RETT09

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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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

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 **September 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of choosing and maintaining a qualified retirement plan. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S GUIDE TO SMALL EMPLOYER RETIREMENT PLANS

COURSE 1

CHOOSING AND MAINTAINING A QUALIFIED RETIREMENT PLAN (RETTG091)

OVERVIEW

COURSE DESCRIPTION: An employer must carefully consider the benefits and costs associated with establishing, maintaining, and terminating a qualified retirement plan. This course examines qualified retirement plans and emphasizes information pertinent to plan selection, as well as procedures for establishing, and maintaining a plan.

PUBLICATION/REVISION DATE: August 2009

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.

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FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **September 30, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Choosing the Right Plan

Completion of this lesson will enable you to:
- Describe a qualified retirement plan and summarize the advantages and disadvantages.
- Determine the plan type that best meets the employer's needs.
- Assess the options available for defined contribution plans and defined benefit plans.
- Recognize other types of retirement plans, such as SEPs and Keogh plans, and describe any relevant issues.

Lesson 2—Establishing and Maintaining a Qualified Retirement Plan

Completion of this lesson will enable you to:
- Summarize how to establish a qualified retirement plan, including special issues related to plan design.
- Describe plan documents, determination letters, and their importance.
- Prepare to file for a determination letter.
- Provide notice and solve related issues when the plan document is amended.
- Assess plan amendment issues related to the anti-cutback rules, retroactive amendments, and law changes.

- Determine appropriate procedures for changing the plan/trust year and obtaining determination letters when a plan is amended or terminates.

TO COMPLETE THIS LEARNING PROCESS:

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Chicago, IL 60694-6700

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Lesson 1: Choosing the Right Plan

INTRODUCTION

Qualified retirement plans are 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. If certain requirements (which vary depending on the type of plan) are met, contributions are currently deductible by the employer, while employees are not taxed until funds are distributed to them.

Qualified retirement plans appeal to both employers and employees. Many employers will find it necessary to offer this type of benefit in order to remain competitive. The employer may adopt a plan tailored specifically to the business or a plan with standard options that enable the employer to accomplish the company's goals. Thus, choosing the right plan is important. In a downward economy, flexibility in deciding whether to make a contribution on a year-to-year basis may be desirable. The employer should define the company's goals and examine each type of plan available to choose the one that matches the goals. In doing so, it is important to consider the advantages and disadvantages of each type of plan.

In choosing the right plan, an employer should consider carefully the benefits and costs associated with establishing, maintaining, and terminating a plan. The contribution level and funding obligations, as well as the anticipated life of the plan, are also important factors to identify when selecting which type of plan to establish. There is no "one plan that fits all." The demographics and motivation of the employees are factors as well in determining which plan will provide the benefits desired at a reasonable cost. For example, a small family business will probably not be a good candidate for a 401(k) plan if the rank-and-file employees choose not to make elective deferrals. However, a SIMPLE-IRA or safe harbor 401(k) plan may work well, since they will automatically pass the nondiscrimination tests. All factors should be carefully considered in selecting a particular type of plan as well as the allocation formula and other design features of the plan.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe a qualified retirement plan and summarize the advantages and disadvantages.
- Determine the plan type that best meets the employer's needs.
- Assess the options available for defined contribution plans and defined benefit plans.
- Recognize other types of retirement plans, such as SEPs and Keogh plans, and describe any relevant issues.

DEFINING A QUALIFIED RETIREMENT PLAN

A qualified retirement plan is a type of tax-favored plan established under the Internal Revenue Code by an employer to provide retirement income for employees. The plan must meet certain requirements under the Internal Revenue Code and ERISA to be afforded special tax-favored treatment. These requirements include minimum vesting rules, minimum coverage and participation rules, nondiscrimination rules, contribution and benefit limitation rules, top-heavy rules, and distribution rules. Provided these requirements are met, the employer can deduct contributions made to the plan, while employees are not currently taxed on such contributions. Employees do not recognize any taxable income from either the contributions or earnings on the contributions until they receive a distribution from the plan.

Tax-favored plans for small employers can be grouped into four categories:

- Defined contribution plans provide each participant with an account to which contributions, earnings, and forfeitures are credited. Benefits are based on the amount in the participant's account. These plans do not provide for a specified benefit at retirement so the risk of investment lies with the participant. This type includes profit-sharing, money purchase, and several variations of these plans.

- Defined benefit plans provide a specified benefit to an employee based on a formula set forth in the plan document. In this type of plan, the risk of investment lies with the employer. Factors such as age, service, and/or compensation are taken into account in computing the amount of this benefit. This type of plan also includes cash balance plans.

- Hybrid plan designs combine the features of both a defined benefit plan and defined contribution plan. Target benefit plans are a hybrid between a defined benefit plan and a money purchase pension plan. Age-weighted or new comparability plans are a hybrid between a profit-sharing plan and a defined benefit plan.

- Payroll deduction IRAs, SEPs, and SIMPLE IRA plans are much like the defined contribution plans in that they have individual accounts to which contributions are credited. However, these plans utilize IRAs to hold the assets and are always 100% vested. Although these plans are tax-favored, they are not *qualified plans* and are subject to different and generally simpler rules.

Protection of Assets in Bankruptcy

The protection of these arrangements from creditors should be carefully evaluated. Debtors can exempt retirement funds from the bankruptcy estate to the extent that money is exempt from taxation under IRC Sections 401 (qualified retirement plans), 403 (tax-sheltered annuities and custodial accounts), 408 (traditional IRAs) 408A (Roth IRAs), 414 (multi-employer plans), and 457 (governmental and exempt organization plans). An inflation adjusted $1,000,000 ceiling is generally imposed upon the value of an individual debtor's interest in an IRA (other than a SEP or a SIMPLE plan) or Roth IRA that the debtor may claim as exempt property. The $1,000,000 cap may be increased if the interests of justice so require. Value for purposes of the $1,000,000 is determined without regard to certain rollover contributions.

QUALIFIED PLANS: ADVANTAGES

Qualified plans appeal to both employers and employees. Employers find qualified plans attractive because contributions they make to the plan are currently deductible. A retirement plan also helps to attract qualified employees and retain existing employees. Loyalty among existing employees may be encouraged by requiring a specified number of years of service before an employee is entitled to employer contributions, otherwise known as *vesting*. In today's job market, qualified retirement plans also help employers to be competitive with other firms that offer qualified plans. Another advantage to both employer and employee is that funds accumulated in a qualified retirement plan, whether or not the plan covers only business owners, are not part of the bankruptcy estate as long as the plans are qualified. This is broader protection than prior case law protecting only those qualified plans that have at least one non-owner employee-participant.

Qualified retirement plans appeal to most employees since they provide a way for the employee to accumulate funds for retirement without being currently taxed on the contributions made to the plan or the earnings on the funds being held in the plan. Employees are taxed on the contributions and earnings when they receive distributions from the plan. In some cases, the distributions may qualify for favorable tax treatment. Certain types of plans [e.g., 401(k) plans] allow an employee to defer part of his or her compensation to the plan on a tax deferred basis or in some cases on an after tax basis to a *Designated Roth Account (DRA)*, thus providing the employee with significantly increasing retirement funds and valuable retirement planning options.

QUALIFIED PLANS: DISADVANTAGES

Although qualified retirement plans are attractive vehicles for accumulating retirement funds, there are some disadvantages. The requirements that must be met to maintain a plan's qualified status have the effect of limiting benefits that may be paid to highly compensated employees and ensure that lower-paid employees are not discriminated against. One of these requirements limits compensation to $235,000 for 2009 for any individual in determining deductible contributions. (This amount is adjusted annually for inflation.) These requirements are complex, and there is a significant amount of administration involved in operating the plan. Thus, there are costs associated with maintaining the plan. Also, if a certain level of benefits or account balances benefit highly compensated or key employees, special rules apply. These rules are referred to as the *top-heavy* rules.

Complying with the qualification requirements also means meeting reporting and filing requirements of various government agencies, such as the IRS, the Department of Labor (DOL), and the Pension Benefit Guaranty

Corporation (PBGC). These agencies enforce these reporting and filing requirements by auditing plans for compliance.

There is significant liability for fiduciaries of the plan. Plan fiduciaries, including the plan administrator, must act in the best interest of plan participants and beneficiaries. Plan fiduciaries are not only subject to significant penalties if they breach this responsibility, they may also be personally liable for any losses to the plan resulting from the breach.

Another disadvantage is that some employees may not value the tax deferral offered by a qualified plan and may want current compensation instead. This is especially true of younger or lower income workers who may not be in the financial position to accumulate savings. However, there is usually strong enough employee interest for an employer to adopt a qualified retirement plan.

The commitment to make plan contributions can be a disadvantage to the employer. If the plan is a money purchase plan or a defined benefit plan, the employer's contribution is mandatory and must be made even if the employer has no profits for that year. However, some types of defined contribution plans, e.g., profit-sharing plans, do not have this requirement because contributions are discretionary on an annual basis. Simplified employee pensions (SEPs) also offer discretionary 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. George has gone into bankruptcy. How will the $75,000 George contributed to an IRA for his retirement be treated?

   a. The retirement assets will be considered part of the bankruptcy estate and must be liquidated to pay off debts.

   b. Because the retirement assets are not covered by IRC Sec. 401, they will not be protected against bankruptcy.

   c. Up to $50,000 of George's retirement assets will be protected against bankruptcy under current legislation.

   d. All of George's retirement assets plan will be protected against bankruptcy under current legislation.

2. Which of the following is an advantage for an employer that maintains a qualified retirement plan for its employees?

   a. Plan contributions and earnings are not taxed until distributions from the plan are received.

   b. It will help retain existing employees and attract qualified new employees.

   c. Meeting the reporting and filing requirements of the various government agencies is done on the honor system.

   d. Highly compensated employees can contribute as much annually to the plan as they wish.

3. Which of the following disadvantages affects employers that maintain a qualified retirement plan?

   a. Some qualified plans require an employer to make mandatory annual contributions.

   b. Younger and lower income employees are more likely to participate the plan.

   c. Vesting requirements may keep employees from participating in the plan.

   d. The top heavy rules are not available for qualified 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. George has gone into bankruptcy. How will the $75,000 George contributed to an IRA for his retirement be treated? **(Page 4)**

   a. The retirement assets will be considered part of the bankruptcy estate and must be liquidated to pay off debts. [This answer is incorrect. It is possible, under certain conditions, for debtors to exempt retirement funds from the bankruptcy estate.]

   b. Because the retirement assets are not covered by IRC Sec. 401, they will not be protected against bankruptcy. [This answer is incorrect. Debtors can exempt retirement funds from the bankruptcy estate to the extent that the money is exempt from taxation under the following sections of the Internal Revenue Code: 401, 403, 408, 408A, 414, and 457.]

   c. Up to $50,000 of George's retirement assets will be protected against bankruptcy under current legislation. [This answer is incorrect. There is a ceiling on the amount invested in an IRA that an individual debtor can exempt from the bankruptcy estate; however, that ceiling is not $50,000.]

   d. All of George's retirement assets plan will be protected against bankruptcy under current legislation. [This answer is correct. A $1 million dollar cap is placed on the amount invested in an IRA that an individual debtor can claim as exempt property. The cap is adjusted for inflation, determined without regard to certain rollover contributions, and may be increased if it is in the interest of justice. Because George's IRA comes in under that cap, his retirement assets should be safe during the bankruptcy proceedings.]

2. Which of the following is an advantage for an employer that maintains a qualified retirement plan for its employees? **(Page 4)**

   a. Plan contributions and earnings are not taxed until distributions from the plan are received. [This answer is incorrect. This is an advantage of a qualified retirement plan that affects the *employees* and the business owner as individuals, not the employer. The tax advantage for the employer is that contributions the employer makes to the plan are tax deductible.]

   b. It will help retain existing employees and attract qualified new employees. [This answer is correct. A retirement plan will create this advantage for an employer. It can also help encourage loyalty from existing employees by requiring a number of years of service before the employee is entitled to contributions.]

   c. Meeting the reporting and filing requirements of the various government agencies is done on the honor system. [This answer is incorrect. The IRS, Department of Labor (DOL), the Pension Benefit Guaranty Corporation (PBGC), and other government agencies enforce reporting and filing requirements by auditing plans for compliance, which is one of the disadvantages of maintaining a qualified retirement plan.]

   d. Highly compensated employees can contribute as much annually to the plan as they wish. [This answer is incorrect. One of the disadvantages of qualified plans is that benefits paid to highly compensated employees are limited, which ensures that lower-paid employees are not being discriminated against. One requirement limits compensation to $235,000 for 2009 when determining deductible contributions for an individual.]

3. Which of the following disadvantages affects employers that maintain a qualified retirement plan? **(Page 5)**

   a. **Some qualified plans require an employer to make mandatory annual contributions. [This answer is correct. Money purchase plans and defined benefit plans require an employer contribution even if the employer has no profits for that year. However, other qualified plans, such as profit-sharing plans, will not affect the employer in this way.]**

   b. Younger and lower income employees are more likely to participate the plan. [This answer is incorrect. Employees that are not in the financial position to accumulate savings may not see the value of a qualified retirement plan. Employees in this situation may prefer current compensation instead.]

   c. Vesting requirements may keep employees from participating in the plan. [This answer is incorrect. Vesting may actually encourage loyalty among employees because they must stay with the employer for a certain number of years to become fully vested in the employer's contributions to the plan on their behalf.]

   d. The top heavy rules are not available for qualified plans. [This answer is incorrect. If a certain level of benefits or account balances benefit highly compensated employees, the top heavy rules will apply. Then the plan must meet those qualifications to maintain its qualified status.]

EMPLOYER NEEDS AND GOALS

The following three questions are a good place to start in determining the employer needs and goals:

- Is the employer willing to accept a mandatory funding requirement of at least 3% of covered payroll?
- How much will the employer contribute to the plan on a consistent basis?
- Which employees are targeted to benefit the most in the plan?

See the flowchart in Exhibit 1-1 for plans to consider based on the answers to these questions.

Will the Employer Accept Mandatory Funding Requirements?

A "no" answer to this question will eliminate certain types of plans and help narrow the process rather quickly.

If the employer is unwilling to accept a mandatory funding requirement of at least 3%, there is little need to consider a defined benefit plan, SIMPLE IRA, SIMPLE 401(k), or safe harbor 401(k) plan. If the plan is small and expected to be top-heavy, it is not likely that any type of 401(k) plan will work for the employer. However, if a self-employed person is the only participant, a one-person 401(k) plan should be considered if there is a desire to contribute more than 25% of earned income. From a practical standpoint, that leaves a basic profit-sharing plan or SEP as the only plan designs that might work for a small employer not willing to contribute at least 3%.

How Much Does the Employer Wish to Contribute to the Plan?

How much the employer is willing to contribute to the plan on a consistent basis determines in large part the type of plan that will be the best fit. If the employer is willing to make significant contributions and accept a mandatory funding requirement, a defined benefit plan may be considered, as well as most of the other types of plans.

A defined benefit plan or age-weighted or cross-tested profit sharing plan should be considered if the targeted group is older (at least age 50) than the average employee. In most cases, a defined benefit plan would provide the highest deductible limit of all plans. Employee ages are an important factor in designing defined benefit plans, which require the services of an actuary to set up and administer. Cross-tested and age-weighted profit sharing plans also allow a focusing of allocations on older employees, although deductions are limited to 25% of compensation.

Profit-sharing plans and SEPs can be used to maximize contributions while still having the flexibility of discretionary contributions.

Who Is the Targeted Group to Benefit?

Most plans are designed to maximize benefits for the owners or key employees while minimizing contributions to rank-and-file employees. One way to do this is to use an integrated allocation formula. However, unless an employer makes an annual contribution of more than 3%, the formula will not result in any additional contribution for the highly compensated employees.

Other allocation formulas that can help target benefits to owners or key employees are the age-weighted formulas available in the target benefit plans, age-weighted profit-sharing plans, and cross-tested profit-sharing plans. These plans work well where the key group is older than the average employee. The cross-tested profit-sharing plans offer some highly effective shifting of benefits to select groups but are more expensive and complex to design and administer. These plans can be very effective even where the key group is not significantly older than the average employees.

While discrimination rules under IRC Section 401(a)(4) provide safe harbor formulas for both defined benefit and defined contribution plans, more complicated, non-safe harbor benefit formulas allow greater focusing of employer funds.

Exhibit 1-1

Flowchart for Plan Selection[a]

1. Will the employer accept a mandatory funding requirement?

Yes—high level of funding desired

Consistent, high level of employer funds available for plan contributions. Willing to accept mandatory funding requirements.

Consider:

Defined Benefit Plan

412(i) Plan

Target Benefit Plan

Yes—minimum level of funding desired

Employer funds available from 3%–25% of total eligible payroll. Desire minimum mandatory funding.

Consider:

Profit-sharing Plan

Age-weighted Profit-sharing Plan

Cross-tested Profit-sharing Plan

401(k) Plan

Safe Harbor 401(k) Plan[b]

Profit-sharing Plan with Qualified Automatic Contribution Arrangement (QACA) feature

SEP

SIMPLE IRA Plan[c]

No

Employer funds available are less than 3% of eligible payroll. Desire discretionary employer contributions and/or employee deferrals.

Consider:

Profit-sharing Plan

Cross-tested Profit-sharing Plan

Age-weighted Profit-sharing Plan

401(k) Plan

SEP

2. How much does the employer wish to contribute to the plan?

Maximize

Fund to the maximum deductible limit.

Consider:

Defined Benefit Plan

412(i) Plan

$49,000 for each key employee

Fund to level necessary to contribute $49,000 for each key employee.

Consider:

Profit-sharing Plan

Cross-tested Profit-sharing Plan

Age-weighted Profit-sharing Plan

Profit-sharing Plan with a Safe Harbor 401(k) or QACA feature

401(k) Plan with Designated Roth Account (DRA) feature

Profit-sharing Plan with integrated allocation formula (permitted disparity plan)

More than 3%

Funding greater than 3% but probably not enough to contribute $49,000 for each key employee.

Consider:

Cross-tested Profit-sharing Plan

Profit-sharing Plan

Age-weighted Profit-sharing Plan

Profit-sharing Plan with QACA feature

401(k) Plan

SIMPLE IRA Plan

SEP

Less than 3%

Minimum funding of less than 3%.

Consider:

Profit-sharing Plan

Age-weighted Profit-sharing Plan

SEP

3. Who is the targeted group to benefit?

All employees

All employees—no special key group.

Consider:

Any of the common plan types with a prorata allocation formula.

Owners and key employees

The owners and other highly compensated employees with salary greater than $110,000.

Consider:

Age-weighted Profit-sharing Plan

Integrated (permitted disparity) allocation formula with any of the common plan types

Cross-tested Profit-sharing Plan

Permitted Disparity Profit-sharing Plan with Safe Harbor 401(k) or Qualified Contribution Arrangement (QACA) feature

Rank and file employees

Any group with compensation less than $110,000.

Consider:

Profit-sharing Plan with 401(k) feature

SIMPLE IRA Plan

SEP

4. What is the employer's tolerance of administration and set-up costs?

Low

Consider:

SIMPLE IRA

SEP

Medium

Consider:

Profit-sharing Plan

Safe Harbor 401(k) Plan

Profit-sharing Plan with QACA feature

412(i) Plan

High

Consider:

401(k) Plan

Defined Benefit Plan

Age-weighted Profit-sharing Plan

Cross-tested Profit-sharing Plan

Notes:

[a] Select the simplest plan type that will meet the employer's goals the best. It is usually preferable to use profit-sharing plans when possible as they have fewer compliance issues and are the simplest qualified plans to administer. The SEPs and SIMPLE IRA plans are even simpler to administer but they require 100% vesting and do not allow for loan features. Each type of plan has its pluses and minuses. Choose carefully and consider all goals and restrictions.

[b] Will require a 3% funding commitment.

[c] Will require a 3% funding requirement, but only to the extent employees elect to contribute.

* * *

Manage Associated Costs

An employer will incur costs in establishing a qualified retirement plan, and in maintaining the plan. The greatest commitment in terms of cost is the amount the employer contributes to the plan. There are also fees to administer and operate the plan on a day-to-day basis, as well as costs incurred in recordkeeping and in complying with reporting and disclosure requirements. There are also costs for amending the plan document and for terminating the plan. Some plan amendments will be required due to changes in the law and regulations. The employer will want to contain the costs as much as possible, while still providing a meaningful benefit to employees. The plan administrator, as a fiduciary, also has a responsibility to defray reasonable costs of the plan. The costs of a qualified plan are determined by how the plan is designed, how the funds are to be invested, and who is to do the administrative work. The safe harbor designs that eliminate the ADP/ACP testing help reduce the administrative cost for a small plan.

Employers seeking to adopt a qualified plan have many types of documents from which to choose. An individually designed plan allows the most flexibility but can be quite costly to develop and maintain. Furthermore, the determination letter process can be expensive for such plans. A less expensive method is to adopt a master/prototype (M&P) plan or volume submitter (VS) plan.

Fees to Establish the Plan. The plan is established by adopting a legal instrument called a plan document. The plan document defines the terms of the plan and usually establishes the terms of the trust which is a second legal entity; however, some plans have a separate trust instrument. The following fees are associated with establishing the plan:

a. *Plan Document.* There are several alternatives for a plan document that are generally simpler and less expensive to adopt. These alternatives include master, prototype and volume submitter plans. In addition to being less expensive to adopt, these types of plans are pre-approved by the IRS so that in many situations, the cost of obtaining a determination letter is saved. However, these plans tend to have standard options and may not accomplish the employer's goals. If one of these alternatives is not suitable for the employer's objectives, using a customized plan will create a plan specific to the employer's needs.

b. *Legal Counsel.* Legal counsel is needed for establishing any qualified plan. Larger employers or employers with complex employee structures generally find that they need a customized plan. This type of employer can easily recoup the added expense of designing such a plan by being able to tailor contributions under the plan to fit their business.

c. *IRS Filing Fee for Application of a Determination Letter.* A determination letter is a written advance determination issued by the IRS that approves the qualified status of a retirement plan. The IRS imposes a filing fee on Form 8717 based on the type of plan. However, small employers (100 or fewer employees) are exempt from paying the otherwise applicable IRS user fees generally imposed on an application for a determination letter, provided that the application is submitted in the first five years of the plan (or later, if a remedial amendment period applies).

Credit for New Retirement Plan Expenses. A nonrefundable income tax credit is available for the administrative and retirement-education expenses of a small business that adopts a new qualified defined benefit or defined contribution plan (including a 401(k) plan), a SIMPLE plan, or SEP (IRC Sec. 45E). The credit applies to 50% of the first $1,000 of qualified expenses for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000. For an employer to be eligible for the credit, the plan must cover at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who have been with the employer at least three months.

The 50% of qualifying expenses offset by the credit are not deductible; however, the other 50% of such expenses (along with other expenses above the $1,000 limit) remain deductible.

Administration Costs. Administration costs arise from functions that must be performed in operating and maintaining the plan. The administrative cost of having a plan will vary greatly depending on the type of plan and the plan design features.

