the tax underpayment attributed to the understatement is $1,000 or less, no additional tax will be imposed.]

34. Based on the guidance found in the Economic Growth and Tax Relief Reconciliation Action of 2001, employers can deduct contributions to money purchase pension plans in an amount that does not exceed the greater of one of two options. Which of the following is one of those options? **(Page 189)**

a. The amount established by the plan's benefit formula. [This answer is incorrect. The employer's funding liability for its money purchase pension plan (which includes a target benefit plan) is established by the plan's benefit formula. This amount is still subject to the minimum funding standard of IRC Sec. 412.]

b. The amount the employer is required to contribute to the trust for the year for a defined contribution plan. [This answer is incorrect. One of the two options provided by this legislation is the amount that the employer is required to contribute to the trust for the year for a SIMPLE plan, not a defined contribution plan.]

c. 25% of compensation paid or accrued to plan beneficiaries during the tax year. [This answer is correct. An employer that maintains a money purchase pension plan can deduct contributions in an amount that does not exceed the greater of this amount or the amount that the employer must contribute to the trust for a year for a SIMPLE plan.]

d. The amount established by the Treasury, which has authority under IRC Sec. 404(a)(3)(A)(v). [This answer is incorrect. The Treasury has authority under this part of the Code to create exceptions for employers with money purchase pension plans that end up in an excess contribution penalty situation.]

35. The TGBT Company maintains both a defined benefit and a defined contribution plan, and a significant number of its employees participate in both plans. TGBT's contributions to the defined contribution plan equal 5% of participant compensation for 2010. Which of the following scenarios applies? **(Page 191)**

a. $245,000 is TGBT's deduction limit for 2010. [This answer is incorrect. If TGBT had both a profit-sharing plan and a money purchase or target benefit plan covering at least one common employee, the overall deduction limit would be 25% of covered compensation. The amount would be limited to $230,000 in 2010.]

b. The combined deduction limit is the greater of contributions to the defined benefit plan or 25% of compensation. [This answer is incorrect. In the scenario described above, these limits will not apply to TGBT's deduction limit. The guidance found in the Pension Protection Act of 2006 must be applied.]

c. No combined deduction limit applies to TGBT Company under these circumstances. [This answer is correct. If TGBT's contributions to the defined contribution plan exceeded 6% of participant compensation for the year, then the combined contribution limit would be (1) 25% of compensation or (2) the contributions to the defined benefit plan or plans to the extent such contributions did not exceed the amount needed to satisfy the minimum funding standard for defined benefit plans.]

d. An excise tax applies to the contributions of all employees that contribute to both plans. [This answer is incorrect. An excise tax would only apply to TGBT if the contribution limit were exceeded. Also exceptions to the excise tax are available.]

36. Dog Walkers, Inc., (DWI) maintains a defined benefit pension plan and a defined contribution elective deferral 401(k) plan for its employees. A number of employees participate in both plans. In which of the following scenarios would DWI qualify for the combined plan limit exception? **(Page 192)**

a. DWI contributes only $10,000 to both plans during the plan year. [This answer is incorrect. According to the Code, if any amount is contributed to the plan in question, qualifications for the exception will not be met.]

b. DWI makes no contributions to the defined benefit plan during the plan year. [This answer is incorrect. According to the Code, contributions to the defined benefit plan do not have any bearing on the combined plan limit exception.]

c. DWI makes no contributions to the defined contribution plan during the plan year. [This answer is correct. If the only contributions to the defined contribution plan during the year are employee elective deferral contributions, then the 25% deduction limit on combined plans will not apply to DWI.]

d. DWI decides to terminate its defined contribution plan at the conclusion of the plan year. [This answer is incorrect. Plan termination does not affect DWI's qualification for the exception to the 25% deduction limit on dual plans per the Code.]

TAKING THE DEDUCTION

Factors influencing the timing of the deduction for plan contributions are discussed in this section.

General Rule

The employer must generally make the contribution to a pension, profit-sharing, or stock bonus trust by the due date (including extensions) for its tax return for the contribution to be deductible for that tax year. However, contributions made after the end of the tax year are deductible for that tax year only if either of the following apply:

a. The employer claims the contribution as a deduction on its tax return for that year.

b. The employer designates in writing to the plan administrator or trustee that the contribution is for the preceding year.

Example 2-17: Deadline for making profit-sharing plan contribution.

As Jones, Inc. is a calendar year corporation, its federal income tax return is due on March 15 each year. For the 2010 year, it extends its return until September 15, 2011. The return is actually filed on July 15, 2011, two months before the end of the extension period. The corporation's profit-sharing plan also uses a calendar year.

Must the contribution for the 2010 year be made on or before July 15, 2011, to be deductible? No. The contribution is deductible if made on or before September 15, 2011, if the extension to file until September 15 is valid.

Valid Extension. Most sponsors of qualified plans can automatically obtain an extension to file their tax return by filing the appropriate extension request with the IRS on or before the due date for their tax return. However, an extension is not valid if the tax return is filed before requesting an extension. An extension is valid for purposes of making a deductible contribution after the normal due date only if the sponsor has a valid extension for filing their tax return. IRS guidance is very clear that an extension is not valid if requested/granted after the tax return has been filed. As illustrated in Example 2-17 the due date for making the contribution is the extended due date for the plan sponsor's tax return even if the return is filed earlier but after obtaining a valid extension.

Example 2-18: Applicability of timely mailing rule.

Boxcorp is a calendar year corporation that extended its 2010 return to September 15, 2011. Boxcorp mailed its profit-sharing contribution to the trust on September 1, 2011. However, the trust did not receive it until September 19, 2011.

Is the contribution considered to be made in a timely fashion? Yes. Under the timely mailed rule, if a contribution is mailed and the envelope bears a U.S. Postal Service postage cancellation date that is not later than September 15, 2011 (the due date of the return), the contribution is considered to be timely made.

Delay in Presenting Check for Payment. A contribution will not be considered to be made in a timely fashion if the employer causes a delay in the handling of a check.

How to Treat a Check That Bounces. A check that bounces is treated as if the contribution was never made.