Administrative functions may be performed internally by an employee or externally by a service provider. Administration costs that are recurring costs may be paid from plan assets, if the plan document expressly authorizes such payment, or paid by the employer. Employers may choose not to reduce plan assets for such expenses and, instead, pay for them directly. It is essential that *only* plan costs are paid from plan assets, and not costs that are the responsibility of the *employer*. For example, plan design costs must be paid by the employer sponsoring the plan.

Plan Redesign or Termination. Consideration should be given to the current design of any plans the employer currently maintains. Before the passage of EGTRRA, money purchase pension plans offered employers an attractive vehicle for maximizing deductible contributions to a defined contribution plan. Combining a money purchase pension plan and a profit-sharing plan offered a method of maximizing contributions while providing some flexibility. EGTRRA increased the contribution limit to profit-sharing plan to 25% of compensation of all participants. As a result, many employers have replaced money purchase plans with profit-sharing plans. The new qualified automatic contribution arrangements (QACAs) and the safe harbor 401(k) plan designs should be considered by small employers to minimize both administrative and fiduciary responsibilities.

Attracting and Retaining Employees

In today's job market, it is often necessary for an employer to be competitive and offer a qualified retirement plan to attract quality new employees. A popular plan is the 401(k) plan, which can provide employees with a way to defer their own dollars, even if the employer does not match the contributions. However, many employers will match employee contributions on some basis to encourage participation in the plan. Matching contributions make the plan more competitive with other employers. Employer contributions may be required if the plan is top-heavy. They also may be necessary to pass special nondiscrimination tests for 401(k) plans. SIMPLE 401(k) plans require a 3% employer matching contribution. Safe harbor 401(k) plans offer effective options for employers with testing problems.

A qualified retirement plan can also serve to retain qualified employees. This is accomplished, for example, by using a vesting schedule that requires a specified number of years of service before the employee's account balance or accrued benefits from employer contributions is nonforfeitable. This encourages employees to stay in service for that period. Weighting the contribution or benefit by years of service may also serve to retain employees.

Considering Leased Employees

One of the influencing factors of plan design is employee structure and whether the employer wants to exclude certain employees (e.g., leased employees) from participating. Standardized prototypes must cover leased employees and employees who are incorrectly classified as independent contractors. Leased employees (not considered common law employees) may be excluded as a class from participating in a recipient employer's (the employer for whom the employment services are rendered) retirement plan if the recipient employer's plan meets the minimum coverage requirements.

Generally, leased employees are those performing services for the employer pursuant to an agreement between the employer and a leasing organization where the services are under the primary direction or control of the recipient employer and the employees have performed those services for the employer on a substantially full time basis for a period of at least one year. The leased employee rules do not apply in situations where the individuals are in fact employees of the recipient employer. (See IRS Notice 84-11 for the definition of *substantially full-time basis*.) Factors to be considered in determining if the leased employee is under the primary direction or control of the recipient employer include:

a. Does the recipient employer directly supervise the actions of the leased employee?

b. Does the leased employee have to perform services in accordance with the directions of the recipient employer?

Safe Harbor. A safe harbor is available if the leasing organization covers the leased employees under a money purchase pension plan and certain requirements are met. When these safe harbor rules are met, the leased employee is not considered to be an employee of the recipient employer for purposes of participating in the retirement plan.

Considering Independent Contractors

Independent contractors have been targets of much attention in the retirement plan area. When designing a plan, the document should be very specific about the employees that it covers. If individuals treated as independent contractors are later reclassified by the IRS as employees, it could mean that such employees are retroactively eligible to participate in the plan [unless the plan excludes such employees by employment classification (e.g., salesmen) and is able to pass the qualification tests excluding such employees]. Those eligible to participate would be included in the qualification tests, e.g., the nondiscrimination tests and the minimum coverage and minimum participation tests.

What is the Deadline for Adopting a Plan?

Qualified retirement plans (e.g., profit-sharing plans) must be adopted before the employer's year-end for contributions made after year-end to be deductible. SEPs may be adopted after year-end and the post-year-end contributions are still deductible. A safe harbor 401(k) plan must have a first plan year that is at least three months long.

Choosing Advisors

As part of the 'corporate governance' concerns following Enron, the Department of Labor has been emphasizing its position that an employer, in choosing fiduciaries and vendors, is acting as a fiduciary. Accordingly, trustees, the official plan administrator, third party administrators and investment options all should be selected and monitored prudently.

SELF-STUDY QUIZ

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

4. Virtual Profits, a web design company, has decided to establish a qualified retirement plan. The owners would like to target benefits toward owners and highly compensated employees instead of the rank and file employees. Because the company is new, the age of the target group ranges from 25 to 35. Virtual Profits plans to contribute $45,000 for each key employee, but would prefer the flexibility of discretionary contributions. Administrative and set-up costs are not a problem, though Virtual Profits would prefer to minimize them if possible. Which of the following plans would best suit the company's needs?

   a. An age-weighted profit-sharing plan.

   b. A 412(i) plan.

   c. A profit-sharing plan using an integrated allocation formula.

   d. A SIMPLE IRA plan.

5. Kinch Kitchens wants to establish a qualified retirement plan that will allow the company to fund up to the maximum deductible limit. Which of the following plans should the company choose?

   a. Simplified employee pension plan (SEP).

   b. 401(k) plan.

   c. Profit-sharing plan.

   d. Defined benefit plan.

6. In which of the following scenarios would it be appropriate for a company to establish a safe harbor 401(k) plan?

   a. Kalecorp needs a plan that will help retain qualified employees.

   b. Dale LLC's plan has testing problems.

   c. Hale Inc. cannot afford contributions but wants to provide employees a way to defer savings.

7. Baker's Dozen is a small employer (25 employees) with a calendar year end. In 2009, the company decides to establish a profit-sharing plan. The company makes its first contribution to the plan in January 2010. Estimate the date that Baker's Dozen must have adopted the plan for that contribution to be deductible in the 2009 tax year.

   a. October 2009.

   b. January 2010.

   c. It depends on whether the company establishes a master or prototype plan or a customized plan.

   d. It depends on when the IRS issues the plan's determination letter.

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.)**

4. Virtual Profits, a web design company, has decided to establish a qualified retirement plan. The owners would like to target benefits toward owners and highly compensated employees instead of the rank and file employees. Because the company is new, the age of the target group ranges from 25 to 35. Virtual Profits plans to contribute $46,000 for each key employee, but would prefer the flexibility of discretionary contributions. Administrative and set-up costs are not a problem, though Virtual Profits would prefer to minimize them if possible. Which of the following plans would best suit the company's needs? **(Page 10)**

   a. An age-weighted profit-sharing plan. [This answer is incorrect. Age-weighted and cross-tested plans would be of more benefit to a company with an older target group, age 50 and up. The owners and highly compensated employees of Virtual Profits are too young to maximize benefits with this type of plan. Also, age-weighted plans have the highest level of administrative and set-up costs which, while not prohibitive to Virtual Profits, is not desirable.]

   b. A 412(i) plan. [This answer is incorrect. A 412(i) plan is more beneficial to a company that wants to contribute the maximum amount of funds possible. Since Virtual Profits will limit its funding to $46,000, a 412(i) plan would not be the best choice for its qualified plan.]

   c. A profit-sharing plan using an integrated allocation formula. [This answer is correct. A profit-sharing plan can help a company maximize contributions, but the company can also structure the plan so that it has the flexibility of discretionary contributions. If the plan uses an integrated allocation formula, it will help skew benefits toward Virtual Profits' target group, and the highly compensated employees will get additional benefits because Virtual Profits plans to contribute more than 3%. Profit-sharing plans have a medium amount of set-up and administration costs, so Virtual Profits will be able to save a little in that regard if it chooses this type of plan.]

   d. A SIMPLE IRA plan. [This answer is incorrect. A SIMPLE IRA would be a good choice for a company that wants to contribute more than 3% but less than $49,000, which is less than Virtual Profits wants to contribute. A SIMPLE IRA plan would also be a good choice for a company that has a low tolerance for set-up and administration costs—something that is not a big concern for Virtual Profits.]

5. Kinch Kitchens wants to establish a qualified retirement plan that will allow the company to fund up to the maximum deductible limit. Which of the following plans should the company choose? **(Page 11)**

   a. Simplified employee pension plan (SEP). [This answer is incorrect. A SEP would be appropriate for an employer that can contribute less that 3%. It would also be appropriate for an employer that can contribute more than 3% but not $49,000 for each key employee. A SEP would be used by an employer with less of a commitment to funding than that held by Kinch Kitchens.]

   b. 401(k) plan. [This answer is incorrect. A 401(k) plan would be appropriate for an employer that cannot contribute $46,000 for each key employee, but that can afford to contribute more than 3%. A profit-sharing plan with a 401(k) feature would be appropriate if the employer can contribute $49,000 for each key employee. Based on the scenario above, Kinch Kitchens would be better off using a plan that allows a higher degree of funding.]

   c. Profit-sharing plan. [This answer is incorrect. If the employer can fund to a level necessary to contribute $49,000 for each key employee, it might consider a profit-sharing plan, a cross-tested profit-sharing plan, an age-weighted profit-sharing plan, a profit-sharing plan with a 401(k) feature, or a profit-sharing plan with an integrated allocation formula (also known as a permitted disparity plan). This is a significant level of funding, but if Kinch Kitchens is serious about maximizing funding, there are other plans that will allow for even more funding from the employer.]

   d. Defined benefit plan. [This answer is correct. Since Kinch Kitchens wants to maximize funding to the retirement plan, a defined benefit plan would help the company in that goal. Another choice Kinch Kitchens should consider is a 412(i) plan.]

6. In which of the following scenarios would it be appropriate for a company to establish a safe harbor 401(k) plan? **(Page 13)**

   a. Kalecorp needs a plan that will help retain qualified employees. [This answer is incorrect. A qualified retirement plan with a vesting schedule that requires a specified number of years of service could help Kalecorp in this scenario, not a safe harbor 401(k) plan.]

   b. Dale LLC's plan has testing problems. [This answer is correct. A safe harbor 401(k)plan offers options for employers with testing problems, so this plan would be effective in Dale LLC's situation.]

   c. Hale Inc. cannot afford contributions but wants to provide employees a way to defer savings. [This answer is incorrect. This is one reason that regular 401(k) plans are popular. By establishing a 401(k) plan, Hale Inc. can meet its goal in this scenario.]

7. Baker's Dozen is a small employer (25 employees) with a calendar year end. In 2009, the company decides to establish a profit-sharing plan. The company makes its first contribution to the plan in January 2010. Estimate the date that Baker's Dozen must have adopted the plan for that contribution to be deductible in the 2009 tax year. **(Page 15)**

   a. October 2009. [This answer is correct. A qualified retirement plan, such as the profit-sharing plan established by Baker's Dozen, must be adopted before the employer's year end or contributions made after year end will not be deductible.]

   b. January 2010. [This answer is incorrect. If Baker's Dozen had established a SEP instead of a profit-sharing plan, the SEP could have been adopted after the fiscal year end and the post-year-end contribution would still have been deductible in the 2009 tax year.]

   c. It depends on whether the company establishes a master or prototype plan or a customized plan. [This answer is incorrect. Whether the plan document is a master or prototype or a customized plan does not have any bearing on whether a post-year-end contribution is deductible. It is possible, though, that a standardized plan will not meet the company's goals; in that case, a customized plan would be preferable. However, a standardized plan would be simpler and less expensive for Baker's Dozen to adopt.]

   d. It depends on when the IRS issues the plan's determination letter. [This answer is incorrect. The IRS's determination letter does not affect when contributions are deductible. Because of its size, Baker's Dozen will be exempt from paying the IRS filing fee for the determination letter if it applies during the first five years of its plan.]

CONSIDERATIONS OF DEFINED CONTRIBUTION PLANS

Each participant has an individual account under a defined contribution plan. Contributions to the plan are either defined by the terms of the plan (e.g., by formula under a typical money purchase pension plan) or discretionary on the part of the employer (e.g., the typical profit-sharing plan). There are profit-sharing plans, however, with contributions that are formula-driven (e.g., a profit-sharing plan with a contribution formula geared to a percentage of current profits). Unlike a defined benefit plan, the contribution for a defined contribution plan is *not* based on the amount that needs to be funded to provide a set benefit for the employee.

In a defined contribution plan, contributions must be allocated to participants by the formula specified in the plan. The formula in a typical defined contribution plan is *not* usually actuarially driven. Target benefit, age-weighted profit-sharing, and cross-tested profit-sharing plans are exceptions in that their allocation formulas involve actuarial requirements.

The most common formula used in a defined contribution plan calls for a percentage of compensation to be allocated to each participant's account (with or without permitted disparity). However, it may also be based on other factors such as age or years of service.

Contributions (including any employee contributions allowed under the plan) are invested and each participant's account is allocated with the investment earnings or losses. This is different from a defined benefit plan, where the employer's contribution is actuarially adjusted for investment earnings or losses. If investments perform well, the employer contributes less; if there are investment losses, the employer contributes more. In a defined benefit plan, the employee's benefit remains the same regardless of investment performance of plan assets. The plan document of a defined contribution plan may allow for self-directed investments, or plan assets may be invested on a pooled basis by the trustee. Thus, an employee's account balance consists of contributions, investment earnings or losses, and forfeitures allocated to the account.

When the employee retires, or distribution is triggered by another qualifying event, the employee is entitled to the nonforfeitable, or *vested* portion of his (or her) account balance. If an employee receives a distribution prior to being fully vested, a defined contribution plan allows the forfeited portion of the account balance to be reallocated among remaining participants, used to reduce employer contributions, or used to pay plan expenses. The plan document dictates the treatment of forfeitures.

Examples of defined contribution plans include profit-sharing plans, money purchase pension plans, target benefit plans, and employee stock ownership plans. These plans are discussed in more detail in this lesson.

Plan Design Options

Although plans must satisfy all the nondiscrimination rules, there are many options to tailor the benefits available to a particular group while providing nondiscriminatory benefits for all employees. Plan design will significantly affect the cost of maintaining a plan and the maximum amount that a participant can receive in benefits. For small business owners who are age 50 or older, allowing catch-up contributions will help maximize their retirement benefits without significantly increasing the cost of maintaining the plan. Using a safe-harbor 401(k) plan or a profit-sharing plan with a qualified automatic contribution arrangement (QACA) feature will provide a small business owner the opportunity to make maximum deferrals even though the rank and file employees may or may not chose to defer to the plan. The increased contribution and deduction limits for plans have significantly changed the importance of plan design. Which plan design a client should use depends on the company's goals and the demographics of the population of the employees. Plan design should be reviewed periodically to determine if there is a more cost efficient design that will make available higher benefits at a lower cost to the company or if the company's goals and resources have changed. Deduction and contribution limits are key elements in designing a plan.

Profit-sharing Plans

Generally, these plans allow employers to make discretionary contributions. The contributions may be keyed to the company's profits, although current or accumulated profits are not required for the company to make a contribution. However, the plan document governs. That is, if the plan document states that contributions are dependent on profits, that is the rule for that particular plan. A contribution formula based on profits may be used by employers to encourage productivity. These plans must define *profits* to be used for contributions. Employers wanting flexibility in making contributions will also find a profit-sharing plan to be appealing. A profit-sharing plan that allows discretionary contributions enables an employer to decide on a year-to-year basis whether or not to contribute to the plan and, if so, what amount.

In general, an employer may deduct contributions up to 25% of eligible participants' compensation to a profit-sharing plan.

Example 1-1: Discretionary contribution to a profit-sharing plan.

Ocean Waves, Inc. maintains a profit-sharing plan that allows for discretionary contributions (irrespective of profits) as either a dollar amount or a percentage of eligible participants' compensation. For the current plan year, Ocean Waves, Inc. decides to contribute $25,000 to the profit-sharing plan. The total eligible participants' compensation for the year was $300,000.

Is the contribution an allowable discretionary contribution under the plan? Yes, the $25,000 contribution is allowed under the plan because it is a discretionary contribution of a dollar amount and is within the allowable deductible limit ($300,000 × 25% = $75,000).

The next plan year, Ocean Waves, Inc. decides to contribute 8% of eligible participants' compensation.

Is the contribution an allowable discretionary contribution under the plan? Yes, the 8% contribution is allowed under the plan because it is a discretionary contribution that is a percentage of eligible participants' compensation.

Example 1-2: Using a profit-sharing plan.

John Nagel, D.D.S., Inc., maintains a profit-sharing plan allowing contributions to be made on a discretionary basis. The plan states that contributions are allocated to participants based on each participant's compensation in relation to total participant compensation. For 2009, the corporation authorizes a contribution equal to 20% of compensation in order to maximize contributions for the owner, John Nagel. The following table shows the allocation of the contribution to the profit-sharing plan for 2009.

Participant	Compensation	20% Contribution
John Nagel	$ 245,000	$ 49,000
Betsy Davis	40,000	8,000
Jane Davis	25,000	5,000
Alisia Barker	28,000	5,600
Totals	$ 338,000	$ 67,600

Another advantage of a profit-sharing plan is that it may allow for in-service distributions, i.e., distributions occurring other than upon retirement, disability, death, or termination of service. Some of the distributable events allowed are the passage of a fixed number of years, reaching a certain age, or financial hardship. A profit-sharing plan must hold contributions in trust for at least two years before making a distribution based on a fixed number of years.

Benefits from the plan may be distributed in any manner allowed by the plan document. The most common forms are lump sum distributions and installment payments.

Money Purchase Pension Plans

Money purchase pension plans (also commonly referred to as money purchase plans) operate similarly to profit-sharing plans. However, the plan must contain a set formula under which contributions are made. Once adopted, contributions determined by the formula must be made annually. These plans were advantageous prior to 2002 because the maximum amount that could be deducted by an employer for contributions to defined contribution plans other than money purchase plans was limited to 15% of total participants' compensation (in contrast to 25% for money purchase plans). After 2001, the need for money purchase plans was virtually eliminated as the maximum deductible contribution percentages for SEPs and profit-sharing plans were increased to 25% by EGTRRA. SEPs and profit-sharing plans both have the advantage of discretionary contributions, where the decision of making a contribution ranging anywhere from 0–25% can be determined annually (unlike a money purchase plan that has a fixed contribution obligation).

Many employers with a money purchase plan may find it of benefit to either terminate the plan and adopt a profit-sharing plan, or to merge the money purchase plan into a profit-sharing plan.

Cash or Deferred Arrangement (CODA)

A 401(k) plan is a profit-sharing or stock bonus plan with an elective deferral feature which allows employees to elect to receive cash (as salary) or defer it (on a pretax basis) to the plan. These plans are referred to as CODAs (cash or deferred arrangements). There are other types of plans that are subject to the CODA: rules 403(b) plans, 457 eligible governmental plans, SARSEP, safe harbor 401(k) plans, and profit-sharing plans with a Qualified Automatic Contribution Arrangement (QACA) feature.

Certain favorable provisions for CODAs make 401(k) plans popular. The favorable provisions include the following:

a. The annual additions limit applying at the participant level has increased to the lesser of $49,000 (for 2009) or 100% of the employee's covered compensation.

b. The employer's deduction limit for contributions to profit-sharing plans is now 25% of the aggregate compensation of eligible participants.

c. An employee's elective deferrals are no longer treated as part of the employer's contributions for the purposes of determining the employer's deduction limit, discussed in item b.

d. Employees age 50 or older at the end of the calendar year can make additional catch-up contributions of up to $5,500 in 2009 if (1) the plan allows such contributions and (2) all of the employer's plans make catch-up contributions available to all catch-up eligible participants who participate in any applicable plan maintained by the employer, other than collectively bargained employees. These contributions are in addition to the annual addition limit and are not affected by the ADP requirements.

e. Designated Roth Accounts (DRAs) may be offered in CODAs. DRAs, if distributed in a qualified distribution, are not taxed, so that the entire gain on designated Roth contributions is tax-free. Unlike Roth IRAs, there are no income limits for making contributions to DRAs. These accounts may be of value to high income individuals that can not otherwise make Roth IRA contributions.

Although CODAs require increased administration and testing, the additional expense is often justified by the advantages such plans offer. Fortunately, there are safe harbor provisions available that eliminate many of the testing requirements, making CODAs simpler to maintain.

Generally, 401(k) plans are the most popular retirement plans that offer employees a way to contribute on a pretax basis. SIMPLE IRAs also allow pre-tax contributions. These amounts accumulate in the plan, along with investment gains or losses, and are taxed when distributed from the plan. The investment gains or losses also are not subject to current taxation. Presumably, if distributions begin at retirement age, the participant will be in a lower tax bracket.

All plans, including 401(k) plans, may allow employees to make after-tax contributions, and these plans may also provide for matching employer contributions in order to encourage employees to save for their retirement. Such plans are referred to as 401(m) plans.

Because the 401(k) plan is part of a profit-sharing plan, employers still have the advantage of flexibility in making discretionary contributions. Employers that cannot afford to make discretionary contributions will still find a 401(k) plan an attractive option to offer employees that wish to contribute on their own. However, elective deferrals must meet certain tests to ensure they benefit rank-and-file employees as well as highly compensated employees. This may present a problem as the lower paid employees often elect to receive cash in lieu of deferring salary. To encourage their participation, employers can offer to "match" salary deferrals under a formula stated in the plan. The employer can also set a cap on the maximum amount they will match. For example, the employer may match 50 cents of each dollar, up to a maximum of 6% of compensation (resulting in a maximum match amount of 3% of compensation). Matching contributions may also be discretionary (i.e., decided at year-end), but must be made according to the terms of the plan document. The matching contribution feature is referred to as a 401(m) plan.

Employees must elect to defer only future compensation. In other words, only compensation that has not yet been earned or that the employee does not have the right to receive is eligible for salary deferrals.

A cash or deferred election may only be made with regard to an amount that is not 'currently available' to the employee on the date of the election, meaning that the amount may not have already been paid to the employee and the employee may not be able to currently receive the cash at the employee's discretion.

Suspending Matching Contributions. An employer that is considering suspending matching contributions will need to consider any restrictions or other consequences of suspending or reducing contributions.

Plans that have a safe harbor design are subject to specific rules and may be restricted on suspending or reducing contributions. Other qualified plans also have requirements which may require the plan document to be amended and the anti-cutback rules to be considered as a result.

Prior employee notifications should be reviewed to make sure that they cannot be interpreted to read that the employer was committing to ongoing contributions. Unions and other collectively bargained organizations may prohibit changes to benefits and contributions. In most circumstances, contributions and benefits cannot be suspended or reduced retroactively.

Participants will need to be provided with notice of the change in contributions. Safe harbor plans have specific notice requirements. In addition, the summary plan description or summary of material modifications will need to be revised. Any other regularly distributed communications, whether written or online, will need to be reviewed for possible updating (e.g., auto enrollment materials).

The effect on calculating contributions will also have to be taken into account. The statutory limit on plan compensation may need to be prorated.

Nondiscrimination requirements also need to be considered by changes in contributions or benefits as well as anticipate the employee's reaction if economic downturn is involved. Employees may opt to discontinue or reduce their employee deferrals and contributions, also. This may cause an issue with the ADP/ACP nondiscrimination testing for 401(k) and 401(m) arrangements.