Contributions Based on Service after Tax Year-end. Contributions that are based on service worked after the close of the employer's tax year are not deductible for that year, even if the contributions are made before the due date (including extensions) of the employer's tax return for such year.

Plan Year Not Corresponding with Employer's Tax Year

Special rules apply for determining the timing of the deduction if the plan year does not coincide with the employer's tax year.

Deduction Limit for Profit-sharing Plans. Determining the deduction limit is routine where the profit-sharing plan year and the employer's tax year coincide. If the years are different, the calculations are much more complex. In this case, the tax year of the employer must end with or within a plan year in which the plan is qualified. If the tax year and plan year do not coincide, the deductible limit is determined from either the plan year that begins in the tax year, the plan year that ends in the tax year, or a pro rata share of each year. The method that is chosen by the employer cannot be changed unless approved as a change in accounting method under IRC Sec. 446(e). After the Schedule MB or SB, Form 5500 is filed, it is generally determinative regarding the minimum funding requirement. The participants included for the deduction limit are those who share in the contribution to which the deduction pertains.

If the employer's tax year ends before the close of the plan year and the plan requires the participant to be employed as of the last day of the plan year to receive a contribution allocation, there may be fewer participants who share in the contribution than the employer may expect at the end of the tax year (i.e., a decrease in the number of participants sharing in the contribution occurring between the end of the tax year and the close of the plan year).

Example 2-19: Different plan and tax years.

Collinsworth Manufacturing, Inc. (CMI) has a tax year-end of June 30. CMI maintains a profit-sharing plan with a year-end of December 31. The maximum profit-sharing contribution based on the participant count as of June 30, 2010, may end up not being fully deductible because of employment terminations that occurred during the last six months of the plan year.

It is possible for the employer to deduct the contribution for a plan year that closes before the tax year, provided that the plan remains qualified during the ensuing plan year.

Example 2-20: Plan year ends before tax year.

Alpha Company has a calendar year profit-sharing plan. Alpha Company's tax year ends June 30. Alpha will take the contribution deduction for the tax year that ends in the plan year following the plan year with respect to which the contribution is allocated. Thus, for a contribution that is allocated as of December 31, 2010, Alpha claims the contribution deduction for its tax year ending June 30, 2011. The plan must be qualified for the 2011 plan year ending December 31, 2011, to enjoy a tax deduction under the qualified plan rules for the tax year ending June 30, 2011. The deduction limit will be based on the participants who share in the contribution as of December 31, 2010, notwithstanding whether they are still employed by the close of the tax year. Here, the compensation basis of the deduction limit may be smaller than the plan year compensation.

The deduction limit is based on qualified compensation for the employer's *tax* year with respect to which the deduction is being taken, while the allocation of the contribution is normally based on the compensation for the *plan* year. The different compensation periods could result in a nondeductible contribution. This typically occurs where the employer is claiming the tax deduction for its tax year that ends after the relevant plan year.

Example 2-21: Determining the 25% deduction limit.

Using the same facts as Example 2-20, assume that Alpha Company decides to make a 25% profit-sharing contribution for the plan year ending December 31, 2010, based on projected wages for eligible participants through June 30, 2011. If, during the period from January 1, 2011, through June 30, 2011, a few of the participants who shared in the contribution terminate, the actual compensation base for the 25% deduction limit will be smaller than anticipated. This will create a nondeductible contribution.

Deduction Limit for Pension Plans. For a pension plan, the deductible limit is determined based on the plan year even though the limit applies for the employer's tax year.

If the plan and employer tax years are not the same, the following three options are available:

a. Compute the deductible limit based on the plan year beginning within the employer's tax year.

b. Compute the deductible limit based on the plan year ending within the employer's tax year.

c. Use a weighted average of items a. and b.

The taxpayer may elect which of these three methods to use. However, once a method has been selected and used, it must be used for all subsequent years unless the Commissioner's consent is obtained to use one of the other two methods.

Deduction Limit for Short Plan Years. A short plan year occurs when the plan year-end is changed. In that instance, for a defined benefit plan, the deductible limit for the short plan year generally is determined by ratably reducing the applicable limit for a 12-month year in proportion to the number of months in the short plan year.

Deduction Limit for Short Tax Years. An employer maintaining a pension plan is required by the IRS to adjust its deductible limit if it has a short tax year and has consistently determined the deductible limit for each tax year on the basis of the plan year beginning in the tax year. Generally a short tax year occurs when a taxpayer changes the end of its tax year. Rev. Rul. 80-267 contains IRS-approved methods of prorating the deduction for the short tax year.

NONCASH PROPERTY CONTRIBUTIONS

Use of Noncash Contributions

Contributions to qualified plans are usually made in cash or a cash equivalent. However, a deduction is allowed for some types of property contributions.

When determining if a property contribution can be deducted, some of the issues to consider include the type of property contributed and the purpose for which the contribution is to be used. It is a prohibited transaction if any liens are attached to the property contributed.

Example 2-22: Contribution of employer's promissory note is prohibited.

Hall, Inc. is short on cash so it would like to make its contribution to its money purchase plan by issuing its own promissory note to the plan in the amount of the contribution.

Can an employer take a deduction for a contribution of its own promissory note? No. An employer cannot take a deduction for a contribution of its own promissory note to a plan it maintains. In addition, such a contribution is a prohibited transaction because of the funding obligation.

Tax Consequences of Property Contributions

The employer should be aware of the tax consequences before making a property contribution. These consequences are discussed in the following paragraphs.

Fair Market Value Deducted. If property is contributed, the employer's deduction equals the property's fair market value (FMV) at the time of contribution.

Recognizing Gain. If the property's FMV exceeds its basis, the excess is a taxable gain. However, if the property's basis exceeds its FMV, the employer cannot claim a tax loss.

Example 2-23: Recognizing gain when property is contributed to the plan.

Munch, Inc. maintains a profit-sharing plan for its employees. The contribution for the current plan year was $25,000. Munch owned a vacant lot with FMV of $25,000 and a basis of $10,000 which it decided to use to fund the contribution to its plan.

What are the tax consequences to Munch? Munch recognizes a gain of $15,000 ($25,000 fair market value less $10,000 basis) on its federal income tax return in the year the property is transferred. It deducts the $25,000 fair market value of the property on its federal income tax return as its plan contribution.

Contributing the Employer's Own Stock. If the employer contributes its own stock, the employer's deduction equals the stock's FMV at the time of the contribution. However, in this case, the employer does not recognize any gain or loss.

THE 10% EXCISE TAX ON EXCESS CONTRIBUTIONS

Computing the Tax

IRC Sec. 4972 imposes a 10% excise tax on nondeductible (i.e., excess) employer contributions to a qualified employer plan. This tax does not apply, however, to an employer that has always been tax-exempt. The tax is imposed on and paid by the employer but is not deductible by the employer. The tax is reported and paid on Form 5330.

A nondeductible contribution is defined as the excess of (a) the total amount contributed by the employer to the plan for the taxable year plus (b) the amount of excess contributions from the preceding tax year over (c) the IRC Sec. 404 deductible amount for that tax year reduced by amounts returned during the tax year to the employer as described in the "Amounts Returned to the Employer" paragraph.

The amount of the excess contribution is determined as of the close of the employer's tax year.

The amount allowable as a deduction under IRC Sec. 404 for any tax year is treated as coming first from carryforwards to the tax year from preceding tax years (in order of time) and then from contributions made during such tax year.

Example 2-24: Application of excise tax to nondeductible contributions.

Harris, Inc. made an excess contribution of $20,000 to its qualified plan for the plan year ending December 31, 2009. Harris, Inc. pays the $2,000 excise tax on this excess contribution. For the 2010 plan year, Harris, Inc. makes a total contribution of $70,000; the maximum deductible amount for that year is $75,000. Thus, at the end of the 2010 plan year, Harris, Inc. has a net nondeductible amount of $15,000 ($70,000 + $20,000 − $75,000).

What is the excise tax for the 2010 plan year? The excise tax for the 2010 plan year is $1,500 (10% × $15,000).

If Harris, Inc. contributes $125,000 for 2011, and the maximum deductible amount for that year is $140,000, what is the 2011 excise tax? No excise tax is due for the 2011 plan year, as the nondeductible contribution has been eliminated ($140,000 − $15,000 − $125,000 = $0).

Avoiding the Tax

Amounts Returned to the Employer. The tax can be avoided on amounts returned to the employer on or before the last day (including extensions) on which the employer could make a deductible contribution for the tax year. This rule only applies to the following:

a. Contributions by reason of mistake of fact.

b. Contributions by reason of (1) failure of the plan to initially qualify, or (2) failure of the contribution to be deductible. (This rule applies to all plans.)

Mistake of Fact. A mistake of fact is one other than an error resulting from a mistake of law. This includes an arithmetic or computational error. However, a mistake resulting from an estimate of future claims in an actuarial projection is not a mistake of fact. Situations where a mistake of fact has occurred include the following:

a. An unintentional clerical error resulting in payments for sales employees who were not covered by the plan.

b. An employer's erroneous belief that a binding contract existed between it and a union.

c. The failure of an employer's payroll clerk to follow specific instructions for calculating the employer's contribution to a pension fund, resulting in an incorrect computation.

Minimum Funding Causing Excess for Self-employed Individual. If the minimum funding rules require a contribution exceeding a self-employed individual's earned income, the excess is not subject to the 10% excise tax.

Accrued Contributions. The law states that nondeductible contributions equal the amount contributed *for* the employer's tax year over the amount of contributions allowable as a deduction under IRC Sec. 404. There is no statutory or regulatory guidance as to whether the phrase "amounts contributed for the tax year" refers to contributions actually made during the tax year or actual contributions plus accrued contributions. The IRS instructions to Part II of Form 5330 state: "The excise tax is equal to 10% of the nondeductible contributions in the plan as of the end of the employer's tax year." Thus, according to the form on which the excise tax is computed, the IRS assesses the 10% excise tax on nondeductible amounts actually contributed *during* the tax year, and not those amounts accrued at the end of the tax year.

Example 2-25: Accrued contributions may escape the excise tax.

XYZ, Inc. is a calendar year taxpayer. XYZ makes $80,000 of contributions to its profit-sharing plan during 2010. XYZ accrues $20,000 of additional contributions at December 31, 2010, but actually makes this contribution January 15, 2011. The employer contribution deduction limitation for XYZ for 2010 is $85,000. Thus, XYZ has a nondeductible contribution of $15,000 ($100,000 − $85,000).

What is the amount of the 10% excise tax attributable to the $15,000 excess nondeductible contribution? According to the IRS instructions to Form 5330, which is used to compute and report the excise tax, there is no excise tax due since only $80,000 was actually contributed *during* the 2010 year and this amount is less than the $85,000 deductible contribution limitation for XYZ.

Some employers make monthly or other periodic contributions. If such an employer contributes more than the maximum deductible amount, the problem may be reduced or eliminated by separating contributions when the contributions can be applied to either of two taxable years, and reassigning such contributions to avoid or alleviate having excess contributions.

Exception for Certain Defined Benefit Plans. An exception to the excise tax is available for nondeductible employer contributions made to defined benefit plans. Under the exception, in determining the amount of its nondeductible contributions for any tax year, an employer may elect not to take into account any contributions to a defined benefit plan, except to the extent that the contributions exceed the full-funding limitation of IRC Sec. 431(c)(6), but determined without regard to the current liability limit in IRC Sec. 431(c)(6)(A)(i). Thus, employers may elect to exclude contributions to a defined benefit plan, to the extent the contributions do not exceed the full funding limit. For this purpose, the full funding limit is determined without regard to the current liability limit, and so only takes accrued liability into account.

Exception for Certain Defined Contribution Plans. There is an exception to the excise tax for contributions made to one or more defined contribution plans that are not deductible because they exceed the combined limit for defined benefit and defined contribution plans under IRC Sec. 404(a)(7). This exception applies to the extent that the contributions do not exceed the greater of (a) 6% of the benefitting participants' compensation paid or accrued during the taxable year the contributions were made, or (b) the sum of (1) the elective deferral contributions to a 401(k) plan plus (2) the employer's matching contributions.