401(k) Plan Requirements. To qualify as a CODA, the plan must satisfy all the requirements of IRC Sec. 401(k). These include the following:

a. Limits on in-service distributions. These limits restrict an employee from receiving a distribution of elective deferrals because of completing a stated number of years of service or the passing of a fixed number of years. Hardship distributions are allowed under certain circumstances.

b. Salary deferral contributions must be 100% vested.

c. Not more than one year of service can be required to participate in a salary deferral feature. For other contributions (i.e., employer matching or nonelective contributions), the participation requirement may be extended to two years if these contributions are 100% vested.

d. Benefits (other than matching contributions) must not be contingent on the employee's election to make salary deferrals.

e. Employees eligible to participate in the salary deferral feature (regardless of whether they elect to contribute) must satisfy the coverage tests. Under the coverage tests, the plan must meet either the ratio percentage test or the average benefit test.

f. Limitations on the maximum salary deferrals. The limit for 2009 is $16,500. However, a 401(k) plan may allow individuals who have attained at least age 50 by year-end to make catch-up contributions. Catch-up contributions are not taken into account in computing the otherwise applicable dollar limit on elective deferrals ($16,500 for 2009). In addition, catch-up contributions are not subject to any other contribution limits or otherwise applicable nondiscrimination rules. However, they must be available to all age 50 or older participants in all applicable employer plans, including those of a controlled group, on an equal basis. For purposes of this universal availability rule: an *applicable employer plan* means a Section 401(k) plan, a profit-sharing plan with a qualified automatic contribution arrangement feature, a SIMPLE IRA plan, a SEP, a 403(b), or a Section 457 eligible governmental plan. 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 that applies to 401(k) plans for 2009 is $5,500.

In addition, salary deferral contributions must satisfy one of two nondiscrimination tests that apply only to 401(k) plans. Each of these tests relates the average rate of salary deferrals made by highly compensated employees to the comparable average rate for nonhighly compensated employees. The salary deferral rate is the ratio of the salary deferral contributed by the employee to that employee's compensation. This ratio is known as the *actual deferral percentage* (ADP).

401(m) Plans. Plans that include employee after-tax contributions and plans that provide for employer matching contributions [referred to as 401(m) plans] are subject to tests on such contributions that are mathematically identical to the ADP tests that apply to salary deferrals. These tests, described in IRC Sec. 401(m), are referred to as *actual contribution percentage* (ACP) tests.

Example 1-3: Using a 401(k) plan.

John Nagel, D.D.S., Inc., maintains a profit-sharing plan with a 401(k) feature that allows employer contributions to be made on a discretionary basis. The plan also allows catch-up contributions. The employer does not match any elective contributions made by employees to the 401(k) plan. Contributions to the profit-sharing plan are based on the participant's compensation in relation to total qualified compensation. The employee's elective deferrals are shown in the following table. For 2008, the corporation wishes to maximize contributions for the owner, John Nagel. The following table also shows the allocation of the contribution to the profit-sharing plan in the plan's current year.

Participant	Age	Compensation	13.261% Employer Contribution	Employee 401(k) Deferral	Catch-up Contribution	Total Annual Addition (Allocation)
John Nagel	54	$ 245,000	$ 32,500	$ 16,500	$ 5,000	$ 54,500
Betsy Smith	35	40,000	5,306	4,000	—	9,306
Jane Davis	25	25,000	3,316	1,000	—	4,316
Alisia Barker	27	28,000	3,714	1,200	—	4,914
Totals		$ 323,000	$ 44,836	$ 22,700	$ 5,500	$ 73,036

Safe Harbor Rules Provide Alternative to Nondiscrimination Testing. An employer may use a safe harbor rule as an alternate method of meeting the nondiscrimination requirements for a 401(k) plan.

For plan years beginning after 2007, an additional safe harbor rule is available as an alternate method of meeting the nondiscrimination requirements for 401(k) plans. The safe harbor is provided for qualified automatic contribution arrangements as provided in the Pension Protection Act of 2006.

Safe Harbor 401(k). Basically, there are notice requirements and provisions for either making a 3% employer contribution for all eligible employees or a 100% fully vested match up to 4% of pay. The 3% contribution not only satisfies the nondiscrimination tests for the deferrals but also provides for a safe harbor match. For small employers, the 3% contribution can provide substantial benefits. The safe harbor contributions must be 100% vested and must be made for all eligible employees including those who terminate employment during the year. This means there can be no requirement of earning 1,000 hours and/or employment on the last day of the plan year for these contributions. Essentially, the employer is trading some flexibility in vesting for some relief from the ADP testing requirements.

Matching or nonelective contributions under a safe harbor 401(k) plan may be taken into account in satisfying the top-heavy minimum contribution. Certain 401(k) plans are excluded from the top-heavy rules. The exclusion applies if a 401(k) plan consists solely of matching or nonelective contributions under the 401(k) safe harbor requirements and matching contributions under the 401(m) safe harbor requirements.

Example 1-4: Safe harbor 401(k) plan.

Dr. John Nagel, D.D.S., P.C., is evaluating maintaining a 401(k) plan for employees. For evaluation purposes, assume a safe harbor notice would be timely provided to the employees informing them that the corporation would make a 3% nonelective contribution for each eligible nonhighly compensated employee as an alternative to nondiscrimination testing. By using the 3% safe harbor contribution, Dr. Nagel can defer $22,000. In comparison, without the safe harbor, the average deferrals for the employees is estimated to be 2% of compensation, which would limit Dr. Nagel's deferrals to 4% and would limit his deferrals to $15,300 ($9,800 + $5,500 of catch-up contributions).

Participant	Age	Compensation	3% Employer Contribution	Employee 401(k) Deferrals	Catch-up Contributions	Total Annual Additions (Allocations)
John Nagel	54	$ 245,000	$ 7,350	$ 16,500	$ 5,500	$ 29,350
Betsy Smith	35	40,000	1,200	800	—	2,000
Jane Davis	25	25,000	750	500	—	1,250
Alisia Barker	27	28,000	840	560	—	1,400
Totals		$ 338,000	$ 10,140	$ 18,360	$ 5,500	$ 34,000

Example 1-5: Basic match with a 3% nonelective contribution.

Assume the same facts as in previous example, except that Dr. Nagel elects to add a basic match and will match 100% of the employee elective contributions up to 3% of compensation and 50% of the next 2% of elective contributions.

Participant	Age	Compensation	Employee 401(k) Deferral	3% Employer Contribution	Matching Contribution	Catch-up Contributions	Total Annual Additions (Allocations)
John Nagel	54	$ 245,000	$ 16,500	$ 7,350	$ 9,800	$ 5,500	$ 39,150
Betsy Smith	35	40,000	800	1,200	800	—	2,800
Jane Davis	25	25,000	500	750	500	—	1,750
Alisia Barker	27	28,000	560	840	560	—	1,960
Totals		$ 338,000	$ 18,360	$ 10,140	$ 11,660	$ 5,500	$ 45,660

Example 1-6: Enhanced matching formula.

Assume the same facts as in Example 1-4, except that Dr. Nagel elects to use an enhanced matching formula and will match 100% of the employee elective contribution up to 6% of compensation.

Participant	Compensation	Employee 401(k) Deferral	3% Employer Contribution	Match	Catch-up Contributions	Total Annual Addition
John Nagel	$ 245,000	$ 16,500	$ 7,350	$ 14,700	$ 5,500	$ 44,050
Betsy Smith	40,000	800	1,200	800	—	2,800
Jane Davis	25,000	500	750	500	—	1,750
Alisia Barker	28,000	560	840	560	—	1,960
Totals	$ 338,000	$ 18,360	$ 10,140	$ 16,560	$ 5,500	$ 50,560

Example 1-7: Basic match with a 3% nonelective contribution, enhanced match, and a discretionary employer contribution.

Assume the same facts as in Example 1-6, except that for evaluation purposes, Dr. Nagel elects to add an employer discretionary contribution sufficient to maximize his personal benefit to the existing enhanced formula that matches 100% of the employee elective contributions up to 6% of compensation.

Participant	Compensation	Employee 401(k) Deferral	4.265 Employer's Discretionary Contribution	3% Employer Contribution	Match	Catch-up Contributions	Total Annual Additions (Allocations)
John Nagel	$ 245,000	$ 16,500	$ 10,450	$ 7,350	$ 14,700	$ 5,500	$ 54,500
Betsy Smith	40,000	800	1,706	1,200	800	—	4,506
Jane Davis	25,000	500	1,066	750	500	—	2,816
Alisia Barker	28,000	560	1,194	840	560	—	3,154
Totals	$ 338,000	$ 18,360	$ 14,416	$ 10,140	$ 16,560	$ 5,500	$ 64,976

Example 1-8: Safe Harbor 401(k) plan with an age-weighted allocation formula.

Assume the same facts as in Example 1-8, except that for evaluation purposes, Dr. Nagel elects to use a discretionary profit-sharing plan contribution to be allocated using an age-weighted formula.

Participant	Compensation	Present Value Factor	Present Value Factor × Compensation	Age-weighted Allocation	Employee Deferrals	Total Annual Additions
John Nagel	$ 245,000	$ 3.24005	$ 793,812	$ 33,000	$ 21,500	$ 54,500
Betsy Smith	40,000	0.68769	27,508	1,200 [a]	4,000	5,200
Jane Davis	25,000	0.30418	7,605	750 [a]	1,000	1,750
Alisia Barker	28,000	0.35807	10,026	840 [a]	1,200	2,040
Totals	$ 338,000		$ 838,951	$ 35,790	$ 27,700	$ 63,490

Note:

[a] Increased to top-heavy minimum (3% of compensation).

The safe harbor provisions make 401(k) plans a viable choice for small employers. Example 1-20 illustrates the use of a safe harbor 401(k)/profit-sharing plan. Example 1-21 illustrates using cross-testing with a safe harbor 401(k) plan.

Safe Harbor for Automatic Contribution Arrangements. Effective for plan years after 2007, employers can set up qualified automatic contribution arrangements (QACAs) and utilize the special safe harbor provided to satisfy the top-heavy rules and the nondiscrimination rules. Although automatic contribution arrangements have been used for several years in some states, their status was often questioned and they were not afforded any special top-heavy or nondiscrimination safe harbors. Such arrangements will be considered *qualified automatic contribution arrangements* if they:

a. meet certain notice requirements,

b. treat each employee eligible to participate in the arrangement as having elected to have the employer make elective contributions in an amount equal to a qualified percentage of compensation,

c. allow employees to affirmatively elect out of the arrangement,

d. provide either a *safe harbor match* or a *safe harbor 3% employer contribution*, and

e. vest the safe harbor contributions when an employee completes at least two years of service.

401(k) Plans for Partnerships, LLCs, and Other Self-employed Individuals. Self-employed individuals [i.e., sole proprietors, members (subject to self-employment tax) of a limited liability company (LLC), and partners of a partnership] are considered employees for plan purposes. Such individuals are eligible to participate in most qualified plans, including 401(k) plans. The following rules apply to self-employed individuals in qualified plans:

a. Compensation is defined by special rules.

b. Employee deferrals (both pretax and post-tax to Designated Roth Accounts) are treated as elective contributions and are subject to the Section 402(g) elective deferral limit.

c. Matching contributions and employer contributions for self-employed individuals are the same as for any other participant and are subject to the annual addition limit and the employer deduction limit.

d. Catch-up contributions are the same as for any other participant and are subject only to the catch-up contribution limits.

e. A self-employed person must deposit elective deferrals using the same deposit rules that apply to employee deferrals for 401(k) plans, even though the employer contributions need not be made until the due date (including extensions) of the self-employed person's related income tax return.

Self-employed individuals must make their 401(k) elections before the last day of the taxable year (i.e., the date a partner's compensation is deemed available) or earlier if required by the plan document.

One-person 401(k) Plans. Benefits available in a one-person 401(k) plan have increased, allowing for greater contributions to be made to one-person 401(k) plans (see Example 1-9). Employer contributions, elective deferrals, and catch-up contributions may be made to a one-person 401(k) plan.

A large amount can be contributed to a one-person 401(k) plan while the participant maintains flexibility in making contributions in future years. In comparison to the additional funding a one-person 401(k) plan allows, the cost of preparing the annual return (Form 5500) is nominal. Also, because these plans cover only highly compensated employees (HCEs) (i.e., the owner), they are not subject to the ACP and ADP tests and, thus, are much easier (and cheaper) to maintain than other 401(k) plans.

<u>Elective Deferrals.</u> First, the owner can contribute up to 100% of his or her compensation up to a limit of $16,500 for 2009. This contribution is treated as an elective deferral contribution made by the owner. Such elective deferral contributions are excluded from the owner's taxable income, which equates to a deduction. For owners age 50 or over by year-end, an additional $5,500 (for 2009) "catch-up" contribution is allowed. Elective deferrals are limited on an individual basis for each calendar year. The limit applies to all CODAs in which an individual participates. These deferrals are not counted towards the 25% deduction limit discussed below. However, the annual additions limit must be complied with. Because elective deferrals are subject to FICA, the profit sharing contribution (which is not subject to FICA at any time) should be maximized to the extent practicable prior to calculating the amount of elective deferrals that will be made.

Deducting Employer Contribution. One-person 401(k) plans also permit a second contribution of up to 25% of compensation. This contribution is treated as a profit-sharing plan (or employer contribution). In calculating the allowable employer contribution, the owner's elective deferrals are not counted towards the 25% deduction limit.

Catch-up Contributions. Catch-up contributions to 401(k) plans of up to $5,500 can be made in 2009 by participants who have attained at least age 50 by the calendar year-end. Catch-up contributions are not included in the annual additions limit.

Effect of the Annual Additions Limit. The combined elective deferral and employer contributions must comply with the annual additions limit. For 2009, the annual additions limit cannot exceed the lesser of 100% of the participant's compensation or $49,000. Catch-up contributions are not included in the annual additions limit. These limits can be confusing. The deduction limit for the employer can be reduced because of the individual's annual addition limit, which is applied at the individual level. Thus, 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 limit. If the employee receives benefits from unrelated employers, there is a separate annual addition limit for each unrelated employer.

A 401(k) plan allows a large amount to be contributed, while maintaining flexibility in making contributions in future years. In comparison to the additional funding a one-person 401(k) plan allows, the cost of preparation for the annual return (Form 5500 required) is nominal.

One-person 401(k) Plans for Self-employed Individuals. Although up to 25% can be deducted for profit-sharing plan contributions, a self-employed individual's earned income is determined after the deduction for half of the SE tax and reduction for the self-employed individual's deductible plan contribution. In effect, the maximum 25% is limited to 20% for self-employed individuals.

Example 1-9: Maximizing contributions for a one-person company.

Randy, age 50 (by the end of 2009), is the sole owner and employee of Flight-in-Training, a sole proprietorship. Flight-in-Training is also the sole source of Randy's earned income. Randy earns $162,500 (net of the 1/2 SE tax) in 2009 and wishes to maximize contributions to a retirement account.

Randy believes that the business will probably continue to be profitable, but he would like the flexibility of determining on a year-to-year basis how much to contribute. Randy does not expect to hire employees and will remain a one-person company.

The following table reflects the maximum amount that can be contributed to a 401(k) plan for Randy for 2009.

25% (20% for self-employed individuals) profit-sharing contribution ($162,500 × 20%)	$ 32,500
Elective 401(k) deferrals	16,500
Contributions subject to annual addition limit ($49,000 for 2009)	49,000
Catch-up contributions	5,500
Total contributions	$ 54,500

Rollovers. Single participant 401(k) plans offer several retirement planning opportunities for someone wishing to consolidate or roll over funds from a previous employer's plan. Clients who are leaving a corporate job to start their own business may benefit greatly from being able to better control and invest the funds in their own 401(k) plan. With the increased contribution and deduction limits these plans can be very attractive. The ability to borrow from the plan at a reasonable rate can also be very beneficial when needed.

Roth 401(k) Accounts

Sponsors of 401(k) plans have the option to include Roth 401(k) accounts as part of the plan. Roth 401(k) contributions are elective contributions that are:

a. Irrevocably designated by the employee at the time of the deferral election as Roth contributions;

b. Treated by the employer as wages and included in the employee's income at the time of deferral;

c. Maintained by the plan in a separate account.

To take advantage of Roth 401(k) accounts, they must be provided for in the plan document. Roth designated contributions will be subject to all of the same requirements that apply to regular pre-tax 401(k) deferral contributions (e.g., nondiscrimination testing) except for the three items noted above. The funds must be maintained in separate accounts which can be rolled over to either a Roth IRA or another Section 401(k) or 403(b) plan that has a designated Roth program. The accounts will be subject to the required minimum distributions rules.

Advantages of Roth 401(k) Accounts. While Roth IRA contributions [up to $5,500 for 2009 ($6,000 if age 50 or over by the calendar year-end)] can be made within qualified plans that offer deemed IRAs, Roth 401(k) accounts will generally be more advantageous. There is no income limit that would restrict a plan participant from making a Roth 401(k) deferral, making them attractive to higher income individuals. Larger contributions can be made to a Roth 401(k) [up to $16,500 for all Roth 401(k) contributions and regular 401(k) elective deferrals in 2009; $22,000 if age 50 or over by the calendar year-end], which is advantageous to both higher and lower income individuals. Also, pretax matching contributions can be made by an employer on contributions to a designated Roth account.

Designated Roth accounts can provide attractive benefits for participants with estate planning needs and longer investment horizons. They provide the opportunity to set up a fund that the retiree can retain total control of and yet pay no income taxes on the earnings and be able to pass the remaining balance to heirs with no income tax consequences to the heirs. The funds would be available to the retiree to withdraw and use as needed with no income tax consequences.

Example 1-10: Roth 401(k) accounts advantageous for high income employees.

Hye Income, age 60, is nearing retirement and wishes to set aside some funds that will be available to eventually pass down to his grandchildren. However, he would like for the funds to grow tax-free and be available for other purposes if they are needed. Hye's salary for 2009 will be $300,000; therefore, he will not be able to make a Roth IRA contribution or convert any existing IRAs to Roths. His company's Safe Harbor 401(k) plan provides for Roth 401(k) accounts.

This means that, for 2009, Hye can elect to defer up to $22,000 [$16,500 of elective deferrals and $5,500 of catch-up contributions for 2008]. He can elect to allocate all or part of his deferrals to the Roth 401(k) account.

His employer's plan provides a 3% safe harbor contribution and a 4% match. Both the employer's safe harbor contribution and match will go to regular employer contribution and match accounts on a pretax basis. (They are not eligible for the Roth account.)

The Roth 401(k) deferrals will be after-tax deferrals. If the plan were not a safe harbor plan, the Roth deferrals would be subject to the ADP test even though they are after-tax deferrals.

Example 1-11: Roth 401(k) accounts may appeal to lower income employees.

Sam Soso is 25 years old and earns $50,000 a year. He is considering participating in the employer's safe harbor 401(k) plan for 2009. He has chosen to contribute to a Roth IRA account because of his age and his belief that the tax rates will be much greater when he retires. For 2008, his employer's plan will offer Roth 401(k) accounts.

This means that, for 2009, Sam can contribute to the safe harbor 401(k) plan the amount he had budgeted for the Roth IRA and more if he wishes. He can elect to make the deferrals to the Roth 401(k) account. His contributions will be after-tax. The big advantage to Sam is that he will receive the plan's employer match for his contributions. The match will be pretax and is not eligible for the Roth tax treatment, but will increase his overall return on his contributions.

Concerns Regarding Designated Roth Accounts (DRAs). The uncertainty of future tax rates make it difficult to determine how beneficial a DRA might be for a participant. If future tax rates are higher, the benefit will be greater. If the participant anticipates lower tax rates in retirement, then there may be little, if any, benefit to using a DRA. Uncertainty makes the decision difficult. DRAs may be beneficial to some and not as beneficial to others. Consideration should be given to the net present value of the tax savings given up by deferring to the DRA as compared to making a pretax contribution, the length of time before the funds are to be withdrawn, and the anticipated tax bracket expected at retirement.

SIMPLE 401(k) Plans

SIMPLE 401(k) plans are easier to operate than the typical 401(k) plan. SIMPLE 401(k) plans do not have to satisfy the special nondiscrimination tests that apply to 401(k) plans. Also, the top-heavy rules do not apply. However, SIMPLE 401(k) plans are subject to all other qualified plan rules, including minimum coverage rules, as well as the Section 415 contribution limits. A SIMPLE 401(k) also must file the annual Form 5500 report.

The IRS provides a model amendment to be used in adopting new SIMPLE 401(k) plans or in amending existing 401(k) plans to incorporate the SIMPLE provisions (Rev. Proc. 97-9). The model amendment is available to sponsors of master, prototype, and volume submitter specimen plans; and individually designed plans that have cash or deferred arrangements (CODAs).

SIMPLE 401(k) plans are available to employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year that do not make any contributions to other retirement plans. SIMPLE 401(k) plans allow employee elective contributions and require employer matching contributions or nonelective contributions. All contributions must be 100% vested. For 2009, employee elective contributions are limited to $11,500 ($14,000 if age 50 or older by the calendar year-end). Employer contributions must be made under one of the following two formulas:

a. *Matching Contribution Formula.* Employers may elect to match employee contributions on a dollar-to-dollar basis, up to 3% of the employee's compensation for the calendar year.

b. *Nonelective Contribution Formula.* In lieu of making matching contributions, the employer may contribute 2% of compensation for each eligible employee having at least $5,000 of compensation during the calendar year. If an employee is eligible for only part of the year, compensation for the year may not be limited to the portion of the year that the employee is eligible, and the non-elective contribution must be based on the employee's compensation for the full calendar year.

Catch-up Contributions. A SIMPLE 401(k) plan may allow individuals who have attained at least age 50 by the calendar year-end to make catch-up contributions. Catch-up contributions are not taken into account when computing the otherwise applicable dollar limit on elective deferrals ($11,500 for 2009). In addition, catch-up contributions are not subject to any other contribution limits or otherwise applicable nondiscrimination rules. However, they must be available to all participants age 50 and older on an equal basis. The allowable catch-up contribution applicable to SIMPLE 401(k) plans for 2009 is $2,500. The amount allowed as catch-up contributions is indexed annually.

An employer is permitted, but is not required, to make matching contributions with respect to catch-up contributions.

SIMPLE 401(k) Plans Provide Limited Benefits to Highly Compensated. SIMPLE 401(k) plans are easier to operate than the typical 401(k) plans since they do not have to satisfy the ADP and ACP nondiscrimination tests that apply to 401(k) plans. Also, the top-heavy rules do not apply. Nevertheless, SIMPLE 401(k) plans are seldom the best plan for an employer. The SIMPLE 401(k) plans are subject to the same filing requirements as the regular

401(k) plans, but the contribution limits are much lower. An employer can only make either a 2% nondiscretionary contribution for all eligible participants or a 100% match up to 3% of compensation. These plans are also subject to the annual addition limit under IRC Sec. 415.

There are a few benefits found in the SIMPLE IRA plans that are not found in SIMPLE 401(k) plans. SIMPLE IRA plans provide for higher contributions, are not subject to annual addition limit, and are not required to file IRS Form 5500.

Example 1-12: Using a SIMPLE 401(k) plan with a matching contribution formula.

John Nagel, D.D.S., P.C., maintains a SIMPLE 401(k) plan that allows catch-up contributions (see paragraph). For the year 2009, he has chosen to satisfy the nondiscrimination requirements by making a 3% matching contribution, as follows:

Participant	Age	Compensation	Employee Deferral	3% Matching Contribution	Catch-up Contribution	Total
John Nagel	54	$ 245,000	$ 11,500	$ 7,350	$ 2,500	$ 21,350
Betsy Smith	35	40,000	4,000	1,200	—	5,200
Jane Davis	25	25,000	1,000	750	—	1,750
Alisia Barker	27	28,000	1,200	840	—	2,040
Totals		$ 338,000	$ 17,700	$ 10,140	$ 2,500	$ 30,340

Example 1-13: Using a SIMPLE 401(k) plan with a nonelective contribution formula.

Assume the same facts as in the previous example, except Dr. Nagel elects to contribute a 2% nonelective contribution.

Participant	Age	Compensation	Employee Deferral	2% Nonelective Contribution	Catch-up Contribution	Total
John Nagel	54	$ 245,000	$ 11,500	$ 4,900	$ 2,500	$ 18,900
Betsy Smith	35	40,000	4,000	800	—	4,800
Jane Davis	25	25,000	1,000	500	—	1,500
Alisia Barker	27	28,000	1,200	560	—	1,760
Totals		$ 338,000	$ 17,700	$ 6,760	$ 2,500	$ 26,960

An employer may find a SIMPLE 401(k) plan too limiting, as additional discretionary employer contributions cannot be made to the SIMPLE 401(k) plan. Other qualified plans cannot be used to supplement contributions because employers using SIMPLE 401(k) plans are prohibited from maintaining any other qualified plan. Employees may not find these plans attractive since their deferrals for 2009 are limited to $11,500 ($14,000 if age 50 or older by the calendar year-end), compared to $16,500 ($220,000 if age 50 or older by the calendar year-end) for traditional 401(k) plans. This can be restrictive for highly compensated employees.

Maximizing Contributions for an Owner/Employee under a SIMPLE 401(k) Plan. A SIMPLE 401(k) plan generally is advantageous only for an employer having a small number of employees and a business owner who is not highly paid. Example 1-14 illustrates a case where a SIMPLE 401(k) plan works well.

Example 1-14: Contributions for an owner/employee under a SIMPLE 401(k) plan can be greater than a traditional 401(k).

Hometown Hobby Shop, Inc. (HHS, Inc.) is an S corporation owned 100% by Joe Smith (age 40) and employs two other employees. The following illustration assumes in the SIMPLE 401(k) plan that the other (nonhighly compensated) employees defer 3% of their compensation in the current year and that HHS, Inc. matches on a dollar-for-dollar basis up to 3% of compensation. The contributions under each plan are as follows:

		Traditional 401(k)			SIMPLE 401(k) Plan		
Employee	**Compensation**	**Employee Deferral**	**Employer Match**	**Total**	**Employee Deferral**	**Employer Match**	**Total**
Joe Smith	$ 80,000	$ 4,000	$ 2,400	$ 6,400	$ 11,500	$ 2,400	$ 13,900
John Wright	40,000	1,200	1,200	2,400	1,200	1,200	2,400
Jed Camp	20,000	600	600	1,200	600	600	1,200
Totals	$ 140,000	$ 5,800	$ 4,200	$ 10,000	$ 13,300	$ 4,200	$ 17,500

In this case, the SIMPLE 401(k) plan enables the owner of the company (i.e, the highly compensated employee) to defer more than under a traditional 401(k) plan. The SIMPLE 401(k) plan allows Joe Smith total contributions of $13,900, while allowing only $6,400 under the traditional 401(k) plan. This is because Joe's elective deferrals are limited under the required ADP/ACP nondiscrimination tests to 5% based on the employee percentage of 3% (assuming for simplicity that the above data is the same for both the current year and the prior year). Joe could have achieved an even better result by using a safe harbor 401(k) plan.

Variation: By giving timely notice and making a 3% non-elective contribution, Joe could have deferred a full $16,500 for 2009 and ended up with $18,900 in addition to his retirement account. The 3% non-elective contribution would have cost the employer the same amount as 3% match in the above table.

Employee Stock Ownership Plans (ESOPs)

An ESOP is a special type of defined contribution plan that invests primarily in employer securities. Qualifying employer securities are generally common stock that is readily tradeable on an established securities market. Noncallable convertible preferred stock also qualifies if it is convertible at any time into readily tradeable common stock at a *reasonable* conversion price. However, guidelines have not been issued on what is *reasonable*. If stock is not readily tradeable, it must be common stock having voting power and dividend rights equal to or greater than the class of the employer's common stock having (a) the greatest voting power, and (b) the greatest dividend rights. Employer securities not readily tradeable must be appraised annually by an independent appraiser.

An ESOP may be a stock bonus plan or a combination of a stock bonus plan and money purchase plan, which has been modified to include the various tax and regulatory requirements of an ESOP. Generally, a stock bonus plan is similar to a profit-sharing plan in that the company makes discretionary contributions to a plan that accumulates on a tax-deferred basis until distributed to the participants. Like a profit-sharing plan, an ESOP offers flexibility as annual contributions are not mandatory. However, a stock bonus plan must provide the participant the right to elect to receive distributions in the form of employer securities. A stock bonus plan distributes only securities, while a profit-sharing plan also distributes cash. ESOPs must meet the same qualification requirements of a defined contribution plan, as well as rules applying only to ESOPs. The plan document must specifically designate the plan as an ESOP, as well as require the plan to invest primarily in employer securities. IRS Ann. 95-33 contains examination guidelines applying to ESOPs.

In an ESOP, the employer makes annual contributions of its stock or cash. If cash is contributed, it is used to purchase the employer's stock or retire debt incurred to acquire the employer's stock. Provided the tax and regulatory requirements are met, the employer's contributions to the ESOP are tax deductible. In addition, ESOPs can provide a very tax-efficient mechanism for the sale of a small business, through non-recognition of the gain under IRC Sec. 1042.

ESOPs are often used to create a market for the sale of shares of a closely held corporation or as a way to obtain corporate financing. ESOPs may borrow money from the employer, its shareholders, or third parties to purchase stock. Such loans are exempt from the prohibited transaction rules if properly structured. An ESOP that borrows to acquire employer stock is referred to as a *leveraged ESOP*. Leveraged ESOPs can borrow funds needed by the employer, transferring the funds to the employer in exchange for the employer's stock. The plan repays the loan with funds contributed by the employer. The employer gets a deduction for the contributions (i.e., is able to deduct the repayment of the loan).

Beginning in 1998, S-corporations can adopt ESOPs. In an S-corporation, profits are not taxed at the corporate level, but rather the shareholders pay tax on their pro-rata shares of corporate earnings. ESOPs, like all qualified retirement plans, are tax exempt entities. Accordingly, to the extent an S-corporation is owned by an ESOP, the company's earnings are not taxed at the federal level, which can be a significant competitive advantage. An ESOP is considered a single shareholder, regardless of how many participants the ESOP has, which is potentially important because S-corporations are limited to 100 owners.

Permitted Disparity Plans

Permitted disparity plans allow for maximization of contributions for highly compensated employees (i.e., owners and key employees) through a design-based safe harbor. Many of the Internal Revenue Code provisions relating to qualified retirement plans prevent highly compensated employees (HCEs) from receiving a greater benefit than rank-and-file (nonhighly compensated) employees (NHCEs). However, under the permitted disparity provisions, employees earning more than the social security taxable wage base ($106,800 for 2009) may be allocated a greater benefit under a defined contribution plan. This is allowed if the employees earning less than the social security taxable wage base receive a certain minimum benefit. This type of plan is commonly referred to as an *integrated* plan. Permitted disparity under a defined benefit plan can have a similar result, but the rules are more complex. For a defined benefit plan, permitted disparity is generally determined with reference to the last 35-year average of the social security taxable wage bases prior to age 65, rather than a single year's wage base. Permitted disparity plans provide highly compensated employees with a greater benefit than nonhighly compensated employees.

Permitted Disparity Not Available. Employee stock ownership plans (ESOPs), 401(k) and 401(m) arrangements, simplified employee pension plans using a salary reduction agreement (SARSEPs), and SIMPLE-IRAs may not use permitted disparity. Also, SEPs using a model SEP (i.e., Form 5305-SEP) are not permitted the option of permitted disparity. Permitted disparity is only available to non-model SEPs.

CONSIDERATIONS OF DEFINED BENEFIT PLANS

A defined benefit plan is defined by the Internal Revenue Code as any plan other than a defined contribution plan. Basically, a defined contribution plan provides each participant with an individual account to which annual additions are credited, and the participant's benefits are based solely on the amount contributed to the account and any income, expenses, gains, and losses, as well as any forfeitures, allocated to the account. A defined benefit plan (other than a cash balance plan) does not use individual participant accounts. Instead, benefits are fixed under a definite formula. Typically, the formula expresses the benefits in one of the ways described below for the following plans:

a. *Fixed Benefit Plans.* A flat dollar monthly payment.

b. *Flat Benefit Plans.* A certain percentage of an employee's compensation averaged over the employee's entire career or a limited number of years.

c. *Unit Credit Plans.* A certain unit percentage of compensation or dollar amount for each year of service with the employer.

The amount of the employer contributions to the defined benefit plan is determined actuarially by an actuary. This ensures sufficient funds to provide the benefits promised by the plan.

Fixed Benefit Plans

This type of defined benefit plan provides a uniform stated, or fixed, retirement benefit for all plan members. This benefit is not related to a participant's length of service or compensation, but is set by the plan. This type of plan may be an advantage to the employer because it is not tied to compensation, and accordingly, the benefit cost does not increase as compensation increases. However, for this same reason, some employees may not perceive it as a meaningful benefit. The value of the benefit compared to wage levels also decreases over time as the fixed retirement benefit does not keep up with inflation. Other employees may actually prefer a fixed benefit for that same reason of not being tied to compensation. These employees are usually lower compensated and typically receive a greater benefit under this type of plan.

Example 1-15: Providing benefits under a fixed benefit plan.

Metal Manufacturers, Inc., maintains a fixed benefit plan that provides a uniform monthly benefit to participants of $125 upon reaching normal retirement age.

Does this benefit qualify as a fixed benefit plan? Yes, because *all* employees who remain in employment until normal retirement age are entitled to receive the same pension benefit, whether they are highly compensated or nonhighly compensated.

Flat Benefit Plans

This type of defined benefit plan provides a set benefit stated by the plan and based on participants' compensation. Employees benefit more under a flat benefit plan than under a fixed benefit plan since benefits increase as compensation increases. A flat benefit plan may also consider years of service when determining the amount of benefit earned by an employee.

Example 1-16: Providing benefits under a flat benefit plan.

QB Producers maintains a flat benefit plan that provides a benefit of 30% of each participant's average compensation payable at normal retirement age. The participant must have 10 years of service to receive the full 30%. Otherwise, the benefit is reduced by 10% for each year of service fewer than 10 years.

Does this benefit qualify as a flat benefit plan? Yes, it qualifies as a flat benefit plan because each participant is entitled to the same percentage applied to their average compensation when they reach normal retirement age. The reduction of benefits is allowed since it is ratable for each year of service completed fewer than the required 10 years.

Unit Credit Plans

A unit credit plan provides a benefit based on the number of years of service a participant has accumulated, or been given credit for. The plan specifies a formula that multiplies either a participant's annual or average compensation times the number of years of service. Also, a plan providing a stated dollar amount at normal retirement per year of service is a plan that falls into the unit credit category.

Example 1-17: Providing a benefit under a unit credit plan.

N-Balance, Inc., maintains a unit credit plan that provides a benefit payable at normal retirement age of 2% of the participant's average compensation for each year of service.

Does the benefit qualify as a unit credit plan? Yes, it qualifies because each participant receives the same percentage applied to their compensation for each year of service upon reaching normal retirement age.

Cash Balance Plans

A cash balance plan is a defined benefit plan having certain defined contribution characteristics. It falls into the defined benefit category because the benefits it provides are not related to the investment experience of the plan's fund. However, unlike a typical defined benefit plan, an employer would find a cash balance plan attractive if it wishes to provide greater benefits for *younger* employees. This is at a greater cost to the employer, since younger employees receive a greater benefit than under a traditional defined benefit plan. However, offering benefits under a cash balance plan often costs less than under a defined benefit plan. The use of an actuary is needed to determine benefits under a cash balance plan. Actuarial valuations to determine the required minimum contribution and the maximum tax-deductible contribution are performed annually.

Under a cash balance plan, the employer promises to pay a set benefit when the participant retires. This benefit is the balance of the participant's account at retirement age, which consists of a prescribed contribution rate and interest as specified in the plan. However, the plan can invest the contributions in a diversified portfolio and actually earn more than the interest income it is required to credit to the participants' accounts. As in a traditional defined benefit plan, the employer bears the investment risk. If the portfolio does not perform as well as the specified rate, the employer must make up the difference. However, the requirement to invest assets in one commingled account to provide benefits to all participants can be a disadvantage, as the employer cannot offer participant-directed accounts.

A cash balance plan begins with for each participant. This account is credited each year for the following:

a. *Contribution Credit.* This is a specified annual amount representing a percentage of the participant's compensation. The annual amount is that needed to provide the participant's benefit under the plan.

b. *Interest Credit.* This rate, specified in the plan, is determined without regard to how the investments of the plan actually perform. The rate can be fixed or tied to an index. For example, the rate might be the yield on one-year Treasury bills. Accordingly, the rate can vary from year to year. The plan may specify a maximum rate no less than the highest standard interest rate. A minimum rate no more than the lowest standard interest rate may be set as well.

Employees will find the mobility of this type of plan an advantage. If they terminate employment prior to reaching retirement age, they are entitled to a lump sum distribution of their account. Depending on what the plan allows, they could keep the funds with the employer, roll the funds over to another qualified plan or IRA, or opt to receive the distribution. As in a defined benefit plan, employees cannot receive a distribution while they are still employed prior to reaching normal retirement age.

An advantage of a cash balance plan over the traditional defined benefit plan is the visibility of the benefit provided each year. The benefit is expressed as a cash account. Under a traditional defined benefit plan, the employees see each year only what they have accrued as a future pension benefit. A current value is not placed on the accrued benefit. Hence, the employees have no "feel" as to what is currently in the plan for them.

412(i) Plans

Concerns have increased recently, in light of the poor stock market returns, about the adequacy of the existing retirements plans to meet the anticipated retirement needs of the participants. Small businesses with a few employees, an owner or top executives in their 50s or 60s, and expected high and stable company income and cash flow for the next several years should consider an IRC Sec. 412(i) plan. A 412(i) plan is appropriate for businesses that need to "catch up" on retirement funding either because of an existing plan's market losses or because the business was late in establishing a retirement plan.

A 412(i) plan is a defined benefit qualified plan that is funded entirely by life insurance or annuity contracts. The retirement benefit to be paid to the plan participant is defined by the employer who then funds the contributions based on the present value of that benefit in order to provide the specified income stream during retirement. The contributions are tax deductible and plan assets growth is tax-deferred. Other advantages include the following:

- The initial and annual contributions to a 412(i) plan can be larger than allowed for a 401(k) plan. Whereas the maximum allowable contribution to a 401(k) plan currently is $54,500 for participants who have reached at least age 50 or older by year-end, contributions to a 412(i) plan can be large enough to provide up to $195,000 annual retirement income. Thus, for example, the contribution for a participant age 50 or older can range up to several hundred thousand dollars. This is because of the limited time period until retirement and the need for the 412(i) plan funding to grow to a level adequate to provide the specific benefit within that time period.

- Plan benefits are guaranteed and insurance risk is minimized because of the safety of the insurance or annuity contract funding. (Of course, the financial soundness of the insurance company must be carefully considered.)

- The plan assets are safe from creditor claims.

- For estate purposes, the insurance component of the plan is not taxed to heirs.

- Highly compensated employees can opt out of the plan if they wish. Contributions would still have to be made for other employees and may average less than 10% of their salaries and possibly less than the amount required for other types of plan.

- The plan is relatively simple to administer.

The IRS issued regulations to stop perceived abuses of IRC Section 412(i) life insurance contract plans. In these regulations, the IRS specified a method for valuing life insurance distributions. Caution should be taken in adopting a 412(i) plan to make certain that it complies with the IRS's guidelines. Arrangements that do not comply with the guidelines will be treated as a listed transaction subject to tax shelter reporting requirements.

Valuation of Life Insurance for Plan Purposes. The IRS issued guidance for fully-insured plans aimed at stopping abusive plan designs utilizing the minimum funding requirements under IRC Sec. 412(i). The regulations clarify the manner in which life insurance contracts should be valued for plan purposes. The method of valuing a life insurance contract found in IRS Notice 89-25 may not result in a fair market value for the contract. This is particularly true for a contract that has a "springing" value in later years. The regulations are applicable to plans in general and are not limited to IRC Sec 412(i) plans.

Insurance Benefits, Rights, and Features Must Be Available on a Nondiscriminatory Basis. Guidance has also been issued to clarify that the rights granted under life insurance contracts held for the benefit of highly compensated employees must be available on a nondiscriminatory basis to non-highly compensated employees as required for benefits, rights and features under the plan.

Life Insurance Providing Excess Death Benefit or Springing Cash Value. Two issues relating to life insurance policies held by a plan that provide excess death benefits are addressed in Rev. Rul. 2004-20. The first issue is that merely holding a life insurance contract which provides for excess death benefits does not necessarily cause a plan to fail to be an IRC Sec. 412(i) plan. The incidental death benefit requirement is not violated if the excess benefits are not payable under the terms of the plan to the participant's beneficiary. The portion of the employer's contributions attributable to the excess death benefits does not constitute normal cost for purposes the deduction limit. The second issue is that if a participant's benefit under the terms of the plan is not equal to the amount provided at normal retirement age under the terms of the contracts, a plan fails to satisfy the requirements to be a fully-insured plan under IRC Sec. 412(i).

Rev. Proc. 2005-25 provides guidance on the determination of the fair market value of life insurance contracts upon distribution from qualified retirement plans, designed to prevent abuses in "springing" cash surrender value subsequent to distribution.

HYBRID PLAN DESIGNS

A hybrid plan design combines some of the features of a defined benefit plan with some of the features of a defined contribution plan. These alternative plan designs have evolved over recent years and include target benefit plans, age-weighted profit-sharing plans and cash balance plans. These designs utilize some of the characteristics of a more traditional defined benefit plan with some of the characteristics of a traditional defined contribution plan.

Age-weighted Profit-sharing Plans

This type of profit-sharing plan takes into account both age and compensation in determining contribution allocations to participants. Age-weighted plans are able to satisfy the nondiscrimination tests using safe harbor plan designs. The safe harbor designs are uniform allocation formulas that take into account points for age. The safe harbor designs are based on the cross-testing method that converts contributions to future benefits and then tests on the future benefits the contribution could provide, rather than on current contributions. In the case of the age-weighted plans, the nondiscrimination requirements are satisfied if the plan meets the uniform allocation safe-harbor.

Employers may find this an economical way to provide benefits for older employees, while reducing costs of contributions for younger employees. At the same time, this plan has the flexibility of discretionary employer contributions since it is a profit-sharing plan. An age-weighted plan may be a good replacement for a terminating defined benefit plan because older employees would continue to be favored.

The contributions are allocated by using the present value of a single life annuity beginning at the *testing age*. The testing age is the normal retirement age under the plan for all participants, or age 65 if the plan does not provide a uniform normal retirement age. If a participant is older than the plan's normal retirement age, the age used is the testing age under a special rule in Reg. 1.401(a)(4)-8(b)(1). For example, an employee whose age is 69 participates in an age-weighted plan having a uniform retirement age of 65. In this case, the participant's testing age is 65. If the special rule is not used, the participant's current age is used as the testing age. The present value of the single life annuity is determined using an interest rate between 7.5% and 8.5% (compounded annually) and a standard mortality table.

The Social Security retirement age is considered a uniform normal retirement age and can be used instead of age 65 as the testing age.

Example 1-18: Using an age-weighted profit-sharing plan.

John Nagel, D.D.S., P.C., is evaluating an age-weighted profit-sharing plan that is top-heavy. The employer wishes to maximize contributions for the owner, John Nagel, for 2009. The plan's uniform normal retirement age, e.g., testing age, is age 65. Following is a comparison of the allocations of the corporation's age-weighted plan to a standard profit-sharing plan that allocates contributions among participants proportionately to compensation (see Example 1-2). Since the plan is top-heavy, the 3% top-heavy minimum contribution has been allocated.

To determine the minimum amount Dr. Nagel can contribute to his profit-sharing plan in 2009 to provide the maximum benefit for Dr. Nagel, begin by multiplying the present value factor by each participant's compensation as shown in the table below. The second step is to determine the allocation percentage, which when multiplied by the present value of his compensation, will result in a maximum annual addition for Dr. Nagel. This percentage is then multiplied by the present value of each participant's compensation to determine a contribution for each participant. If the plan were not top-heavy, the calculation would be complete. However, the plan is top-heavy, so an additional step is required. The third step is to determine if each participant's contribution satisfies the 3% top-heavy minimum requirements. In this case, additional contributions are needed to increase the contributions for Davis and Barker.

The final column in this example illustrates a prorata allocation to a basic profit-sharing plan that would be required to achieve the same level of benefit for Dr. Nagel.

Participant	Age	Compensation	Present Value Factor	Present Value Factor × Compensation	Non-top-heavy Age-weighted Allocation of Contribution	Top-heavy Age-weighted Allocation of Contribution	Standard Profit-sharing Allocation of 20% Contribution
John Nagel	54	$ 245,000	3.24005	$ 793,812	$ 49,000	$ 49,000	$ 49,000
Betsy Smith	35	40,000	.68769	27,508	1,698	1,698	8,000
Jane Davis	25	25,000	.30418	7,605	469	750 [a]	5,000
Alisia Barker	27	28,000	.35807	10,026	619	840 [a]	5,600
		$ 338,000		$ 838,951	$ 51,786	$ 52,288	$ 67,600

Note:

[a] Increased to top-heavy minimum (3% of compensation).

Age-weighted Plans for Self-employed Individuals. Age-weighted plans may also be used for self-employed individuals. However, a trial-and-error basis must be used in determining the self-employed individual's compensation for allocation purposes. When calculating a self-employed individual's own contribution deduction to an age-weighed plan, compensation is defined as net self-employment earnings less the deduction for half of the self-employment (SE) tax after a reduction for the individual's own contribution. If the individual's compensation after the previous deductions is not reduced below $245,000 [the IRC Sec. 401(a)(17) limit for 2009], $245,000 is used for compensation for allocation purposes. However, if the individual's compensation falls below $245,000 after the necessary reductions, a trial-and-error basis must be used to determine compensation.