An employer subject to a 10% excise tax under IRC Sec. 4972 is not entitled to correct such occurrence under the Employee Plans Compliance Resolution System (EPCRS).

Common Mistakes in Preparing Form 5330. Preparers of Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans) commonly make the following mistakes:

- Failure to sign the Form 5330.
- The plan number is left blank or an invalid plan number is used.
- Reporting of two or more excise taxes on a single Form 5330 that do not have the same filing due date and therefore may not be filed together.
- Not completing lines 17–19 in Part II when there is tax reflected on line(s) 1 through 16.

- When Schedule C is applicable, failure to check the box on line 1 (discrete or not discrete prohibited transactions).

- When Schedule C is applicable, failure to complete line 2, columns (d) and (e).

- Confusion about the information to be reported on lines 2 and 5 of Schedule C (Form 5330).

TERMINATING A PLAN

IRC Sec. 404(g) provides rules regarding the deduction of employer liability payments paid under IRC Secs. 4041(b), 4062, 4063, 4064, or part 1 of Subtitle E of Title IV of ERISA. No deduction is allowed under IRC Sec. 404(g) to provide for benefits in excess of guaranteed benefits. Alternatively stated, an employer cannot immediately deduct the difference between the present value of accrued benefits and the assets even if the plan is terminating. Contributions to the plan in the year of termination, though not fully deductible, are subject to the deduction rules under IRC Sec. 404(a) in subsequent years. Contributions deductible under IRC Sec. 404(g) are subject to the full funding limit. These rules discussed above regarding plan termination are applicable to qualified plans only.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. The firm of Thomas, Jefferson & Howe maintains a stock bonus plan. Both the firm's tax year and the plan year run on the calendar year. TJ&H files an extension on its tax return, which makes the return due on September 15, 2011. In which of the following scenarios, can TJ&H deduct a contribution to the stock bonus trust in the 2010 tax year?

    a. The contribution is made on September 13, 2011, and is based on service performed from March 1 to April 30, 2011.

    b. TJ&H causes a delay in the handling of the check, so the trust does not receive it until September 16, 2011.

    c. TJ&H mails the contribution to the trust on September 10, 2011, but the trust does not receive it until September 17, 2011.

    d. When the check is deposited in to the trust, the check bounces.

38. In which of the following scenarios does the employer correctly determine its deduction limit?

    a. The Connor Company changes its plan year from the calendar year to a fiscal year ending on June 30, which gives the company a short plan year in the year of change. The company maintains a defined benefit plan, and determines the deductible limit for the short plan year by ratably reducing the applicable limit for a 12-month year in proportion to the number of months in the short plan year.

    b. Dunston & Hughes maintains a pension plan with a plan year of September 30. The firm has a tax year that ends on November 30. Its deductible limit is determined based on a pro rata share of the plan year and the tax year.

    c. Meyers, Meyers & Tait make a 25% profit-sharing contribution for the plan year ending December 31 based on projected wages for eligible participants through the end of the tax year (April 30). Between January 1 and April 30, several plan participants terminate their employment. The extra contributions are allocated to the remaining participants so that the deduction limit is still met.

    d. Sanderson, Inc., has a profit-sharing plan with a tax year end of May 31 and a plan year of December 31. Sanderson determines its deductible limit by using a weighted average of the plan year beginning with the employer's tax year and the plan year ending with the employer's tax year.

39. Snyder Farm Supply maintains a profit-sharing plan for its employees. The plan contribution for 2010 should be $30,000. The company owns real estate with a fair market value of $30,000 and a basis of $20,000, and uses this real estate to fund its contribution to the plan. What tax consequences will be noted on Snyder's federal income tax return?

    a. A gain of $10,000 and a plan contribution deduction of $30,000.

    b. A plan contribution deduction of $20,000 only.

    c. A gain of $20,000 and a plan contribution deduction of $30,000.

    d. A gain of $30,000 and a plan contribution deduction of $10,000.

40. In some circumstances, the amount of an excess contribution can be returned to the employer so the employer can avoid the excise tax on excess contributions to a qualified plan. One such circumstance is contributions made because of a mistake of fact. Which of the following qualifies as a mistake of fact?

    a. The failure of the plan to initially qualify.

    b. The failure of the contribution to be deductible.

    c. A mistake of law.

    d. An arithmetic or computational error.

41. Roy's Autos is a calendar year taxpayer and makes $50,000 of contributions to its profit-sharing plan in 2010. The employer accrues additional contributions of $12,000 at December 31, 2010, and contributes them on January 15, 2011. The employer contribution deduction limitation for Roy's Autos in 2010 is $60,000. How much excise tax will Roy's Autos owe for the 2010 tax year?

    a. $200.

    b. $5,000.

    c. $12,000.

    d. Roy's Autos does not owe excise tax for the 2010 tax year.

42. In which of the following scenarios would an employer be exempt to the excise tax on excess contributions?

    a. Haddock & Herring is enrolled in the Employee Plans Compliance Resolution System (EPCRS) and will correct its excess contribution through that system.

    b. Beddington Enterprises owes excise taxes on two different excess contributions. The contributions have different due dates, and are filed on the same Form 5330.

    c. BenCorp maintains a defined benefit plan, and in 2010 elects to exclude contributions to that plan to the extent that the contributions do not exceed the full funding limit.

    d. Summer Slides has excess contributions for 2010, the same year that the company will terminate its qualified plan.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. The firm of Thomas, Jefferson & Howe maintains a stock bonus plan. Both the firm's tax year and the plan year run on the calendar year. TJ&H files an extension on its tax return, which makes the return due on September 15, 2011. In which of the following scenarios, can TJ&H deduct a contribution to the stock bonus trust in the 2010 tax year? **(Page 200)**

    a. The contribution is made on September 13, 2011, and is based on service performed from March 1 to April 30, 2011. [This answer is incorrect. Contributions based on services performed after the firm's tax year is closed would not be deductible in 2010, even if the contribution was made before the due date of the return. Therefore, this contribution will not be deductible by TJ&H in 2010.]