Cross-tested Plans

As with age-weighted plans, cross-tested plans are based on equivalent future benefits, rather than equivalent contributions. Cross-tested plans are also commonly referred to as new comparability plans. Cross-tested plans are age-weighted by groups of *employees*, not by individuals. Each employee may be a classification, allowing for great flexibility in allocations.

Under the cross-testing method of determining whether the nondiscrimination rules are met, contributions to a defined contribution plan (such as a profit-sharing plan) are converted to and tested as equivalent benefits payable at normal retirement age. The conversion is done by making an actuarial projection of the benefits payable at normal retirement age that are attributable to such contributions. (Practitioners will normally use a software program to make these calculations.)

In a typical case where cross-testing works as intended, there are enough young non-highly compensated employees to enable an employer to demonstrate compliance with the nondiscrimination standards. The actuarially projected value of the small allocations for non-highly compensated employees (which grows to a much larger number in the future due to the time value of money and the long time period before these employees retire) is compared with the actuarially projected value of the larger allocations for the older highly compensated employees (who obviously are much closer to retirement age and, thus, have less time for earnings to increase their balances in the plan).

Cross-tested and other defined contribution plans (such as age-weighted plans), that attempt to pass the nondiscrimination rules by cross-testing, work best when the average age of the employees the company wants to favor (normally the owners) is greater than the average age of the other employees.

Minimum Allocation Gateway. A defined contribution plan normally must satisfy what's referred to as a minimum allocation gateway before it's allowed to test plan benefits (rather than plan contributions) to determine if it meets the Section 401(a)(4) nondiscrimination rule. A plan satisfies the minimum allocation gateway in one of two ways—

a. each non-highly compensated employee (NHCE) must have an allocation rate that's at least one-third of the allocation rate of the highly compensated employee (HCE) with the highest allocation rate, or

b. each NHCE must receive an allocation of at least 5% of the NHCE's compensation.

As explained in the preamble to the applicable final regulations, the allocation rate in the first test is expressed as a percentage of compensation, as defined under the relatively liberal definition of compensation in IRC Sec. 414(s) that allows employers to design plans that include or exclude from compensation such items as elective deferrals and salary reduction contributions to a cafeteria plan. The second (5%) test, however, uses the more expansive definition of compensation in IRC Sec. 415(c)(3) that includes essentially all taxable compensation, plus elective deferrals [under IRC Secs. 401(k), 403(b), etc.], Section 125 cafeteria plan salary reductions, and salary reductions under IRC Sec. 132(f)(4) for qualified transportation fringe benefits. The apparent rationale for the two definitions of compensation is that the 5% allocation can be substantially less than one-third of the NHCE's allocation rate. Thus, the regulations make sure the compensation number on the second test is as high as possible to maximize the benefit to the NHCEs.

Passing the Gateway Tests. Plans that fail both the one-third and 5% gateway tests may still use cross-testing, if they provide broadly available allocation rates or certain age-based allocation rates. However, the first option (broadly available) is likely to be of little use with many small employer plans because plans that can satisfy this requirement probably won't need to test on the basis of benefits in the first place. In other words, such plans will typically be able to pass the nondiscrimination requirements simply by testing based on contributions rather than benefits.

The second (age-based) option for avoiding the gateway tests requires use of an allocation formula that applies to all plan participants and is based solely on age, years of service, or a combination of the two. This option is what will allow most existing age weighted plans to continue without significant changes. However, age weighted plans should be reviewed in light of the new IRC Sec. 415 limits. Otherwise, older NHCEs could receive significantly increased allocations if the plan has in the past limited allocations by reference to the old 25% of compensation limit (which has been increased to 100% of compensation). Target benefit plans can also continue under the new rules for benefit testing without significant changes because of a special exception to the gateway test.

Example 1-19: Satisfying the gateway test.

Pulmonary Associates, Inc. maintains a calendar-year profit-sharing plan that covers all of its employees, consisting of two HCEs (the doctors, Tom and Alan, who each own 50% of the corporation) and 7 NHCEs. Tom's compensation in 2009 is $245,000 and Alan's is $220,522. The plan's 2009 allocation for each doctor is $49,000, resulting in an allocation rate of 20% for Tom and 23.8499% for Alan. Under the plan, each NHCE receives an allocation of 5% of compensation [as defined in IRC Sec. 415(c)(3)].

Because the allocation rates for Tom and Alan are not currently available to any NHCE, it is easy to conclude that the profit-sharing plan does not have broadly available allocation rates, nor does the plan provide for age-based allocation rates. Thus, the plan can only test for compliance with the Section 401(a)(4) nondiscrimination rule based on benefits if it passes the minimum allocation gateway test.

The highest allocation rate for any HCE under the plan is 23.8499%. Thus, the plan satisfies the minimum allocation gateway test if all NHCEs receive an allocation of at least the lesser of—

1. 7.9499% (i.e., $^1/_3$ of 23.8499%) of compensation [as defined in IRC Sec. 414(s)], or

2. 5% of compensation [as defined in IRC Sec. 415(c)(3)].

Because the plan in this example provides for an allocation of 5% of Section 415(c)(3) compensation to each NHCE, it passes the minimum allocation gateway test. Thus, it's eligible to base its Section 401(a)(4) nondiscrimination testing on the benefits provided rather than the contributions made to the plan. Normally this test will be performed using a software program.

Cross-tested Plans That Include a 401(k) Feature. The final regulations clarify some provisions related to cross-tested profit-sharing plans that include a Section 401(k) feature. For example, the final regulations confirm that elective deferrals and matching (employer) contributions are not considered in determining allocation rates. However, any nonelective contributions, such as the 3% safe harbor employer contribution [for a safe-harbor 401(k) or a top heavy plan], will count toward the minimum allocation requirement needed to pass the gateway test. This allows (a) HCEs to make elective deferrals, without increasing the minimum required allocation and (b) any nonelective employer contributions to be included in satisfying the gateway minimum allocation requirement. These provisions, coupled with the EGTTRA changes that exclude 401(k) deferrals from being counted as part of the employer contribution and increase the deferral, contribution, and annual addition limits, significantly increase the possibilities for cross-tested profit-sharing plans.

The following examples compare the contribution limits for a safe harbor 401(k)/profit-sharing plan [i.e., a 401(k) plan that uses a nondiscretionary 3% employer contribution to pass the 401(k) ADP/ACP tests] with a plan with cross-tested features.

Example 1-20: Safe harbor 401(k) plan.

Tom, age 54, owns 100% of Brown, Inc., which has a profit-sharing plan with a 401(k) feature. Active participants must complete 1,000 hours of service to share in the plan contribution. A 3% employer contribution is made to the profit-sharing plan to satisfy the 401(k) safe harbor for discrimination purposes and the top-heavy requirements. (Betty became a participant in 2004. In 2008, she earned 500 hours of service. Note that Betty will be allocated a 3% contribution even though she worked less than 1,000 hours). Tom wishes to maximize his total benefit in the plan. Therefore, for 2009 he deferred $22,000 (the 2009 deferral limit of $16,500 plus the $5,500 catch-up contribution that does not count against this limit) to his 401(k) plan and the corporation will make the 3% safe harbor contribution for all participants. The corporation will also make a profit-sharing contribution of an amount to cause Tom to reach his maximum annual addition for the year. The profit-sharing contribution will be allocated to all participants who completed 1,000 hours of service.

The maximum amount Brown, Inc. can deduct for plan contributions in 2009 (not including elective deferrals and catch-up contributions) is 25% of total compensation, which is $36,250 ($145,000 × 25%). This means that in addition to the 3% safe harbor contribution, Brown Inc. can contribute an additional $31,900 to the plan. The amount is allocated prorata to participants according to their compensation. The maximum that can be contributed for Tom for 2009 is $49,538, while only $8,712 is allocated to the other employees.

	Age	Compensation	Profit-Sharing Plan	401(k) Deferral	Catch-up Contribution	3% Safe Harbor 401(k)	Total	% of Comp.	% of Total Contributed
Tom (HCE)	59	$ 100,000	$ 24,538	$ 16,500	$ 5,500	$ 3,000	$ 49,538	49.54 %	85.0 %
Sue (NHCE)	31	30,000	7,362	—	—	900	8,262	27.54 %	14.18 %
Betty (NHCE)	55	15,000	—	—	—	450	450	3.00 %	0.77 %
Total		$ 145,000	$ 31,900	$ 16,500	$ 5,500	$ 4,350	$ 58,250		

Example 1-21: Using a cross-tested allocation with a safe harbor 401(k) plan.

Assume the same facts as in Example 1-20, except that for 2009 Brown, Inc. changed its profit-sharing plan to take advantage of the cross-testing plan rules (because Tom wishes to maximize his benefit while minimizing the overall cost).

Tom can defer $22,000 to the 401(k), which includes the $5,500 catch-up contribution allowed for those 50 years of age or older. A 3% employer contribution is made to the profit-sharing plan for the 401(k) safe harbor plus another 2% contribution for Sue and Betty to satisfy the 5% gateway test and allow the plan to be tested on a benefits basis. Tom needs $27,500 more allocated to his account to reach his maximum annual addition limit of $54,500 (the $49,000 contribution limit plus the $5,500 catch-up contribution that does not count against this limit). The plan still must, and in this case does, satisfy the non-discrimination requirements based on a benefits basis. Due to the increased limits and the change in his company's plan design, Tom can receive a slightly larger benefit at a substantially lower cost. Under this plan design, $54,500 is contributed for Tom, while only $2,850 is contributed to the other employees.

	Age	Compensation	Profit-sharing Plan	401(k) Deferral	Catch-up Contribution	3% Safe Harbor 401(k) or 5% Gateway	Total	% of Comp.	% of Total Contributed
Tom (HCE)	60	$ 100,000	$ 29,500	$ 16,500	$ 5,500	$ 3,000	$ 54,500	55 %	95.03 %
Sue (NHCE)	32	30,000	600	—	—	1,500	2,100	7 %	3.66 %
Betty (NHCE)	55	15,000	—	—	—	750	750	5 %	1.29 %
Total		$ 145,000	$ 30,100	$ 16,500	$ 5,500	$ 5,250	$ 57,350		

Target Benefit Plans

A target benefit plan is a hybrid between a defined benefit plan and a money purchase pension plan. The annual contribution amount needed to fund a projected retirement benefit is actuarially determined. However, unlike a defined benefit plan, if the investment performance of the plan differs from the actuarial assumptions used, the employer does not increase or decrease its future contributions so as to provide the promised benefits. The contribution, as actuarially determined without adjusting for investment performance, is allocated to participants' accounts. When the participants retire, they are entitled to the balance in their account. If the investment performance is greater than expected, their benefit will be greater. Likewise, if investment performance is less than expected, participants will not receive the full projected, or target, benefit. The use of an actuary is needed to evaluate target benefit plans. The rules for target benefit plans are set out in Regulation 1.401(a)(4)-8(b)(3)(i).

SELF-STUDY QUIZ

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

8. Which of the following best describes the benefit a participant is allocated in a typical defined contribution plan?
   a. The benefit remains the same whether the plan's investments gain or lose money.
   b. The participant's balance includes contributions, investment earnings/losses, and allocated forfeitures.
   c. The participant's benefit is based on an actuarially driven allocation formula.
   d. Investments must be directed by the plan's trustee.
9. In which of the following scenarios would the plan qualify as a 401(k) plan?
   a. Alphonse receives a distribution of elective deferrals when he completes his 10th year of service.
   b. Barbara's salary deferral contributions to her company's plan are 50% vested.
   c. Chris becomes eligible to participate in his company's plan upon beginning his 2nd year of service.
   d. Donna, age 35, makes salary deferrals of $16,500 in 2009.
10. Carla, age 45, runs a small business with two employees. She wants to use the 3% employer contribution safe harbor instead of nondiscrimination testing for the business's 401(k) plan. In 2009, $225,000 of Carla's compensation qualifies for the matching contribution, and she contributed $16,500 in elective deferrals to the plan. John has $30,000 of qualified compensation and has deferred $600 to the plan. Shelia has $22,000 of qualified compensation and has deferred $440. Assuming that Carla makes the safe harbor notice in a timely fashion, calculate the total annual addition for 2009.
    a. $1,560.
    b. $6,750.
    c. $17,540.
    d. $25,850.
11. Jenna, age 60, is self-employed and participates in a 401(k) plan. Which of the following statements would apply in this scenario?
    a. Jenna can contribute to a Designated Roth Account. These contributions are not subject to the Section 402(g) elective deferral limit.
    b. Employer contributions for the self-employed individual are determined by the same rules as the other participants.
    c. Jenna must make her 401(k) elections before the last day of the plan year.
    d. Jenna's catch-up contributions are subject to the employee deferral limit.
12. Humberto, age 57, participates in his company's 401(k) plan. In 2009, the plan establishes a provision for Roth IRA accounts. What is the maximum amount Humberto can contribute to the Roth IRA account in 2009?
    a. $5,500.
    b. $6,000.
    c. $16,500.
    d. $22,000.

13. What type of defined benefit plan expresses benefits as a percentage of the employee's compensation averaged over a limited number of years or his or her entire career?

    a. Unit credit plan.

    b. Flat benefit plan.

    c. Cash balance plan.

    d. Fixed benefit plan.

14. Which of the following scenarios best illustrates a cash balance plan?

    a. Alloway Company invests the contributions to its defined benefit plan and earns more than the amount the plan needs to contribute to the participant's accounts.

    b. Karen resigns from the BakerCorp. Upon the termination of her employment, the company's defined benefit plan distributes Karen's funds to her in a mandatory lump sum distribution, per regulations.

    c. Thomas participates in Collin Creek's defined benefit plan. It provides 20% of his average compensation payable when he reaches age 65. If Thomas does not have 15 years of service at retirement, the benefit is reduced 5% for each year of service less than the requirement.

    d. Dashwood Market maintains a defined benefit plan that provides its employee participants $250 a month when they reach age 65.

15. 412(i) plans are funded by life insurance or annuity contracts. Which of the following is an advantage of this type of defined benefit plan?

    a. It offers a maximum annual contribution of $54,500 for participants age 50 or older.

    b. The complexity of a 412(i) plan to administer is offset by the variety of options it allows participants.

    c. Up to 50% of a 412(i) plan's assets are protected from creditor claims.

    d. The insurance component of the plan is not taxed to the participant's heirs.

16. Panther Printing has terminated its defined benefit plan and established an age-weighted profit-sharing plan instead. Which of the following best illustrates how contributions will be allocated to the plan?

    a. The present value of a single life annuity beginning at the testing age is used.

    b. Annually, using a set formula.

    c. A trial-and-error basis is used to determine compensation for allocation purposes.

    d. An actuary must be employed to allocate contributions.

17. Jane and Heather own an antique store. In 2009, Jane earned $200,000 and Heather earned $150,000. They each allocate $49,000 into their profit-sharing plan. They employ five other people, all of whom are considered non-highly compensated employees (NHCEs). The NHCEs are allocated 10% of their compensation in 2008. Does this plan meet the minimum allocation gateway requirements to test benefits instead of contributions?

    a. Yes.

    b. No.

    c. Yes, if the plan adopts a 401(k) feature.

    d. No, but the plan can use one of the other methods to determine if it can use cross-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.)**

8. Which of the following best describes the benefit a participant is allocated in a typical defined contribution plan? **(Page 20)**

   a. The benefit remains the same whether the plan's investments gain or lose money. [This answer is incorrect. This would be the case for a defined benefit plan, not a defined contribution plan. In a defined benefit plan, a participant's account is actuarially adjusted for investment earnings and losses so the benefit remains the same regardless of the performance of the investments.]

   b. The participant's balance includes contributions, investment earnings/losses, and allocated forfeitures. [This answer is correct. Employer and employee contributions to a defined contribution plan are invested, and each participant's account is allocated with the applicable earnings and losses. If an employee receives a distribution before he or she is fully vested, a typical defined contribution plan will allow the forfeited portion of his or her account to be reallocated among other participants in the plan.]

   c. The participant's benefit is based on an actuarially driven allocation formula. [This answer is incorrect. A typical defined contribution plan would not use an actuarially driven formula to allocate contributions to plan participants. Target benefit plans, cross-tested profit-sharing plans, and age-weighted profit-sharing plans are exceptions to this rule.]

   d. Investments must be directed by the plan's trustee. [This answer is incorrect. Participants in a defined contribution plan may be allowed to self-direct their investments. It depends on whether this is allowed by the plan document or if the plan specifies that plan assets are invested on a pooled basis by the plan's trustee.]

9. In which of the following scenarios would the plan qualify as a 401(k) plan? **(Page 23)**

   a. Alphonse receives a distribution of elective deferrals when he completes his 10th year of service. [This answer is incorrect. Under IRC Sec. 401(k)(2)(B), employees are restricted from receiving distributions of elective deferrals for completing a stated number of years or passing a fixed number of years. Under certain circumstances, hardship distributions are allowed, however.]

   b. Barbara's salary deferral contributions to her company's plan are 50% vested. [This answer is incorrect. According to IRC Sec. 401(k)(2)(C), salary deferral contributions to a 401(k) plan must be 100% vested.]

   c. Chris becomes eligible to participate in his company's plan upon beginning his 2nd year of service. [This answer is incorrect. Under IRC Sec. 401(k)(2)(D), no more than one year of service can be required before the employee is allowed to participate in the salary deferral feature.]

   d. Donna, age 35, makes salary deferrals of $16,500 in 2009. [This answer is correct. The 2009 limitation on the maximum salary deferral is $16,500. However, if Donna were over age 50, she could make additional catch-up contributions that would not be taken into account in computing this limit.]

10. Carla, age 45, runs a small business with two employees. She wants to use the 3% employer contribution safe harbor instead of nondiscrimination testing for the business's 401(k) plan. In 2009, $225,000 of Carla's compensation qualifies for the matching contribution, and she contributed $16,500 in elective deferrals to the plan. John has $30,000 of qualified compensation and has deferred $600 to the plan. Shelia has $22,000 of qualified compensation and has deferred $440. Assuming that Carla makes the safe harbor notice in a timely fashion, calculate the total annual addition for 2009. **(Page 25)**

    a. $1,560. [This answer is incorrect. This is the total of the 3% safe harbor contribution that Carla will contribute on John and Shelia's behalf in 2009.]

    b. $6,750. [This answer is incorrect. This is the 3% safe harbor contribution that Carla will make on her own behalf in 2009.]

c. $17,540. [This answer is incorrect. This is the total of the elective deferrals made by Carla, John, and Shelia in 2009.]

d. $25,850. [This answer is correct. The annual addition for 2009 is the total of the elective deferrals and the 3% safe harbor contributions that the business makes for all three employees.]

11. Jenna, age 60, is self-employed and participates in a 401(k) plan. Which of the following statements would apply in this scenario? **(Page 27)**

a. Jenna can contribute to a Designated Roth Account. These contributions are not subject to the Section 402(g) elective deferral limit. [This answer is incorrect. Jenna's pretax and post-tax deferrals to designated Roth accounts are subject to the Section 402(g) elective deferral limit.]

b. Employer contributions for the self-employed individual are determined by the same rules as the other participants. [This answer is correct. Both are subject to the annual addition limit and the employer deduction limit.]

c. Jenna must make her 401(k) elections before the last day of the plan year. [This answer is incorrect. Her elections must be made before the last day of the taxable year, not the plan year, or earlier, if the plan document requires it so.]

d. Jenna's catch-up contributions are subject to the employee deferral limit. [This answer is incorrect. Jenna's catch-up contributions are only subject to the catch-up contribution limit. As for any employee, a self-employed person's catch-up contributions are not subject to the elective deferral limit.]

12. Humberto, age 57, participates in his company's 401(k) plan. In 2009, the plan establishes a provision for Roth IRA accounts. What is the maximum amount Humberto can contribute to the Roth IRA account in 2009? **(Page 29)**

a. $5,500. [This answer is incorrect. This is the amount someone under age 50 could contribute to a regular Roth IRA account outside of a 401(k) plan in 2009.]

b. $6,000. [This answer is incorrect. This is the amount Humberto could contribute to a regular Roth IRA account in 2009, not taking the 401(k) element into account. if age 50 or over by the calendar year-end.]

c. $16,500. [This answer is incorrect. This is the amount of non-catch-up elective deferrals Humberto could make to his 401(k) plan in 2009.]

d. $22,000. [This answer is correct. This is the amount Humberto can defer to the plan, $16,500, plus a $5,500 catch-up contribution. Humberto can elect to put all of his deferrals into the Roth IRA account. If his company provides matching contributions, those would not be eligible to include in the Roth account, but would go into the regular employer contribution and match accounts on a pretax basis.]

13. What type of defined benefit plan expresses benefits as a percentage of the employee's compensation averaged over a limited number of years or his or her entire career? **(Page 33)**

a. Unit credit plan. [This answer is incorrect. A unit credit plan expresses the benefits as a dollar amount or a unit percentage of compensation for each year that the employee has been in the employer's service.]

b. Flat benefit plan. [This answer is correct. A flat benefit plan is a defined benefit plan that expresses its benefit with the formula described above.]

c. Cash balance plan. [This answer is incorrect. This type of defined benefit plan has certain characteristics of a defined contribution plan. It is considered a defined benefit plan because the benefits the cash balance plan provides are not related to the investment experience of the plan's fund.]

d. Fixed benefit plan. [This answer is incorrect. Benefits in a fixed benefit plan are expressed by the same monthly payment of a flat dollar amount for all participants.]

14. Which of the following scenarios best illustrates a cash balance plan? **(Page 34)**

    a. **Alloway Company invests the contributions to its defined benefit plan and earns more than the amount the plan needs to contribute to the participant's accounts. [This answer is correct. Alloway can earn more interest than it is required to credit to the participants' accounts. However, Alloway bears the investment risk for its cash balance plan. If the plan's investments do not perform well enough to meet the specified rate of return for the participants, Alloway must make up the difference.]**

    b. Karen resigns from the BakerCorp. Upon the termination of her employment, the company's defined benefit plan distributes Karen's funds to her in a mandatory lump sum distribution, per regulations. [This answer is incorrect. A cash balance plan provides participants the advantage of mobility. If BakerCorp. maintained a cash balance plan, upon her resignation, Karen could receive her funds as a lump sum, leave the funds with BakerCorp., roll them over to another qualified plan, or roll them over to an IRA. It depends on what the plan allows. Regulations do not require cash balance plans to distribute funds as a lump sum.]

    c. Thomas participates in Collin Creek's defined benefit plan. It provides 20% of his average compensation payable when he reaches age 65. If Thomas does not have 15 years of service at retirement, the benefit is reduced 5% for each year of service less than the requirement. [This answer is incorrect. Based on the way that the benefit is funding, Collin Creek's defined benefit plan is a flat benefit plan, not a cash balance plan.]

    d. Dashwood Market maintains a defined benefit plan that provides its employee participants $250 a month when they reach age 65. [This answer is incorrect. Because of the manner in which Dashwood Market's defined benefit plan plays the benefit to its participants, this plan is a fixed benefit plan, not a cash balance plan.]

15. 412(i) plans are funded by life insurance or annuity contracts. Which of the following is an advantage of this type of defined benefit plan? **(Page 35)**

    a. It offers a maximum annual contribution of $54,500 for participants age 50 or older. [This answer is incorrect. This is the maximum contribution allowed for participants (age 50 or older) for a 401(k) plan. Contributions to a 412(i) plan can be large enough to provide up to $195,000 of annual retirement income.]

    b. The complexity of a 412(i) plan to administer is offset by the variety of options it allows participants. [This answer is incorrect. One of the advantages of a 412(i) plan is that they are simple to administer.]

    c. Up to 50% of a 412(i) plan's assets are protected from creditor claims. [This answer is incorrect. All of a 412(i)'s assets, not just 50%, are safe from the claims of creditors.]

    d. **The insurance component of the plan is not taxed to the participant's heirs. [This answer is correct. Another advantage of a 412(i) plan is that insurance risk is minimized and plan benefits are guaranteed because of the safety of the type of funding.]**

16. Panther Printing has terminated its defined benefit plan and established an age-weighted profit-sharing plan instead. Which of the following best illustrates how contributions will be allocated to the plan? **(Page 37)**

    a. **The present value of a single life annuity beginning at the testing age is used. [This answer is correct. The testing age is the normal retirement age for all participants under Panther Printing's plan. If the plan does not provide a normal retirement age, age 65 is used.]**

    b. Annually, using a set formula. [This answer is incorrect. This is how contributions are allocated to participants in a money purchase pension plan, but in this scenario Panther Printing has an age-weighted profit-sharing plan. The Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA) has virtually eliminated the need for money purchase pension plans.]

    c. A trial-and-error basis is used to determine compensation for allocation purposes. [This answer is incorrect. This basis would be used for a self-employed individual making contributions to an age-weighted plan, but it would not be used by Panther Printing in the above scenario.]

    d. An actuary must be employed to allocate contributions. [This answer is incorrect. Panther Printing will not need to employ an actuary to allocate all of its annual contributions. However, the formula used for this purpose will be actuarially based.]

17. Jane and Heather own an antique store. In 2009, Jane earned $200,000 and Heather earned $150,000. They each allocate $49,000 into their profit-sharing plan. They employ five other people, all of whom are considered non-highly compensated employees (NHCEs). The NHCEs are allocated 10% of their compensation in 2009. Does this plan meet the minimum allocation gateway requirements to test benefits instead of contributions? **(Page 38)**

    a. **Yes. [This answer is correct. The NHCEs received an allocation rate of more than one-third of the allocation rate of the highly compensated employee (Heather), so the plan can test plan benefits. In addition, the NHCEs receive more than 5% of their compensation.]**

    b. No. [This answer is incorrect. All of the methods for determining if the plan can be cross-tested must be applied to this scenario.]

    c. Yes, if the plan adopts a 401(k) feature. [This answer is incorrect. Adopting a 401(k) feature is not necessary in this scenario. If Jane and Heather did adopt a 401(k) feature, however, they could make elective deferrals without increasing the minimum allocation required by the plan.]

    d. No, but the plan can use one of the other methods to determine if it can use cross-testing. [This answer is incorrect. Plans can qualify for cross-testing if they have certain age-based allocation rates or broadly available allocation rates. However, neither of these are true in this scenario.]

CONSIDERATIONS OF SEPs, SIMPLE IRA PLANS, AND PAYROLL DEDUCTION IRAs

Simplified Employee Pension Plans

A simplified employee pension plan (SEP) is a written arrangement that allows employers to make tax-deductible contributions without having to meet all the qualification requirements of a qualified retirement plan. Under a SEP, the employer has the employees establish individual retirement accounts or annuities. The main advantage of a SEP is that it is easier to administer and does not require the filing of an annual report with the IRS. Thus, administration costs are significantly lower than those of a qualified plan. SEPs are easy and economical to establish if a model SEP using IRS Form 5305 is adopted. Prototype SEPs are also available. An employer may customize a SEP, but the cost of doing so is generally prohibitive and may result in a Form 5500 filing requirement for the plan.

Special requirements apply to SEPs in regard to participation and discrimination. In general, employees must participate in the plan that are over age 21, earn at least $550 for 2009 (adjusted annually for cost of living), and have worked for the employer for three of the last five years. (There are certain exceptions for nonresident aliens and employees covered by a collective-bargaining agreement.) A SEP may not be suitable if an employer has many part-time employees or seasonal workers.

One disadvantage of a SEP is that participants' accounts are immediately nonforfeitable, i.e., they must be 100% vested at all times. Accordingly, a SEP does not encourage longevity of service. The employee may also take a distribution at any time, but that employee will be currently taxed on the distribution and may be subject to the premature distribution penalty if under age 59½.

For 2009, an employer may contribute up to 25% of an employee's compensation. The contribution is limited to a maximum of $49,000 per employee for 2009. Like a profit-sharing plan, SEPs offer the flexibility of discretionary contributions, in that an employer may decide from year to year whether (and what amount) to contribute to the plan.

Savings Incentive Match Plans for Employees (SIMPLE) IRA Plans

SIMPLE IRA plans are available to employers with 100 or fewer employees who received at least $5,000 of compensation from the employer in the preceding year, and must cover all employees who received at least $5,000 in compensation from the employer during any two preceding years and are reasonably expected to receive at least $5,000 in compensation during the year. Union and non-resident alien employees with no U.S. source income may be excluded from participation. Self-employed individuals are eligible to participate in SIMPLE IRA plans. An employer wishing to adopt a SIMPLE IRA plan may not maintain any other qualified retirement plans, SEPs, or 403(b) plans. For this purpose, an employer maintained another qualified plan if contributions were made to such a plan, or benefits accrued, for service in the period beginning with the year when the SIMPLE IRA became effective and ending with the year for which the determination is made.

SIMPLE IRA plans replace salary reduction simplified employee pensions (SARSEPs). As of January 1, 1997, employers cannot adopt new SARSEPs. However, SARSEPs established before 1997 can continue to receive contributions under present-law rules, and new employees hired after 1996 may participate in the SARSEP under such rules.

SIMPLE IRA plans are designed to be much easier to operate than qualified retirement plans. SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. For 2009, employee elective contributions are limited to $11,500 ($14,000 if age 50 or older by December 31, 2009). Employer contributions must be made under one of the following two formulas:

a. *Matching Contribution Formula.* Employers may elect to match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year.

b. *Nonelective Contribution Formula.* In lieu of making matching contributions, the employer may contribute 2% of compensation for each eligible employee having at least $5,000 of compensation during the calendar year. For purposes of this formula, compensation of each eligible participant is limited to the IRC Sec. 401(a)(17) limit ($245,000 for 2009).

Like a qualified retirement plan, SIMPLE IRA plans are attractive to employees because they are not taxed currently on any contributions made to the plan, or on any earnings of the contributions. Participants are not taxed until they receive a distribution from the IRA.

Employers generally receive a current deduction for SIMPLE IRA contributions. Employer matching or nonelective contributions to SIMPLE-IRAs are not treated as wages for employment tax purposes (i.e., not subject to payroll taxes). (Employee elective contributions are, however, subject to payroll taxes.)

SIMPLE IRA plans are not tools for encouraging longevity among employees because all contributions to an employee's account are fully vested at all times. Another disadvantage is that notice requirements can also be difficult to comply with. Employers must give employees advance notice each calendar year of the level of employer contributions for the coming year. Since the profitability for that year is unknown at the time, deciding on the employer contribution (matching or nonelective) can be difficult.

The greatest advantage of SIMPLE-IRA plans is that they are easier to operate than other qualified retirement plans. SIMPLE IRA plans do not have to meet the nondiscrimination requirements, the minimum participation and minimum coverage rules, and the vesting rules. In addition, the top-heavy rules discussed do not apply. Fiduciaries of SIMPLE IRA plans also have limited relief of liability.

Payroll Deduction IRAs

Payroll deduction IRAs are even simpler than SEPs to administer. This is merely a payroll deduction and not a qualified plan. Therefore, there are no filing or nondiscrimination requirements. It allows employees to instruct the employer to automatically deposit part of their pay into their IRA account. It has the same tax advantages available to the individual employee under the normal IRA rules. It is a convenient way for employees to save on a regular basis.

IRAs within a Qualified Retirement Plan (Deemed IRAs). A qualified employer plan can set up separate accounts or annuities as "deemed IRAs," which will be treated as IRAs. A 401(k) or 403(b) plan can establish separate accounts or annuities to be treated much like a Roth IRA.

SPECIAL ISSUES FOR INDIVIDUALS WHO ARE SELF-EMPLOYED

What Is a Keogh Plan?

In 1962, Congressman Keogh introduced legislation that made qualified plans available to self-employed individuals. Thus, the term *Keogh plan* originally referred to a special type of plan for self-employed individuals. The Tax Equity and Fiscal Responsibility Act of 1982 changed that by providing a special definition of compensation to be used for self-employed individuals. This essentially eliminated the distinction between Keogh plans and other qualified plans. Today, all types of plans can cover self-employed persons by providing a special definition for compensation. The term *Keogh* is now used to refer to any plan that covers at least one self-employed individual and does not refer to a specific type of plan.

Qualified plans must be established by the employer. For a self-employed individual, the employer is the sole proprietorship, the partnership, or the LLC (if taxed as a partnership), as the case may be.

What Is Self-employment Income?

Self-employment income includes income from a trade or business. Sole proprietors may carry on a trade or business by working as an independent contractor. Serving as director of a corporation is a trade or business, and director's fees constitute self-employment income for purposes of establishing a qualified plan (*Steffens v. Comm.*). Personal services must be rendered in generating self-employment income for plan purposes.

How Are Contributions Calculated?

Contributions for self-employed individuals are based on net earnings from the trade or business maintaining the plan, less the amount of their Keogh contribution and one-half of their self-employment tax attributed to the trade or business sponsoring the Keogh. If an individual is engaged in more than one trade or business, the earned income is determined separately for each trade or business and is limited based on the total of all businesses. If employees also participate in the plan, the net earnings of the self-employed individual are first reduced by any amounts contributed for the employees and then the contribution for the self-employed individual and $^1/_2$ of the self-employment tax is calculated.

Other Special Issues

Partnerships. If a partner does not receive earned income from the partnership subject to self-employment tax, the partner cannot participate in the qualified plan of the partnership. Partners must make their 401(k) elections before the last day of the tax year (i.e., the date a partner's compensation is deemed available) or earlier if the plan document so provides.

Limited Liability Corporations (LLCs). In general, the rules that apply to LLC's depend on whether the LLC is classified as a partnership or a corporation for federal income tax purposes. A member of an LLC must either (a) receive earnings subject to self-employment tax or (b) receive W-2 earnings as an employee, if the member is to participate in the qualified plan of the LLC.

The limited liability protection offered by an LLP or an LLC classified as a partnership may not extend to ERISA claims due to breaches of fiduciary relationship with respect to the qualified plan. Members of an LLC should not take exposure to ERISA-based liabilities too lightly. A partner in an accounting firm was held an employee under ERISA and was able to sue the firm for damages.

SELF-STUDY QUIZ

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

18. In which of the following scenarios would a SEP be most appropriate?

    a. EagleCorp desires a retirement plan with low administrative costs.

    b. Fitzpatrick Flyers is located in a university town and hires many part-time, short-term employees.

    c. GriffinCo wants a retirement plan with a long vesting schedule to encourage employee loyalty.

19. Which of the following scenarios correctly illustrates how retirement plans apply to self-employed individuals?

    a. Carolyn participates in a special type of retirement plan called a Keogh Plan that is only available for self-employed individuals.

    b. Harrison is the director of CorpCo and excludes his director's fees from the self-employment income considered when he established a qualified plan.

    c. Terry is a member of an LLC and receives earnings subject to the self-employment tax.

    d. Zoe's contributions to her retirement plan are based solely on net earnings from the business that maintains 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.)**

18. In which of the following scenarios would a SEP be most appropriate? **(Page 47)**

    a. EagleCorp desires a retirement plan with low administrative costs. [This answer is correct. Ease of management and no requirement for an annual filing with the IRS are the main advantages of a SEP, which means administrative costs are significantly lower than maintaining a qualified retirement plan. Using a model SEP is more economical than customizing a SEP.]

    b. Fitzpatrick Flyers is located in a university town and hires many part-time, short-term employees. [This answer is incorrect. Generally, employees that are over 21, earn at least $550 (in 2009, adjusted annually for inflation), and who have worked for the employer for three of the last five years must participate in the plan. These qualifications mean that a SEP may not be appropriate for an employer like Fitzpatrick Flyers that has many part-time, short-term employees.]

    c. GriffinCo wants a retirement plan with a long vesting schedule to encourage employee loyalty. [This answer is incorrect. A SEP has the disadvantage of being 100% vested to the participants at all times, which will not allow GriffinCo the long vesting schedule it desires from its retirement plan.]

19. Which of the following scenarios correctly illustrates how retirement plans apply to self-employed individuals? **(Page 48)**

    a. Carolyn participates in a special type of retirement plan called a Keogh Plan that is only available for self-employed individuals. [This answer is incorrect. This would have been correct before The Tax Equity and Fiscal Responsibility Act of 1982 provided a definition of compensation for self-employed individuals. Now the term *Keogh* is used to refer to any plan that covers at least one self-employed individual instead of referring to a specific type of plan.]

    b. Harrison is the director of CorpCo and excludes his director's fees from the self-employment income considered when he established a qualified plan. [This answer is incorrect. Self-employment income includes income from a trade or business. It also includes fees earned serving as the director of a corporation, because serving as a director is a trade or business.]

    c. Terry is a member of an LLC and receives earnings subject to the self-employment tax. [This answer is correct. Terry could participate in the LLC's qualified plan in that case. Alternatively, if the LLC is a corporation for federal income tax purposes, Terry could receive W-2 earnings as an employee and participate in the LLC's qualified plan.]

    d. Zoe's contributions to her retirement plan are based solely on net earnings from the business that maintains the plan. [This answer is incorrect. Zoe's contributions as a self-employed individual would be based on net earnings from a trade or business maintaining the plan minus the amount of her Keogh contribution and one-half of her self-employment tax that was attributed to the trade or business sponsoring the Keogh.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (RETTG091)

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. Which of the following properly defines *qualified retirement plan*?

   a. A type of tax-favored plan established under the Internal Revenue Code by an employer to provide retirement income for employees.

   b. A type of plan that should be considered when an employer is unwilling to accept a mandatory funding requirement of at least 3%.

   c. Special rules that apply to certain level of benefits or account balances that benefit highly compensated or key employees.

   d. A type of plan that should be considered for a targeted group that is older than the average employee.

2. Match the following plan types with the correct description.

1. Defined contribution plans	i. Tax favored plans that are always 100% vested and subject to different and usually simpler rules than qualified retirement plans.
2. Defined benefit plans	ii. Qualified retirement plans in which each participant has an account to which contributions, earnings, and forfeitures are credited, and include profit-sharing and money purchase plans.
3. Payroll deduction IRAs, simplified employee pension plans (SEPs), and SIMPLE IRA plans	iii. Qualified retirement plans that provide a specified benefit to an employee based on a formula set forth in the plan document, and includes cash balance plans.

   a. 1., iii.; 2., ii.; 3., i.

   b. 1., ii.; 2., iii.; 3., i.

   c. 1., i.; 2., iii.; 3., ii.

   d. 1., ii.; 2., i.; 3., iii.

3. Gary serves as the plan fiduciary for Holland Steel's qualified retirement plan. Which of the following considerations will affect Gary in this role?

   a. His contributions to the plan will vest more quickly because of his important role in plan finances.

   b. He will be considered a highly compensated individual in regard to the retirement plan because of this role, and, therefore, all related regulations and limitations will apply.

   c. If he enters bankruptcy proceedings, the plan's assets may be included as part of the bankruptcy estate.

   d. If he does not act in the best interest of the plan's participants, he may be subject to penalties and be personally liable for any related plan losses.

4. Killdare Publishing wants to establish a qualified retirement plan that will allow owners and key employees more benefits than the rank and file employees. Many of the employees in this target group are over age 50. The company can only afford an annual contribution of less than 3%. Which of the following plans would best meet the company's needs?

   a. A plan with an integrated allocation formula.

   b. A cross-tested profit-sharing plan.

   c. A plan with a prorata allocation formula.

   d. A SIMPLE IRA plan.

5. Sandra Jacobs, MD, has her own medical practice and employs three other individuals. Because of the small size of her business, Sandra needs a retirement plan with the lowest possible administration and set-up costs. Which of the following plans would best meet Sandra's needs?

   a. A SIMPLE IRA plan.

   b. A defined benefit plan.

   c. A profit-sharing plan.

   d. An individually designed plan.

6. Assume the same information as in the question above. Is Sandra eligible for the tax credit that offsets the administrative and retirement-education expenses of adopting a new qualified retirement plan?

   a. Yes, but only if she adopted a 401(k) plan.

   b. Yes, if the administration fees are less than $1,000.

   c. Yes, if the plan covers at least one nonhighly compensated employee.

   d. No, Sandra's practice does not qualify for the credit.

7. The Babylon Company staffs its IT department through one-year contracts with an employee-leasing organization. Harold, a Babylon employee, directly supervises the IT staff. Babylon is in the process of creating a qualified retirement plan, and would prefer not to include the leased employees under the plan. Which of the following applies in this scenario?

   a. Babylon can exclude all leased employees from the plan as a class if the plan meets minimum coverage requirements.

   b. Babylon could establish a plan based on a standardized prototype and exclude both leased employees and independent contractors.

   c. The company could establish a money purchase pension plan to meet the safe harbor requirements.

   d. The leased employee rules will cover the IT staff in all circumstances, so they must be addressed in the plan.

8. If a company wants to establish a qualified defined contribution plan, which of the following would qualify?

   a. Top hat plan.

   b. Fixed benefit plan.

   c. 412(i) plan.

   d. Employee stock ownership plan.

9. High Ground, Inc., maintains a profit-sharing plan. The plan allows High Ground to make discretionary contributions as a dollar amount. In 2009, total eligible participants' compensation is $200,000. Calculate the maximum deductible contribution to the plan for 2009.

   a. $6,000.

   b. $20,000.

   c. $50,000.

   d. $100,000.

10. Watson Homes has established a 401(k) plan for its employees. The plan includes a Designated Roth Account (DRA). Jessica participates in the 401(k) plan. At what income level will Jessica be ineligible to contribute to the DRA.

    a. $10,000.

    b. $114,000.

    c. $166,000.

    d. There are no income limits for DRA contributions.

11. Craig, age 55, runs a small business with three employees. He wants to use the 3% employer contribution safe harbor instead of nondiscrimination testing for the business's 401(k) plan. The plan includes an enhanced matching formula, and will match 100% of employee elective contributions of up to 6%. In 2009, $245,000 of Craig's compensation qualifies for the matching contribution, and he contributed $16,500 in elective deferrals to the plan. Jonas has $45,000 of qualified compensation and has deferred $2,700 to the plan. Sally has $32,000 of qualified compensation and has deferred $960 to the plan. Harry has $27,000 of qualified compensation and has deferred $540. Craig also makes a catch-up contribution of $5,500. Assuming that Craig makes the safe harbor notice in a timely fashion, calculate the total annual addition for 2009.

    a. $10,020.

    b. $18,000.

    c. $47,720.

    d. $55,570.

12. Assume the same details as in the question above. Calculate the total amount paid to meet the enhanced matching formula portion of the qualified plan.

    a. $5,000.

    b. $10,020.

    c. $18,900.

    d. $19,700.

13. A SIMPLE 401(k) plan would be appropriate in which of the following scenarios?

    a. The Bread Box has 50 employees that receive $5,000 of compensation or more.

    b. To Have and Hold wants the ability to contribute $16,500 for each employee in 2009.

    c. The Candlestick Emporium wants the ability to make discretionary contributions to its plan.

    d. The Shoe Shoppe's owner would qualify as a highly compensated employee.

14. Microcosm Mutual maintains a defined benefit plan that provides flat benefit amount for all plan participants. The benefit amount is not tied to length of service or compensation. What type of plan is this?

    a. Fixed benefit plan.

    b. Flat benefit plan.

    c. Unit credit plan.

    d. Cash balance plan.

15. The Blue Water Café is a small business with 15 employees. The owners are Becky, age 57, and Sal, age 62. Because the café is well established in the community and has been popular for the past two decades, they expect to continue their high, stable income and cash flow for the next several years, until Becky and Sal are ready to retire. Becky and Sal would like the chance to catch up on their retirement funding, because this is the first time they have established a retirement plan for their business. Which of the following plans will meet Sal and Becky's needs?

    a. SIMPLE 401(k) plan.

    b. Cash balance plan.

    c. Payroll deduction IRA.

    d. 412(i) plan.

16. MacDougal & Sons plans to establish a 412(i) plan. Which of the following should be used to fund the plan?

    a. Life insurance or annuity contracts.

    b. Life insurance contracts with springing cash value.

    c. Life insurance contracts with excess death benefit.

    d. Funding choice is up to the company that establishes the plan.

17. Match the following plans with the correct descriptions.

1. Cross-tested plan	i. A type of defined contribution plan that invests primarily in employer securities.
2. Target benefit plan	ii. A plan that is age-weighted by groups of employees, not individuals, and that is based on equivalent future benefits instead of equivalent contributions.
3. Employee stock ownership plan (ESOP)	iii. Allows for contributions to highly compensated employees to be maximized through a design-based safe harbor.
4. Permitted disparity plan	iv. A hybrid between a defined benefit plan and a money purchase pension plan.

a. 1., ii.; 2., iv.; 3., i.; 4., iii.

b. 1. iv.; 2., iii.; 3., ii.; 4., i.

c. 1., ii; 2., i.; 3., iv.; 4., iii.

d. 1., iii.; 2., iv.; 3., i.; 4., ii.

18. Match the following plans with the correct descriptions.

1. SEP	i. A plan that covers at least one self-employed individual.
2. SIMPLE IRA	ii. A written arrangement allowing employers to make tax-deductible contributions without meeting all the qualification requirements of a qualified retirement plan.
3. Payroll deduction IRA	iii. A plan for employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year. It replaces salary reduction simplified employee pensions.
4. Keogh plan	iv. An arrangement that allowed employees to instruct their employer to automatically deposit part of their pay into their IRA account.

a. 1., ii.; 2., iii.; 3., iv.; 4., i.

b. 1., iv; 2., i.; 3., ii.; 4., iii.

a. 1., ii.; 2., iv.; 3., i.; 4., iii.

b. 1., iii.; 2., iv.; 3., i.; 4., ii.

19. In which of the following scenarios would a SIMPLE IRA plan be the most appropriate?

a. Inspired Creations needs a retirement plan that does not require employer contributions.

b. Jewelry Jamboree may have difficulty meeting the requirement of the minimum participation and minimum coverage rules.

c. Kentworthy, LLC, has an established 403(b) plan and would like to add additional benefit opportunities for its employees.

d. Llewellyn & Mann needs a retirement plan that will encourage longevity among its employees.