    b. TJ&H causes a delay in the handling of the check, so the trust does not receive it until September 16, 2011. [This answer is incorrect. A contribution is not considered made in a timely fashion if the employer has caused a delay in the handling of the check, so TJ&H cannot deduct the contribution in 2010 in this scenario.]

    c. TJ&H mails the contribution to the trust on September 10, 2011, but the trust does not receive it until September 17, 2011. [This answer is correct. Based on the timely mailed rule, if the contribution is mailed and the envelope has a U.S. Postal Service postage cancellation date of no later than September 15, 2011, (which is the due date of the return) the contribution will be considered timely made. Therefore, TJ&H can deduct this contribution in 2010.]

    d. When the check is deposited in to the trust, the check bounces. [This answer is incorrect. A bounced check is treated as if the contribution was never made; therefore, TJ&H will not be able to deduct the contribution in 2010 in this scenario.]

38. In which of the following scenarios does the employer correctly determine its deduction limit? **(Page 202)**

    a. The Connor Company changes its plan year from the calendar year to a fiscal year ending on June 30, which gives the company a short plan year in the year of change. The company maintains a defined benefit plan, and determines the deductible limit for the short plan year by ratably reducing the applicable limit for a 12-month year in proportion to the number of months in the short plan year. [This answer is correct. When a company changes its plan year end, a short plan year occurs. In this scenario, the company has adopted the correct procedures for dealing with the short plan year.]

    b. Dunston & Hughes maintains a pension plan with a plan year of September 30. The firm has a tax year that ends on November 30. Its deductible limit is determined based on a pro rata share of the plan year and the tax year. [This answer is incorrect. The deductible limit would be correctly determined if Dunston & Hughes maintained a profit-sharing plan. This limit is not correct for a pension plan per the Code.]

    c. Meyers, Meyers & Tait make a 25% profit-sharing contribution for the plan year ending December 31 based on projected wages for eligible participants through the end of the tax year (April 30). Between January 1 and April 30, several plan participants terminate their employment. The extra contributions are allocated to the remaining participants so that the deduction limit is still met. [This answer is incorrect. If plan participants who shared in the contribution terminate between the time that the contribution was made and the end of the tax year, the actual compensation base is smaller than anticipated for the 25% deduction limit. Thus, the firm will have created a nondeductible contribution per the Code.]

    d. Sanderson, Inc., has a profit-sharing plan with a tax year end of May 31 and a plan year of December 31. Sanderson determines its deductible limit by using a weighted average of the plan year beginning with the employer's tax year and the plan year ending with the employer's tax year. [This answer is incorrect. According to the Code, the deductible limit would be determined correctly in this scenario if Sanderson had a pension plan. A profit-sharing plan would require the use of a different method.]

39. Snyder Farm Supply maintains a profit-sharing plan for its employees. The plan contribution for 2010 should be $30,000. The company owns real estate with a fair market value of $30,000 and a basis of $20,000, and uses this real estate to fund its contribution to the plan. What tax consequences will be noted on Snyder's federal income tax return? **(Page 202)**

    a. A gain of $10,000 and a plan contribution deduction of $30,000. [This answer is correct. The gain is calculated by taking the value of the real estate ($30,000) and subtracting the basis ($20,000) for a total of $10,000. The contribution amount is the amount of the real estate contributed ($30,000).]

    b. A contribution deduction of $20,000 only. [This answer is incorrect. According to the IRS, the contribution deduction does not equal the basis in the contributed real estate.]

    c. A gain of $20,000 and contribution deduction of $30,000. [This answer is incorrect. According to the IRS, the basis amount has been used as the gain amount in this answer choice, which is not correct. A specific calculation must be performed to determine the gain amount in relation to the basis amount and the value of the real estate.]

    d. A gain of $30,000 and contribution deduction of $10,000. [This answer is incorrect. Because of the basis in the real estate, the entire $30,000 should not be claimed on the company's federal income tax return as a gain per the IRS.]

40. In some circumstances, the amount of an excess contribution can be returned to the employer so the employer can avoid the excise tax on excess contributions to a qualified plan. One such circumstance is contributions made because of a mistake of fact. Which of the following qualifies as a mistake of fact? **(Page 203)**

    a. The failure of the plan to initially qualify. [This answer is incorrect. Under these circumstances, the excess contribution could still be returned to the employer by the deadline, and the employer would avoid the excise tax. However, this is a separate circumstance and does not qualify as a mistake of fact per the Code.]

    b. The failure of the contribution to be deductible. [This answer is incorrect. Though this circumstance does not qualify as a mistake of fact, if this had happened, the excess contribution could be returned to the employer (on or before the last date, including extensions, that the employer could make a deductible contribution for the tax year) and the employer would not have to pay the excise tax per the Code.]

    c. A mistake of law. [This answer is incorrect. According to the Regulations, a mistake of fact is specifically defined as not being a mistake of law.]

    d. An arithmetic or computational error. [This answer is correct. Arithmetic or computational errors qualify as mistakes of fact, though a mistake that results from an estimate of future claims in an actuarial projection is not a mistake of fact.]

41. Roy's Autos is a calendar year taxpayer and makes $50,000 of contributions to its profit-sharing plan in 2010. The employer accrues additional contributions of $12,000 at December 31, 2010, and contributes them on January 15, 2011. The employer contribution deduction limitation for Roy's Autos in 2010 is $60,000. How much excise tax will Roy's Autos owe for the 2010 tax year? **(Page 204)**

    a. $200. [This answer is incorrect. This is 10% of $2,000. Roy's Autos did contribute (actually paid plus accrued) $2,000 more than the contribution deduction limit, but the calculation of excise tax per the instructions to Form 5330 would not be based on the $2,000 excess per the Code.]

    b. $5,000. [This answer is incorrect. This is 10% of $50,000. According to the Code, Roy's Autos would not need to pay excise tax on the entire $50,000 of actual contributions made to the plan in 2010.]

    c. $12,000. [This answer is incorrect. This is 10% of $12,000. According to the Code, Roy's Autos would not need to pay excise tax on the entire amount of additional contributions that accrued in 2010.]

d. Roy's Autos does not owe excise tax for the 2010 tax year. [This answer is correct. According to the instructions on IRS Form 5330 (the form used to compute and report the excise tax) no excise tax would be due because only $50,000 was actually contributed during 2010, which is less than Roy's Autos' deductible contribution limit of $60,000.]