Lesson 2: Establishing and Maintaining a Qualified Retirement Plan

INTRODUCTION

This lesson deals with the procedures for establishing and maintaining a qualified retirement plan. Qualification provides tax benefits to the employer maintaining the plan (deductions for contributions to the plan); to the trust, custodial account, or annuity contract under which the funds of the plan are maintained (exemption from taxation of income on plan assets); and to the participants in the plan (deferral of taxation on amounts contributed to the plan on the participants' behalf until those amounts are distributed from the plan). This lesson discusses the rules for qualified retirement plans.

An employer initially adopts a plan by creating a written plan document that contains the provisions specifying how the plan will be operated. An employer may need to apply to the IRS for a determination letter to ascertain whether the plan is initially qualified as of its adoption. This lesson discusses when a determination letter is needed and the procedures for applying for a determination letter. From time to time, the plan document may need to be amended. The employer may decide to change the provisions (this is referred to as a discretionary amendment), or a change in law or regulations affecting qualified retirement plans may require the document be updated (referred to as a mandatory amendment).

Amendments generally cannot reduce an employee's accrued benefit. Generally, defined benefit plan amendments cannot reduce or eliminate optional forms of benefit accrued at the time of amendment. Some of the requirements have been relaxed regarding eliminating optional forms of benefit, especially those which are very similar, in particular in the situation of benefits added by corporate mergers and acquisitions. Amendments to defined contribution plans can be made to eliminate some forms of distribution. The timing of an amendment must not have the effect of significantly discriminating in favor of highly compensated employees. Amendments normally affect contributions in the year of adoption, but an exception exists where amendments may be retroactive to a prior year if certain requirements are met.

When the law is changed and a mandatory amendment is required, a certain period of time is allowed for the plan to be formally amended. This time period is referred to as the *remedial amendment period*. However, the new laws must be complied with according to their effective dates and by government regulations, even if the plan has not yet been formally amended. The formal amendment may be a model amendment, which is provided by the IRS for some law changes as a means of simplifying the amendment process.

When a plan is amended, certain events require that notice be given to participants or other interested parties. These notices are discussed in this lesson. In addition, the reports that must be filed with the IRS are discussed. As part of the amendment process, a plan administrator concerned about the impact of an amendment on the qualification of the plan can request a determination letter from the IRS. A determination letter may also be needed in the event of a plan termination or merger.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize how to establish a qualified retirement plan, including special issues related to plan design.
- Describe plan documents, determination letters, and their importance.
- Prepare to file for a determination letter.
- Provide notice and solve related issues when the plan document is amended.
- Assess plan amendment issues related to the anti-cutback rules, retroactive amendments, and law changes.
- Determine appropriate procedures for changing the plan/trust year and obtaining determination letters when a plan is amended or terminates.

HOW TO ESTABLISH A QUALIFIED RETIREMENT PLAN

Written Plan and Trust Requirements

Qualified retirement plans must be established and maintained pursuant to a written instrument. Employees must be provided a Summary Plan Description when a plan is established. Further, in general, the assets of qualified retirement plans must be held in trust.

Plan assets must be held in trust to ensue their use for the benefit of the participants and their beneficiaries, unless exempted from the trust prerequisite. The trust requirement is satisfied if securities are held (including those held in a street name or the name of a nominee) by any of the following:

a. A bank or trust company subject to supervision by the United States or a state, or a nominee of such a bank or trust company.

b. A broker or dealer registered under the Securities Exchange Act of 1934, or a nominee of such a broker or dealer.

c. A clearing agency or its nominee.

Most small and medium-sized plans appoint individuals as trustees, rather than a bank. In that case, the bank holding the securities acts in a custodial capacity and depends upon the plan administrator or the trustee for specific investment instructions.

The trustee has exclusive authority and discretion to manage and control plan assets, except to the extent the plan provides that the trustee is subject to the direction of a named fiduciary who is not a trustee, (such as the plan administrator or an investment committee) or where authority to manage, acquire, or dispose of plan assets is delegated to an investment manager under ERISA Sec. 402(c)(3).

Exceptions to the Trust Requirement

Assets that generally do not have to be held in trust include the following:

a. Insurance contracts or policies issued by an insurance company qualified to do business in a state.

b. Assets held by an insurance company.

c. Assets of a plan established by a sole proprietorship or partnership covering the sole proprietor or partners and their employees held under a custodial account pursuant to IRC Sec. 401(f) or 408(h).

Employer contributions are categorized as plan assets only once they have been contributed to the plan. However, participant deferrals that are withheld from wages by the employer become plan assets as of the earliest date the contributions can reasonably be segregated from the employer's general assets. However, in DOL Field Assistance Bulletin 2008-01, the EBSA took the position that when an employer fails to make a required contribution to a plan in accordance with the plan documents, the plan has a claim against the employer for the contribution, and that claim is a plan asset.

FLOW-THROUGH ENTITIES AND SELF-EMPLOYED PERSONS

In establishing and maintaining a retirement plan for flow-through entities (i.e., partnerships, S corporations, and LLCs) and self-employed persons, special issues must be addressed. These issues are discussed in Lesson 1.

ISSUES RELATED TO PLAN DESIGN

In designing a plan, there are specific IRS and ERISA requirements that must be met, as well as options in meeting these requirements. Plan options should be chosen carefully to best suit the employer's goals. Legal counsel should be obtained when designing the plan, as it is a legal contract between the employer and the employees.

Plan design issues include the following areas:

- The type of qualified retirement plan to adopt—e.g., guaranteed benefits or investment-based benefits
- The type of plan document to use—an individually designed plan or a prototype plan.
- Setting eligibility requirements—less or more restrictive.
- Vesting of participant account balances or accrued benefits—how quickly should employees be fully vested.
- Contribution and account allocations under defined contribution plans or pension formulas under defined benefit plans.
- Investment direction—availability of employee options.
- Distribution timing and options—degree of flexibility desired.
- For 401(k) plans—use of matching contributions, safe harbor features, and automatic enrollment—use of matching contributions, safe harbor features, and automatic enrollment.
- Definition of compensation to be used for determining contributions.

SELF-STUDY QUIZ

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

20. In which of the following scenarios, has the company met one of the qualifications for establishing a qualified retirement plan?

    a. Mendelson Brothers provides a Summary Plan Description to all executives and highly compensated employees when the plan is established.

    b. Nottingham Enterprises establishes a plan with assets held by a clearing agency for the benefit of the participants and their beneficiaries.

    c. Oshman Funding establishes and maintains a plan pursuant to an oral agreement between the owners and the plan trustee.

    d. Penny's Pets establishes a plan funded by assets held by an insurance company and makes arrangements for those assets to be held in trust.

21. Should a company consult legal counsel while designing a qualified retirement plan?

    a. Yes, because a plan is a legal contract.

    b. No, as long as the plan is able to meet IRS requirements.

    c. Yes, if vesting is to be allowed.

    d. No, unless the plan is for a flow-through entity.

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.)**

20. In which of the following scenarios, has the company met one of the qualifications for establishing a qualified retirement plan? **(Page 60)**

    a. Mendelson Brothers provides a Summary Plan Description to all executives and highly compensated employees when the plan is established. [This answer is incorrect. A qualified plan's Summary Plan Description must be provided to all employees when the plan is established.]

    b. Nottingham Enterprises establishes a plan with assets held by a clearing agency for the benefit of the participants and their beneficiaries. [This answer is correct. The assets of a qualified plan must be held in trust for the benefit of participants and beneficiaries. In addition to a clearing agency, the assets may be held by a bank or trust company subject to the supervision of the United States or a state, a broker or dealer registered under the Securities Exchange Act of 1934, or a nominee of any of these.]

    c. Oshman Funding establishes and maintains a plan pursuant to an oral agreement between the owners and the plan trustee. [This answer is incorrect. Under the ERISA regulations, qualified retirement plans have to be established and maintained pursuant to a written instrument.]

    d. Penny's Pets establishes a plan funded by assets held by an insurance company and makes arrangements for those assets to be held in trust. [This answer is incorrect. There are several exceptions to the requirement that a qualified plan's assets must be held in trust. One of these exceptions is assets held by an insurance company. The other two exceptions are assets of a plan established by a sole proprietorship or partnership that covers the sole proprietor or partners and their employees that is held under a custodial account pursuant to IRC Sec. 401 (f) and insurance policies or contracts issued by an insurance company qualified to do business in a state.]

21. Should a company consult legal counsel while designing a qualified retirement plan? **(Page 60)**

    a. Yes, because a plan is a legal contract. [This answer is correct. A qualified retirement plan is a legal contract between employees and their employer, so it stands to reason that the company should consult legal counsel while designing the plan.]

    b. No, as long as the plan is able to meet IRS requirements. [This answer is incorrect. One important issue in designing a qualified retirement plan is meeting the specific IRS and ERISA requirements; however, meeting these requirements is separate from the consideration of the need to consult legal counsel.]

    c. Yes, if vesting is to be allowed. [This answer is incorrect. There are many plan design issues that must be considered, including the type of plan the company should adopt, setting eligibility requirements, and vesting, among other things. However, the plan design issues are separate considerations from the need to consult legal counsel while developing the plan.]

    d. No, unless the plan is for a flow-through entity. [This answer is incorrect. Flow-through entities (e.g., S corporations, LLCs, and partnerships) and self-employed individuals have special issues in regards to establishing and maintaining a qualified retirement plan. However, this issue is unrelated to the need for the company to consult legal counsel while designing the plan.]

PLAN DOCUMENTS

Why Is the Plan Document So Important?

While the Internal Revenue Code and ERISA set forth the requirements and available options for qualified retirement plans, it is through the plan document that the plan complies with these requirements and states which options have been adopted. The plan must operate in accordance with the terms of its document.

Types of Plan Documents

Employers seeking to adopt a qualified plan have several choices of type of document to use. An individually designed plan allows the most flexibility but can be quite costly to develop and maintain. Furthermore, the determination letter process can be expensive for such plans. A less expensive method is to adopt a master/prototype plan (M&P Plan) or Volume Submitter plan (VS Plan).

Employers who adopt M&P or VS plans that are identical to an approved M&P or VS specimen plan and select only options permitted under the terms of the approved plan can rely on a favorable letter issued to the sponsor or volume submitter practitioner. The reliance that is given based on the favorable letter extends to nonstandardized plans, standardized plans, and volume submitter plans not departing significantly from the specimen plan. The reliance is equivalent to a favorable determination letter for all purposes, including such applications as the Employee Plans Compliance Resolution System (EPCRS). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), addresses the issue of reliance by employer plans, that do not have their own favorable determination letters, on the underlying prototype and volume submitter documents in respect to asset protection in bankruptcy afforded to qualified plans.

Prototype Plans. A prototype plan is developed by the sponsoring organization (typically banks, credit unions, regulated investment companies, lawyers, accountants, or third-party administrators) and either partially or completely preapproved by the IRS. It is typically in a *check-the-box* format with a preprinted plan document. This type of document can be used to either initially establish a plan or to amend or restate an existing plan.

An M&P may be either a standardized or nonstandardized plan, depending on the elections allowed by the document. A standardized plan is one that meets specific requirements relating to coverage, eligibility, participation, contributions, and allocation methods. Essentially, such plans are designed to guarantee the coverage and nondiscrimination requirements are met. Therefore, design options are fairly limited. Nonstandardized plans have more design options and tend to rely on testing to pass the coverage and nondiscrimination requirements.

Master Plans. A master plan is a single trust or custodial account that combines several employer plans in a single account for joint use of all adopting employees. It has the same features as a prototype plan, including the option of using a standardized or a nonstandardized arrangement. The difference between a prototype plan and a master plan is that a prototype plan establishes a separate funding account for each employer plan, while a master plan combines several employer plans.

Volume Submitter Plans. This specimen plan has features of both an individually designed, or customized, plan and a prototype plan. The bulk of the document is standardized and is submitted to the IRS for preapproval. However, the document can be changed to meet an employer's specific needs. Once the employer has adopted the plan and completed the document, it may be sent to the IRS for approval. However, the IRS user fee for a determination letter for a volume submitter plan is significantly lower than that of a customized plan since it has been previously approved in part.

Synopsis of Qualified Plan Provisions

Qualified retirement plans are required to have a written plan document spelling out their terms. As this document is the primary source of plan provisions, it is essential that a current signed copy be available for easy reference and that it be consulted before any plan engagement is begun or when dealing with matters involving the plan. Doing so will enable the practitioner to determine the type of plan, trustee information, and provisions specific to the plan—such as eligibility, vesting, and allocation formulas—all of which are necessary to properly perform engagements, such as allocating contributions, compliance testing, Form 5500 preparation, and answering client questions.

To ensure that pertinent plan information is readily available and efficiently accessed, it is a good idea to take the time to read and summarize the plan document when the file is set up. The summary should be kept current and carried forward to be used year after year. Taking time up front to summarize plan provisions should help all involved to better understand the plan, quickly answer client or employee questions, and easily verify pertinent information. Getting staff involved should also help them learn how to read and decipher plan documents and better understand the various types of plans and how they function.

DETERMINATION LETTERS

A determination letter is a written statement by the IRS in response to a written inquiry about whether a plan is qualified under IRC Sec. 401(a) (i.e., the plan qualifies in form). Among other things, qualification means that the employer's contributions to the plan are deductible, the plan's investment earnings are exempt from regular income tax, and participants are not taxed until they receive distributions from the plan. In addition, submission of a Schedule Q (Elective Determination Requests) can secure a determination with respect to various operational issues and qualification requirements relating to minimum participation, coverage and nondiscrimination.

The determination letter does not mean the IRS will qualify a plan throughout its existence. It is only a finding that the plan qualifies in form at the time the IRS issues the letter. The determination letter may not be relied upon if a significant change in plan coverage results from plan operations. Furthermore, a plan that has received a favorable determination letter could lose its qualified status if it does not operate according to the plan document and the qualification requirements or if the plan is not timely amended for a required amendment.

Benefits Provided by Favorable Determination Letters

Although a plan may be considered a qualified plan under IRC Sec. 401(a) without requesting a determination letter from the IRS, a favorable determination letter is generally advisable because it provides the following assurances:

a. A plan with a favorable determination letter may be less likely to be audited than a plan for which a determination letter was not received.

b. If the plan is disqualified during an IRS audit because of a plan document failure (but not an operational failure), the disqualification will not be retroactive if the noncomplying provision was disclosed in the request for application of the determination letter.

c. The IRS reviews the application and points out any part of the plan that might possibly result in discriminatory operation of the plan, thus allowing the applicant time to correct that area of the plan. In this case, the applicant will be given an opportunity to correct the defect by plan amendment, thereby returning the plan to qualified status.

d. If the plan has a current determination letter or can rely on the document sponsor's letter and it inadvertently fails to follow the terms of its document (referred to as an operational failure), it can use the SCP and VCP programs of the IRS Employee Plans Compliance Resolution System (EPCRS) to correct the failure. Without a determination letter, only the VCP or Audit CAP programs are available for operational failures.

Employers who adopt M&P or VS plans can rely on a favorable letter issued to the sponsor of the plan document (within specific limits) if the employer adopts a plan that is identical to an approved M&P or a VS specimen plan and chooses only options permitted under the terms of the approved plan.

Qualification in Operation

To continue to qualify after the determination letter is issued, the plan must operate in accordance with the law and regulations pertaining to retirement plans (e.g., nondiscrimination requirements). Generally, a plan will meet this requirement if it operates according to the terms under which the determination letter was issued, provided the law in effect at the time of determination remains unchanged, and the demographics of the covered employee population are not materially altered.

Limitations on Use of Determination Letter

Although a favorable determination letter may provide some assurance concerning deductions for employer contributions, it does not mean that contributions are necessarily deductible as made. This can only be determined based on an examination of the employer's income tax return in accordance with the IRC Sec. 404 limitations.

Generally, a plan's qualification will not be adversely affected by the publication of a revenue ruling, a revenue procedure, or an administrative pronouncement after the plan's prior qualification. (All plans, however, must be amended to comply with the published revenue ruling for subsequent years.) However, even if an applicant received a favorable determination letter, that letter cannot be relied on in the following situations:

a. The applicant misstated or omitted material facts.

b. Subsequent facts are materially different from the facts on which the determination was made.

c. The law was changed.

d. The employer cannot establish that the plan acted in good faith in relying on the determination letter.

SELF-STUDY QUIZ

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

22. The Amberleigh Foundation needs a retirement plan that takes less time to administer, and, thus, would prefer to limit the testing necessary to ensure that it meets the nondiscrimination and coverage requirements. The foundation would prefer a plan that is easy to set up, and it does not want to spend much time or expense seeking approval of the plan from the IRS. Which of the following plan types would best meet the foundation's needs?

    a. A customized plan.

    b. A standardized prototype plan.

    c. A nonstandardized master plan.

    d. A volume submitter plan.

23. A plan can be considered qualified under IRC Sec. 401(a) without requesting a determination letter from the IRS. Which of the following is a benefit that would encourage a plan to request a determination letter anyway?

    a. Determination letters are relatively simple and inexpensive to obtain.

    b. A determination letter means that the IRS has qualified the plan throughout its existence.

    c. The determination letter ensures contributions are deductible as made.

    d. Having a determination letter means that the plan is less likely to be audited.

24. Under which circumstances could a plan use the SCP or VCP programs of the IRS Employee Plans Compliance Resolution System (EPCRS) to correct an inadvertent failure to follow the terms of its plan document?

    a. When it has a favorable determination letter.

    b. When it has submitted a Schedule Q.

    c. If it is a master or prototype 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.)**

22. The Amberleigh Foundation needs a retirement plan that takes less time to administer, and, thus, would prefer to limit the testing necessary to ensure that it meets the nondiscrimination and coverage requirements. The foundation would prefer a plan that is easy to set up, and it does not want to spend much time or expense seeking approval of the plan from the IRS. Which of the following plan types would best meet the foundation's needs? **(Page 65)**

    a. A customized plan. [This answer is incorrect. This type of plan document is the most flexible, but it can also be expensive to develop and maintain. Going through the process to get a determination letter from the IRS that approves a customized plan can be expensive, as well. Therefore, a customized plan would not be appropriate for the Amberleigh Foundation.]

    b. A standardized prototype plan. [This answer is correct. A standardized plan meets specific coverage, eligibility, participation, contribution, and allocation method requirements. Therefore, the foundation would not have to rely on testing to pass the coverage and nondiscrimination requirements. Because a prototype plan is developed by the sponsoring organization and preapproved by the IRS, the foundation would also not have to spend as much time or money setting up the plan or going through the determination letter process.]

    c. A nonstandardized master plan. [This answer is incorrect. A master plan would meet some of the Amberleigh Foundation's requirements, but master plans are a single trust or custodial account combining several employer's plans into a single account. A one employer plan would be sufficient for the foundation. Also, a nonstandardized plan must rely too much on testing to determine of the plan meets the nondiscrimination requirements to meet the foundation's requirements in that regard.]

    d. A volume submitter plan. [This answer is incorrect. Because of its ability for customization, a volume submitter plan is flexible. However, in this scenario, the volume submitter plan would not be appropriate because the foundation would still have to have the plan approved by the IRS, even if the cost of the determination letter process is less than that of some of the other plan options.]

23. A plan can be considered qualified under IRC Sec. 401(a) without requesting a determination letter from the IRS. Which of the following is a benefit that would encourage a plan to request a determination letter anyway? **(Page 66)**

    a. Determination letters protect a plan against future law changes. [This answer is incorrect. To continue to qualify once the determination letter has been issued by the IRS, the plan must operate in accordance with the law and regulations that pertain to retirement plans. If a law is changed, the plan may have to be amended.]

    b. A determination letter means that the IRS has qualified the plan throughout its existence. [This answer is incorrect. The plan cannot rely on the determination letter if plan operations result in a significant change in plan coverage or if it does not operate in accordance with the qualification requirements.]

    c. The determination letter ensures contributions are deductible as made. [This answer is incorrect. A favorable determination letter provides some assurances about deductions for employer contributions, but only an examination of the employer's income tax return in accordance with IRC Sec. 404 limitations ensures that they are deductible as made.]

    d. Having a determination letter means that the plan is less likely to be audited. [This answer is correct. This is one of the benefits of obtaining a determination letter. Another benefit is that when issuing the determination letter, the IRS reviews the application and points out parts of the plan that might result in discriminatory operation of the plan, which allows the applicant time for corrections.]

24. Under which circumstances could a plan use the SCP or VCP programs of the IRS Employee Plans Compliance Resolution System (EPCRS) to correct an inadvertent failure to follow the terms of its plan document? **(Page 66)**

    a. When it has a favorable determination letter. [This answer is correct. Without a favorable determination letter, the plan only has the VCP or Audit CAP programs as options for correcting operational failures.]

    b. When it has submitted a Schedule Q. [This answer is incorrect. The Schedule Q can secure a determination with respect to various operational issues, but it is not related to error correction.]

    c. If it is a master or prototype plan. [This answer is incorrect. The type of plan document used by the employer (master, prototype, volume submitter, or customized) does not have any bearing on whether the plan can use the SCP or VCP EPCRS programs. However, if the plan is a master or prototype plan, it can rely on the determination letter issued to the sponsor of the plan document.]

OBTAINING A DETERMINATION LETTER

The procedure for obtaining a determination letter is quite involved. Often, an attorney or third-party administrator will handle the determination letter process. Accordingly, this discussion describes the general steps in that process but does not provide detailed guidance. Generally, there are two steps involved in applying for a determination letter for a plan: (a) requesting a determination letter from the IRS and (b) notifying interested parties of the application.

Which Plans Need Not File

The IRS has issued guidance regarding which plans need not apply for determination letters. The IRS indicated that in most cases employers who adopt previously approved M&P or VS plan documents without modifications can rely on the favorable letters received by the document sponsors. This reliance is equivalent to a favorable determination for all purposes, including the Employee Plans Compliance Resolutions System (EPCRS) and covers both standardized and nonstandardized documents.

Conditions for Reliance

Reliance is more limited for non-standardized prototype plans than for standardized and *safe harbor* non-standardized prototypes. All of the following conditions must be met to have reliance on an opinion letter:

a. The employer must adopt a prototype or volume submitter plan that has obtained a GUST opinion/advisory letter and has been amended to reflect the definition of compensation under IRC Secs. 414(s) and 415(c)(3).

b. The employer adopts the prototype or volume submitter plan in identical form, and chooses only options permitted by the plan.

c. Adoption of the prototype or volume submitter plan is a restatement of an existing plan, the plan being restated was in compliance with pre-GUST law, the plan complied with GUST in operation, and the amended plan provides the appropriate retroactive effective dates to comply with GUST.

d. The plan in operation did not continue to apply the family aggregation rules after the 1996 plan year.

e. The plan in operation did not continue to apply the IRC Sec. 415(e) combined plan limitation in post-1999 limitation years.

f. If the plan being adopted is a volume submitter plan, the employer adopted the plan after the advisory letter was issued.

g. The employer does not modify the trust agreement in a manner that would cause the plan to fail to be qualified.