42. In which of the following scenarios would an employer be exempt to the excise tax on excess contributions? **(Page 204)**

a. Haddock & Herring is enrolled in the Employee Plans Compliance Resolution System (EPCRS) and will correct its excess contribution through that system. [This answer is incorrect. If Haddock & Herring is subject to the excise tax under IRC Sec. 4972, the firm is not entitled to correct the occurrence under EPCRS, according to Rev. Proc. 2008-50, Section 6.09.]

b. Beddington Enterprises owes excise taxes on two different excess contributions. The contributions have different due dates, and are filed on the same Form 5330. [This answer is incorrect. Reporting two or more excise taxes that do not have the same filing due date (and, thus, cannot be filed together) on the same Form 5330 is one of the most common mistakes made during preparation of the Form 5330. It has no relation to exemptions from the excise tax, according to the Code.]

c. BenCorp maintains a defined benefit plan, and in 2010 elects to exclude contributions to that plan to the extent that the contributions do not exceed the full funding limit. [This answer is correct. In this situation, BenCorp is taking advantage of an exception to the excise tax that is available for nondeductible employer contributions made to defined benefit plans. When determining the amount of nondeductible employer contributions for a tax year, the employer can elect not to take into account any contributions to a defined benefit plan, except to the extent that they exceed the full-funding limitation found in IRC Sec. 413(c)(6)(A)(i). If BenCorp maintained a defined contribution plan instead, a different exception might apply.]

d. Summer Slides has excess contributions for 2010, the same year that the company will terminate its qualified plan. [This answer is incorrect. According to the Code, plan termination does not provide an exception for the excise tax. However, plan termination will affect the deductions available to Summer Slides in the year of termination.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (RETTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

22. Employer contributions are affected by the plan document. Which of the following questions answered in the plan document should be reviewed with the sponsor to ensure the most current information?

    a. Are there any matching contributions?

    b. Are there any commonly controlled businesses to be considered?

    c. What type of plan is it?

    d. What is the sponsor's taxable year?

23. Angela works for Breaker Corp. and participates in the company's 401(k) plan. She earns an annual salary of $30,000, which is typical for people in her profession and geographic area. Breaker Corp. makes a matching contribution of 3% of Angela's salary to the plan on her behalf. That percentage is made for all employees companywide. Apply the guidance found in IRC Secs. 162 and 404 to determine if the company can deduct the contribution it made to Angela's account.

    a. The contribution is deductible according to both Code Sections.

    b. The contribution does not meet the qualifications of either Code Section, so it cannot be deducted.

    c. The contribution is deductible under IRC Sec. 404, but does not meet the "ordinary and necessary" qualifications of IRC Sec. 162; therefore, Breaker Corp. cannot make the deduction.

    d. The contribution does not meet the "ordinary and necessary" qualifications of IRC Sec. 162, but since it is deductible under IRC Sec. 404, the deduction will be allowed.

24. Midnight Mysteries, Inc., maintains a defined benefit pension plan for its employees. During 2010, the plan spends $2,000 on recurring administrative expenses, including actuary's fees. Can these expenses be deducted?

    a. Yes.

    b. No.

    c. Yes, as long as the employer pays the expenses directly.

    d. No, unless 2009 deductions have not exceeded the Section 404 limit.

25. Match the defined contribution plan deduction limits with the correct definitions.

1. Employer deduction limit	i. $5,500 for qualified plans and $2,500 for SIMPLE plan
2. Annual addition limit	ii. The amount an employer can deduct for contributions made to a qualified plan.
3. Employee deferral limit	iii. The amount of contributions and forfeitures that can be added to an individual participant's plan account.
4. Catch-up contribution limit	iv. The amount an employee can defer with respect to the calendar year.

a. 1., i.; 2., ii.; 3., iii.; 4., iv.

b. 1., iii.; 2., iv.; 3., i.; 4., ii.

c. 1., iv.; 2., i.; 3., ii.; 4., iii.

d. 1., ii.; 2., iii.; 3., iv.; 4., i.

26. Mac-Town Outfitters maintains a profit-sharing plan. Its plan document calls for an annual contribution of 9% of its profits. The company's employees received $250,000 of qualified compensation, and the company's 2010 profits were $975,000. Calculate Mac-Town's deduction limit.

    a. $2,525.

    b. $25,250.

    c. $62,500.

    d. $87,750.

27. Assume the same details as in the previous question. Calculate the amount that can be carried forward to succeeding tax years.

    a. $2,525.

    b. $25,250.

    c. $62,500.

    d. $87,750.

28. Tale Weaver, Inc., exceeded the deduction limitation on contributions to its profit-sharing plan in 2010 by $6,000. Which of the following best illustrates the consequences to the plan?

    a. Tale Weaver's plan loses its qualified status.

    b. Because the excess deduction is less than $10,000, Tale Weaver can claim it in 2010.

    c. The $6,000 can be carried over to Tale Weaver's 2011 plan year.

    d. Tale Weaver is subject to a 25% excise tax on the $6,000.

29. Harold is a shareholder in an S corporation. What is the earned income requirement for calculating Harold's qualified compensation for a retirement plan?

    a. Personal services must be performed and must be a material income-producing factor.

    b. Potential contributions to the plan are limited to self-employment income from a trade or business conducted by the S corporation.

    c. Distributions to a limited partner would not be considered earned income.

    d. Harold's pass-through income would not be treated as earned income.

30. Connie is self-employed. She employs three other individuals. All four participate in the profit-sharing plan that Connie maintains. In 2010, the employees' total compensation is $80,000, and Connie has a net income of $115,000 before making plan contributions for herself or the employees. Calculate the maximum amount Connie can contribute for herself, if she makes the maximum contribution on the behalf of her employees?

    a. $6,712.

    b. $17,658.

    c. $19,000.

    d. $28,750.

31. If the owners of a company want to set up a defined benefit plan, which of the following should be considered?

    a. The contribution deduction is based on actuarial assumptions and computations.

    b. The deduction limit is the contribution amount calculated under the straight-line rule.

    c. Each defined benefit plan the company owns is a separate entity for determining the number of participants.

    d. The deduction limit is no more than 100% of the current liability, as determined under IRC Sec. 412.

32. Megan's Charters maintains a defined benefit plan with a plan year end of December 31. At the end of the 2010 plan year, the company has a funding deficiency of $25,000 in the plan's minimum funding standard account. Calculate the initial excise tax Megan's Charters will have to pay on this funding deficiency.

    a. $2,250.

    b. $2,500.

    c. $6,250.

    d. $25,000.

33. Assume the same details as in the question above. The excise tax owed by Megan's Charters is assessed on April 30, 2011, and the company pays the excise tax on May 31, 2011, but has not corrected the plan's original funding deficiency. What is the total amount owed by Megan's Charters now?

    a. An additional excise tax of the same amount paid on May 31 is due.

    b. An additional excise tax of $25,000 is due and the funding deficiency is waived.

    c. An addition excise tax of $25,000 is due, and the company must still replace the full amount of the funding deficiency.

    d. As long as the funding deficiency is corrected by December 31, 2011, the company does not have to pay more taxes on the deficiency.

34. Money purchase pension plans combine elements of defined contribution plans and defined benefit pension plans. Which of the following is an element used in money purchase pension plans and **not** defined contribution plans?

    a. The employer's deduction limit is 25% of compensation paid during the tax year to plan beneficiaries.

    b. Individual account balances are maintained.

    c. The employer's annual contribution is a fixed obligation.

    d. The minimum funding standard rule applies in the same way.

35. Lavinia is a calendar-year sole proprietor with a calendar-year money purchase pension plan. The plan requires Lavinia to make a contribution of $7,000 in 2010. Lavinia's 2010 Form 1040 has been extended until October 15, 2011. If Lavinia wants to claim the deduction on her 2010 tax return and meet the minimum funding requirements, when must she make the $7,000 contribution to the plan?

    a. December 31, 2010.

    b. April 15, 2011.

    c. September 15, 2011.

    d. October 15, 2011.

36. Raine Daze maintains a money purchase plan and a profit-sharing plan, and Ernie participates in both plans. Raine Daze makes contributions to both plans in 2010. Which option best describes how Ernie's overall deduction limit is affected?

    a. It is limited to 25% of covered compensation (no more than $245,000 for 2010).

    b. It is the greater of the contributions to the money purchase plan or 25% of compensation.

    c. It is limited to $49,000 for 2010.

    d. Ernie's situation meets the qualifications to waive the deduction limit.

37. Beldon Enterprises has a profit-sharing plan, and both the company and the plan run on a calendar year basis. The company makes a contribution to the profit-sharing plan's trust on June 30, 2011. Is it possible for the company to deduct this contribution in 2010?

    a. Yes, the company will always be able to claim this deduction for the 2010 tax year.

    b. No, the contribution was made too late for the company to claim the deduction in 2010.

    c. The company can claim the deduction in 2010 if it claims the contribution as a deduction on its 2010 tax return.

    d. The company can claim the deduction in 2010 if all plan participants are informed in writing that the contribution is for the preceding year.

38. Betacorp maintains a pension plan for its employees. The plan year ends on December 31, but the company's taxable year ends on April 30. Because the plan year is not the same as the employer's tax year, which of the following is an option Betacorp can use to determine its deduction limit?

    a. Compute the deductible limit based on the plan year beginning within the employer's tax year.

    b. Determine the deductible limit from the plan year that begins in the tax year.

    c. Compute the deductible limit based on a pro rata share of the plan year only.

    d. Determine the deductible limit based on the short tax year.

39. McMillan Brothers contributes real estate to its defined benefit plan. Is the company eligible for a contribution deduction?

    a. No, only cash and cash equivalents are allowed.

    b. Yes, under certain conditions.

    c. Only if liens are attached to the contributed property.

    d. Only if McMillan Brothers recognizes a loss on the contributed property.

40. In 2010, TV Town made an excess contribution to its qualified plan of $30,000. How much excise tax will TV Town have to pay?

    a. $1,500.

    b. $3,000.

    c. $4,500.

    d. $10,000.

41. Bogart Boats (BB) will terminate its qualified plan in 2010. Which of the following applies?

    a. BB should immediately deduct the difference between the present value of accrued benefits and the assets.

    b. Contributions to the plan in 2010 will be fully deductible.

    c. Contributions are subject to the full funding limit if they are deductible under IRC Sec. 404(g).

    d. The rules for deductions related to plan termination are applicable even if BB loses its qualified status.

GLOSSARY

401(k) plan: A 401(k) plan (or a cash or deferred arrangement plan) is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a profit-sharing or stock bonus plan, a pre–Employee Retirement Income Security Act of 1974 (ERISA) money purchase plan, or a rural cooperative plan. In addition, contributions to the plan may be made by the employee, employer, or both (i.e., through a matching arrangement). Contributions to the plan are made pre-tax (tax-deferred). Earnings, gains, or losses within the account are tax-deferred. Distributions from the account are fully taxable.

Actual contribution percentage limit: The amount of matching employer contributions and employee after-tax contributions allowed.

Actual deferral percentage limit: The highest amount of elective deferrals that can be retained in the plan by any highly compensated employee.

Actuary: An individual professionally trained in the technical aspects of calculating insurance and annuity premiums, reserves, and dividends.

Annual addition limit: The amount of contributions that can be added to an individual participant's plan account. This limit includes the employer and employee contribution as well as reallocated forfeitures allocated to the account of the participant.

Catch-up contribution limit: For 2007, the catch-up limit is $5,000 for qualified plans and $2,500 for SIMPLE plans.

Catch-up contributions: Catch-up contributions can be made by individuals age 50 and over if the plan allows. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying the nondiscrimination rules.

Compensation: There are several definitions for compensation that can be used for various purposes. Compensation for the purpose of determining the employer deduction limit is referred to as *qualified compensation* in this course. Qualified compensation for self-employed participants is determined by earned income and adjusted by half of the self-employment tax and the participant's deductible contribution to the plan. For purposes of the deduction limit, compensation is defined as the amount paid or accrued during the tax year to plan participants, not including contributions to a qualified plan.

Defined benefit limit: IRC Sec. 415(b) limits the amount of the plan benefit to which a participant in a defined benefit plan is entitled. The indirect impact of the benefit limit is that the employer's deductions for contributions to the plan are also limited. The benefit limit prescribed applies to a benefit payable as either a straight-life annuity or a qualified joint and survivor annuity. If the plan benefit is not payable in the form of a straight-life annuity or a qualified joint and survivor annuity, the benefit is adjusted to the actuarial equivalent of a straight-life annuity for the purpose of applying the limits.

Defined benefit plan: A pension plan that defines the amount of pension benefit to be provided, usually as a function of one or more factors including age, years of service, or compensation. Accounting is difficult because annual expense is based on estimates of future benefits. The employer bears the investment risk and must provide sufficient funds to meet the defined level of benefit. The Employee Retirement Income Security Act of 1974 (ERISA) made funding of defined benefit plans mandatory.

Defined contribution plan: A pension plan that specifies the amounts contributed to the plan and does not specify the amount of the benefits to be received by the retired employees. Contributions to the plan are based on specified amounts (e.g., 7% of the employee's salary). The benefits to be received by the retired employee are unspecified and uncertain. The employee bears the investment risk and the pension expense is the amount funded (paid in). Defined contribution plans can be profit-sharing plans or money purchase plans.

Elective deferral limit: The annual elective deferral limit is $15,500 for 2007. This limit is applied on a per-individual basis with respect to a calendar year and applies to all elective deferrals (excluding catch-up contributions) that an individual makes to 403(b) plans, salary reduction simplified employee pension plans (SARSEPs), and SIMPLE IRAs, as well as 401(k) plans. These are combined for this limitation regardless of whether related or unrelated employers provide the plans.

Employee Plans Compliance Resolution System (EPCRS): The IRS has issued guidance on self-correcting plan errors, including the timing of corrective distributions, in EPCRS. Under EPCRS, significant excess annual additions will generally not present a qualification problem as long as the plan distributes the excess by the end of the second year after the year the excess contribution was made.

Employer deduction limit: The amount an employer can deduct for contributions made to a qualified plan.

Employee deferral limit: This limit applies to employee deferrals on a per-individual basis with respect to a calendar year. They are included in the annual addition limit but not in the employer deduction limit.

Employer-provided limit: Any limit on the elective deferrals an employee is permitted to make that is contained in the terms of the plan, but is not required under the Internal Revenue Code.

Excise tax: An excise tax is a type of ad valorem (according to value) tax or in rem (on the physical units) tax levied by various levels of government on specified goods or services. There are several different federal excise taxes that can be triggered by excess contributions to or insufficient withdrawals from pension plans.

Limitation year: The limits on contributions and benefits apply to a limitation year. The limitation year is a calendar year, unless the employer elects to use any other consecutive 12-month period.

Qualified retirement plan: Programs established under the Internal Revenue Code by an employer to provide retirement income for employees. The plans receive tax-favored status by complying with the qualification requirements under one of several Internal Revenue Code Sections.

Section 415 limit: IRC Sec. 415 limits the amount of contributions and benefits available to a participant through a qualified plan. This limit must be satisfied as a condition of a plan's qualified status. It is separate from, but integrated with, the limit imposed on the amount the employer can contribute to the plan and deduct on its tax return.

Statutory limits: The elective deferral limit under IRC 402(g) and the annual additions limit under IRC Sec. 415(c).

Vest: To earn the rights to. A share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Small Employer Retirement Plans—Course 1—Understanding Eligibility and Vesting Rules, and Testing for Minimum Coverage and Participation (RETTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **August 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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CPE Examination Questions (Lesson 2) **105**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Small Employer Retirement Plans—Course 1—Understanding Eligibility and Vesting Rules, and Testing for Minimum Coverage and Participation (RETTG101)

CTEC Course No. 3039-CE-0254
Price $79

First Name: ______________________

Last Name: ______________________

Firm Name: ______________________

Firm Address: ______________________

City: ______________________ State /ZIP: ______________________

Firm Phone: ______________________

Firm Fax No.: ______________________

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Express Grading Requested: ☐ Add $24.95

CTEC No.: ______________________

Signature: ______________________

Credit Card Number: ______________________ Expiration Date: ______________________

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: August 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Small Employer Retirement Plans—Course 1—Understanding Eligibility and Vesting Rules, and Testing for Minimum Coverage and Participation

Course Acronym: RETTG101

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
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Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

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2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
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6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Small Employer Retirement Plans Course 2—Contribution Limits and Deductions (RETTG102)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

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3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

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EXAMINATION FOR CPE CREDIT

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CPE Examination Questions (Lesson 1) **163**

CPE Examination Questions (Lesson 2) **212**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Small Employer Retirement Plans—Course 2—Contribution Limits and Deductions (RETTG102)

CTEC Course No. 3039-CE-0255
Price $79

First Name: ______

Last Name: ______

Firm Name: ______

Firm Address: ______

City: ______ State /ZIP: ______

Firm Phone: ______

Firm Fax No.: ______

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Express Grading Requested: ☐ Add $24.95

CTEC No.: ______

Signature: ______

Credit Card Number: ______ Expiration Date: ______

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
2.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
3.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
4.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
5.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
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7.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
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9.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○
10.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○	41.	○	○	○	○
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Expiration Date: August 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Small Employer Retirement Plans—Course 2—Contribution Limits and Deductions

Course Acronym: RETTG102

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
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3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
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7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
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9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
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2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
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5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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