The IRS announced that adopting employers using prototype and volume submitter defined contribution plans for which opinion and advisory letters were issued on March 31, 2008, have until April 30, 2010 to adopt the EGTRRA-approved plan document. The end of plans' remedial amendment cycle for such employers with respect to EGTRRA and the changes in plan qualification requirements on the 2004 Cumulative List is April 30, 2010.

Rev. Proc. 2005-16 (as modified by Rev. Proc. 2007-44) provides the rules for the application of determination letters for M&P and VS plans. Rev. Proc. 2007-44 implemented a system of staggered remedial amendment periods for pre-approved and individually designed plans. Under this system, every individually designed plan qualified under IRC Sec. 401(a) has a regular, five-year remedial amendment cycle. The cycles are staggered and spread over five-year periods. The cycles commence in different years for different plans within a five-year period, so that different plans have different cycles. Thus, plan sponsors generally are required to apply once every five years. In addition, M&P and VS plans generally have a six-year remedial amendment cycle. Sponsors, practitioners, and adopters of M&P and VS plans should apply for new opinion, advisory, or determination letters once every six years. M&P and VS defined contribution plans have different six-year cycles than M&P and VS defined benefit plans.

What to File

An applicant for a determination letter must file the appropriate form and all attachments/documents required by the form and its instructions. Generally, a request for an initial qualification determination of an individually designed plan is submitted on Form 5300 (Application for Determination for Employee Benefit Plan). For pre-approved prototype and volume submitter plans, Form 5307 is used. Certain attachments and demonstrations such as Schedule Q (Elective Determination Requests) are optional and must accompany the determination request only if a sponsor is requesting a determination letter covering both the form requirements as well as coverage and nondiscrimination requirements. Form 8717 (User Fee for Employee Plan Determination Letter Requests), along with the applicable payment, must also be attached. However, an application for a determination letter upon plan termination, with IRS Form 5310 (Application for Determination for Terminating Plan), must include a schedule providing certain information regarding employees who separated from vesting service with less than 100% vesting. Other attachments may also be necessary.

Revenue Procedure 2009-6 is part of a series of procedures that the IRS updates annually (usually in January) on the issuance of determination letters on the qualified status of employee plans. Another procedure in this series, Rev. Proc. 2009-8, indicates what user fee must be paid to the IRS for each type of determination application. This guidance is also usually updated in January.

When to File

Requests for determination should be filed on or before the extended due date of the employer's tax return for the taxable year that the determination application relates to (i.e., the year of plan adoption, amendment, or termination) or by such later year as specifically allowed by IRS rules. The application is considered made on the date it is received by the IRS. If the application is mailed, it is considered received on the date of the postmark, certification, or registration. If filed by this deadline, the IRS will grant additional time to retroactively adopt any necessary amendments to the plan that the IRS may require resulting from its review of the request. The period of time during which a plan may be retroactively amended to meet the qualification rules is known as the *remedial amendment period*.

An employer may voluntarily file after this deadline under the IRS Voluntary Correction Program (VCP) as a 'late amender' to maintain plan qualification; late amenders filing within one year of the deadline pay 50% of the normal fee. If the IRS uncovers the failure to file timely outside of a VCP submission, the issue must be resolved through the audit CAP component of the EPCRS, with a larger sanction.

User Fees for Determination Letters

Form 8717. Required user fees and Form 8717 (User Fee for Employee Plan Determination Letter Request) must accompany a request for determination. Form 8717 includes a certification section for small employers who qualify for an exemption from user fees. A request for determination not accompanied by a user fee, if required, will be returned by the IRS.

User Fee Amounts. The user fee amount depends on the type of form filed and the type of testing applied. The IRS generally issues a revenue procedure setting forth user fees in the first Internal Revenue Bulletin each year. However, the IRS can modify these user fees at any time during the year. If they do so, the modification will be issued in the form of another revenue procedure. The current user fee schedule is provided in Rev. Proc. 2009-8.

Small Employer Exemption. An eligible (small) employer with no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year is exempt from paying the otherwise applicable IRS user fees generally imposed on an application for a determination letter, provided there is at least one NHCE and that the application is submitted in the first five years of the plan or, if later, the end of the remedial amendment period that begins within the first five plan years with respect to the plan. Additional guidance includes the following:

a. User fees are not eliminated for any opinion or advisory letter request made by a sponsor of any master or prototype or volume submitter specimen plan that the sponsor intends to market to participating employers.

b. A plan spun off from another plan will be treated as if it were in existence on the first day of the plan from which it was spun off was in effect. A plan established from a merger of two or more plans will be treated as if it were in existence on the earliest date any of the merged plans was in effect.

c. Employers aggregated under IRC Sec. 414(b), (c), or (m) are treated as a single employer, and leased employees defined under IRC Sec. 414(n) are treated as employed by the employer.

d. Determination of an eligible employer is made as of the date the determination request is made. The employer must have no more than 100 employees who received at least $5,000 of compensation from the employer for the calendar year immediately preceding the calendar year in which the determination letter request is filed (the preceding calendar year). In addition, the plan must have at least one NHCE for the plan year immediately preceding the plan year in which the determination letter request is filed (preceding plan year).

e. All employees, including self-employed individuals described in IRC Sec. 401(c)(1), employed during the preceding calendar year are taken into account. Employees excluded under IRC Sec. 410(b)(3) because they are covered by a collective bargaining agreement or are nonresident aliens who received no earned income from sources within the United States are taken into account in determining whether the employer is an eligible employer. Employees not satisfying the plans minimum eligibility requirements must also be taken into account.

f. The user fee for a determination letter application for a multiple employer plan is not eliminated unless each employer that maintains the plan is an eligible employer, even if the application is for a letter only for the plan and not for any employer that maintains the plan.

g. Individually designed defined contribution plans are assigned a filing cycle, with cycles C and D required to file by January 31, 2009 and January 31, 2010 respectively. Requests for individual determination letters for pre-approved defined contribution plans may now be filed for EGTRRA.

Notifying Interested Parties

Before the IRS will issue an advance determination as to the qualified status of plans, the applicant must provide satisfactory evidence that the applicant has notified all interested parties of the application for the determination letter. *Interested parties* include current employees that are eligible to participate in the plan and all other current employees whose principal place of employment is the same as any eligible employee. For certain small employers with plans that cover a principal owner, interested parties include all present employees without regard to whether they are eligible to participate in the plan.

Interested Parties for Plan Termination Purposes. In the case of a determination letter for a plan termination, interested parties generally include all employees with accrued benefits under the plan, all former employees with vested benefits under the plan, and all deceased participants' beneficiaries currently receiving benefits under the plan.

Method of Giving Notice

Notice may be provided to present employees, former employees, or beneficiaries who are interested parties by any method reasonably calculated to ensure that each interested party is notified of the application for a determination. The notice may be provided through an electronic medium under a system that satisfies the requirements of Reg. 1.402(f)-1 Q&A-5.

Timing of Notice. The notice must be given at least 10 days but not more than 24 days before the date on which the determination application is made.

Employees Covered by a Collective-bargaining Agreement. If the interested party is a present employee who is in a unit of employees covered by a collective-bargaining agreement, notice must also be given to the collective-bargaining representative of the interested party.

Information to Be Provided

General Rules. The following information must be provided to the interested parties:

a. A brief description identifying the class or classes of interested parties to whom the notice is addressed (e.g., all present employees).

b. The plan name, identification number, and the name of the plan administrator.

c. The name and taxpayer identification number of the applicant.

d. A statement that the application for determination as to the qualified status of the plan is to be made to the IRS for initial qualification, plan amendment, plan termination or partial termination, and the address of the Employee Plans (EP) Determinations where the application will be submitted. Currently, all applications are filed with the EP unit in Covington, Kentucky.

e. A description of the class of employees eligible to participate under the plan.

f. A statement as to whether the IRS has issued a previous determination on the plan's status.

g. A statement that any person to whom the notice is addressed is entitled to submit to EP Determinations (or request the Department of Labor to submit) a comment on the qualification of the plan and information on the procedures for making such comment.

h. The specific dates by which a comment to EP Determinations or a request to the Department of Labor must be received.

i. A statement outlining the procedures under which any other available information required will be made available to the interested parties.

j. The number of interested parties needed for the Department of Labor to comment.

A sample notice prepared by the IRS incorporating this information can be found in the Exhibit attached to Rev. Proc. 2009-6.

In addition, the applicant must make the following items available to interested parties:

a. An updated copy of the plan and the related trust agreement, if any.

b. The application for determination.

c. A copy of Rev. Proc. 2009-6, Sec. 17.

Exception for Certain Small Plans. If a plan has fewer than 26 participants, the employer is allowed to substitute for the plan document and determination letter application, a document containing the information listed in the "General Rules" paragraph above along with the following information:

a. Participation and benefit accrual eligibility requirements.

b. Vesting provisions.

c. Circumstances resulting in ineligibility or denial or loss of benefits.

d. Plan financing and the identity of any organization through which benefits are provided.

e. Optional benefit forms reduced or eliminated by plan amendment.

f. Whether the coverage requirement is satisfied.

Receipt of Notice of Final Determination. Once an interested party receives a notice of final determination, the applicant must (on request from the interested party) make available an updated copy of the plan, the related trust agreement (if any), and the application for determination.

Rights of Interested Parties

Persons who receive notice as interested parties have the following rights:

a. To submit written comments to the IRS with respect to the qualification of the plan. Such comments must be received by the IRS by the 45th day after the day it receives the application for determination.

b. To request the Department of Labor to submit comments to the IRS on behalf of interested parties. Such request must be received by the DOL by the 25th day after the day the IRS receives the application for determination. If the interested party wishes to reserve the right to comment to the IRS in the event the DOL declines to comment (see item c.), the request must be received by the DOL by the 15th day after the day the IRS receives the application for determination.

c. To submit written comments to the IRS on matters with respect to which the DOL was requested to comment but declined to do so. Such comments must be received by the IRS by the later of the 45th day after the day it receives the application for determination or the 15th day after the day on which the DOL gives notice that it declines to submit a comment on the matter. The comment must in all events be received no later than the 60th day after the day the application for determination is received.

How Long Does It Take to Receive the Determination Letter?

Upon receiving the determination letter request, the IRS will review the request to make sure it is complete. If the request is complete, the IRS will acknowledge the receipt of the request and also provide an estimate of the time the IRS will take to process the request (usually 145 days). The IRS has 270 days to act on the determination letter request. The IRS will wait at least 60 days after the application is received to allow time for comments by interested parties.

If an applicant requesting a determination letter does not comply with all the required provisions, the IRS may return the application and point out to the applicant those provisions that have not been met. The request will also be returned if the correct user fee as shown in Rev. Proc. 2009-8 is not attached. If such a request is returned to the applicant, the 270-day period will not begin to run until such time as the correct user fee is paid. In practice, the IRS often contacts the Power of Attorney and allows the person to cure minor omissions without returning the entire application.

Special Rules for Affiliated Service Groups and Leased Employees

Generally, a determination letter does not consider whether an employer is a member of an affiliated service group or the recipient of services of leased employees. If the employer wants these issues to be considered, it must specifically request so and include sufficient information with the application to allow such a determination. Form 5300 (with Schedule Q optional) is submitted for a request on affiliated service group or leased employee status. Form 5307 cannot be used for this purpose.

Appealing an Adverse Opinion

If the Covington, Kentucky office issues an adverse determination letter, the applicant can usually appeal to the IRS appeals office. The appeal must be submitted to the key district director in writing within 30 days of issuance of the notice of proposed determination. However, no appeal is available if the adverse determination is issued based on technical advice of the IRS National Office.

Once administrative appeals within the IRS itself have been exhausted, the adverse determination may be appealed to the Tax Court for a declaratory judgment that the plan is qualified. This avenue of appeal is only available if (a) there is an actual controversy involving the IRS's determination with respect to the initial or continuing qualification of a plan or (b) a failure by the IRS to make a determination on such initial or continuing qualification if the controversy arises from a plan amendment or termination. An appeal to the Tax Court can only be filed by an employer, plan administrator, or an employee who qualifies as an interested party.

Exhaustion of administrative remedies. All administrative remedies are considered exhausted only when the determination letter applicant has performed the following:

a. Filed a completed determination application that meets the outlined requirements.

b. Given notification to all interest parties.

c. Appeals proposed adverse determination from the district direct.

d. Requests IRS National Office consideration for of the district director's proposed adverse determination when upheld by the Assistant Regional Commissioner.

DETERMINATION LETTER PROCEDURES FOR EMPLOYERS THAT ADOPT MASTER, PROTOTYPE, AND VOLUME SUBMITTER PLANS

Master and Prototype Plans

Basically, master and prototype plans (M&P plans) are written to be adopted by many unrelated employers. M&P plans are typically sponsored by banks, credit unions, or regulated investment companies (referred to in this discussion as sponsoring organizations) while prototype plans are also sponsored by other service providers, such as lawyers, accountants, or third party administrators.

Simplified Process. The IRS provides a simplified process for determining the qualification status of M&P plans. Specifically, the sponsoring organization files a request for an opinion letter in the case of an M&P plan, using the Form 4461 series. The IRS will then issue the opinion letter to the sponsoring organization.

The opinion letter is a statement as to acceptability of the plan; it is not a determination as to the qualification of the plan or the exempt status of the underlying trust or custodial account. However, if the plan is a *standardized* plan, adopting employers can usually rely on the opinion letter as evidence that the plan is a qualified plan, thereby avoiding the need for a separate determination letter request. However, if the employer has ever maintained a plan that is not part of a paired plan with this prototype and/or had previously maintained a defined benefit plan, a determination letter is necessary if the employer wants assurance that the plan in its situation qualifies.

A standardized form plan is a plan that meets specific requirements relating to coverage, eligibility, participation, compensation, contributions, and vesting. Essentially, such plans are designed to guarantee the coverage and nondiscrimination requirements are met. Therefore, design options are fairly limited.

An M&P plan will lose its M&P status should the sponsoring organization cease to support it. For example, this would occur if the plan ceases to use the investment services of the sponsor (i.e., it changes brokers). In the majority of these situations, the plan document does not need to be replaced because it contains all the necessary qualification and operating provisions. However, if the adopting employer never applied for or received an individual favorable determination letter for the plan, the plan is considered an individually designed arrangement without a favorable determination as to the plan's qualified status. On the other hand, if the adopting employer had secured a favorable determination letter while the plan still had M&P or regional prototype sponsorship, the fact that it lost sponsorship would not adversely affect the plan's qualified status. However, if an amendment was required subsequent to the date on which the adopting employer terminated its relationship with the M&P sponsor, and the adopting employer did not individually make that amendment (because the M&P sponsor would not be automatically providing that amendment to the employer after the relationship terminated), there could be a plan document failure.

Employers with M&P plans that lose sponsorship should move the plan to a sponsoring organization that is continuing to sponsor M&P plans as quickly as possible, and perform a comprehensive review of the plan to ensure it is fully updated as to all existing qualification requirements.

Determination Procedures for Volume Submitter Plans

Volume submitter plans have features of both an individually designed plan and prototype plan. The bulk of the document is standardized and submitted by the sponsor to the IRS for preapproval. However, the document can be customized to meet an employer's specific needs by using alternate provisions, which have also been submitted to the IRS for preapproval.

Basically, with volume submitter plans, the sponsor develops a specimen plan and alternate provisions, which it submits to the IRS for preapproval in the form of an advisory opinion. Employers can then adopt the specimen plan along with the alternate provisions of their choosing. They can also add a limited number of individually designed features. However, too many deviations from the approved model will cause the plan to be an individually designed plan (rather than a volume submitter plan).

Any firm can request an advisory letter for a volume submitter specimen plan and alternate provisions if the plan will be adopted by at least 30 employers. This requirement is reduced to 10 employers for money purchase plans meeting certain requirements.

Adopting employers of volume submitter plans can generally rely on a favorable advisory letter issued to a volume submitter practitioner if the employer adopts a plan that is identical to an approved specimen plan and chooses only options permitted under the terms of the approved plan. These employers can forego filing Form 5307 and rely on a favorable advisory letter issued to the volume submitter practitioner with respect to most basic qualification requirements. However, in certain cases where the employer maintains or has ever maintained another plan covering some of the same participants, reliance is limited. There is no reliance provided for the requirements of IRC Secs. 401(a)(4), 401(a)(26), 401(l), 410(b), or 414(s). If the employer maintains or has ever maintained another plan covering some of the same participants they cannot rely on a favorable opinion or advisory letter with respect to the requirements of IRC Secs. 415 or 416. This may or may not be a concern for an employer. If an employer wishes to not file Form 5307 a careful review of IRS Ann. 2001-77 (as modified by Rev. Proc. 2005-16; as modified by Rev. Proc. 2007-44) should be made to determine that employer's situation will provide the desired reliance for their plan.

Unlike master or prototype plans, there are no standardized volume submitter specimen plans.

SELF-STUDY QUIZ

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

25. Mary administers a retirement plan and is in the process of filing for a determination letter. The plan she administers is a plan that the employer customized. Which form should Mary use when filing for the letter?

    a. Form 5300.

    b. Form 5307.

    c. Form 5310.

    d. Schedule Q.

26. In which of the following scenarios would the employer be exempt from paying the user fee for its qualified plan's determination letter?

    a. Howard Mutual provides master and prototype plans for other businesses to adopt. It files for a determination letter for a plan that it intends to market within the next year.

    b. Promised Lands has 57 employees that received at least $5,000 of compensation from the employer last year. Thirty of these employees are nonhighly compensated employees. The plan was established in 2008, and the determination letter application is filed in 2009.

    c. Flower Power has 85 employees that received at least $5,000 of compensation from the employer last year, and it also covers 20 independent contractors that received roughly the same amount. The plan was established in 2007, and the determination letter application is filed in 2009.

    d. The Karlsberg Corporation maintains a multiemployer plan that covers four employers under the corporation's umbrella. Three of those employers are eligible for the user fee exemption and the determination letter is requested for the plans, not the individual employers.

27. When an entity is filing for a determination letter, which of the following scenarios meets the qualifications for giving notice established by the IRS?

    a. The Tidwell Company applies for a determination letter on April 27, 2009, and gives notice on April 1, 2009.

    b. Buntington, Inc., provides notice to interested parties via an electronic medium.

    c. GaterCo provides notice to all employees except for those covered by a collective-bargaining agreement.

    d. Whammy! does not provide interested parties a statement as to whether the IRS ever issued a previous determination on the plan's status.

28. Kenworth-Powers, a plan with less than 26 participants, must provide notice of a retirement plan amendment to interested parties. Which of the following is one of the items that must be included in the notification?

    a. Participation and benefit accrual eligibility requirements.

    b. Written comments submitted to the IRS with respect to the plan's qualification.

    c. The number of interested parties needed for the Department of Labor to comment.

    d. A request for issues related to affiliated service groups or leased employees to be considered.

29. Lariats & Lassos (L&L) recently established its first retirement plan—a standardized prototype plan. Which of the following best illustrates the process L&L must follow to obtain IRS approval for its new plan?

    a. The company must file for its own determination letter from the IRS.

    b. The company can rely on the plan sponsor's advisory letter.

    c. The company can rely on the plan sponsor's opinion letter.

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. Mary administers a retirement plan and is in the process of filing for a determination letter. The plan she administers is a plan that the employer customized. Which form should Mary use when filing for the letter? **(Page 73)**

    a. Form 5300. [This answer is correct. Generally, a request for the initial qualification determination of an individually designed plan, such as the plan Mary administers, is submitted on Form 5300. This form is titled Application for Determination for Employee Benefit Plan.]

    b. Form 5307. [This answer is incorrect. Form 5307 is used for pre-approved prototype and volume submitter plans.]

    c. Form 5310. [This answer is incorrect. Form 5310 is an application for a determination letter for a plan that is terminating.]

    d. Schedule Q. [This answer is incorrect. Schedule Q is an optional attachment to the request for a determination letter. Schedule Q and Elective Determination Requests must only accompany the request for the determination letter if the sponsor is requesting a determination letter that covers both form requirements and coverage and nondiscrimination requirements.]

26. In which of the following scenarios would the employer be exempt from paying the user fee for its qualified plan's determination letter? **(Page 73)**

    a. Howard Mutual provides master and prototype plans for other businesses to adopt. It files for a determination letter for a plan that it intends to market within the next year. [This answer is incorrect. The sponsor of master or prototype plans or volume submitter specimen plans is not exempt from user fees even if the sponsor plans to market those plans to participating employers.]

    b. Promised Lands has 57 employees that received at least $5,000 of compensation from the employer last year. Thirty of these employees are nonhighly compensated employees. The plan was established in 2008, and the determination letter application is filed in 2009. [This answer is correct. Promised Lands meets all the qualifications for the small employer exemption—less than 100 employees with $5,000 of compensation from the employer last year, at least one nonhighly compensated employee, and the application was submitted in the first five years of the plan.]

    c. Flower Power has 85 employees that received at least $5,000 of compensation from the employer last year, and it also covers 20 independent contractors that received roughly the same amount. The plan was established in 2007, and the determination letter application is filed in 2009. [This answer is incorrect. Self-employed individuals, Flower Power's 20 independent contractors, are taken into account when determining the 100 employees that received at least $5,000 of compensation from the employer last year for the small employer exemption.]

    d. The Karlsberg Corporation maintains a multiemployer plan that covers four employers under the corporation's umbrella. Three of those employers are eligible for the user fee exemption and the determination letter is requested for the plans, not the individual employers. [This answer is incorrect. Even though the corporation is requesting a letter for the plan only, the user fees cannot be waived unless all of the businesses participating in the multiemployer plan are eligible for the fee exemption.]

27. When an entity is filing for a determination letter, which of the following scenarios meets the qualifications for giving notice established by the IRS? **(Page 74)**

    a. The Tidwell Company applies for a determination letter on April 27, 2009, and gives notice on April 1, 2009. [This answer is incorrect. Tidwell meets the qualification that notice must be given at least 10 days before the application is made, but it does not meet the qualification that notice cannot be given more than 24 days before the determination application is made.]

    b. Buntington, Inc., provides notice to interested parties via an electronic medium. [This answer is correct. As long as the electronic medium is part of a system that meets the requirements of Reg. 1.402(f)-1 Q&A-5, it can be used to provide notice.]

c. GaterCo provides notice to all employees except for those covered by a collective-bargaining agreement. [This answer is incorrect. If the company has employees that are part of a collective-bargaining agreement, they must receive notice and their collective-bargaining representative must receive notice, as well.]

d. Whammy! does not provide interested parties a statement as to whether the IRS ever issued a previous determination on the plan's status. [This answer is incorrect. Such a statement is part of the information that must be provided to interested parties. Other information that must be included is the plan name, identification number and the name of the plan administrator, as well as a description of the class of employees eligible to participate under the plan.]

28. Kenworth-Powers, a plan with less than 25 participants, must provide notice of a retirement plan amendment to interested parties. Which of the following is one of the items that must be included in the notification? **(Page 75)**

a. Participation and benefit accrual eligibility requirements. [This answer is incorrect. If a plan meets the small plan exception, the employer can substitute a document containing certain information (including participation and benefit accrual eligibility requirements) for the plan document and the determination letter application.]

b. Written comments submitted to the IRS with respect to the plan's qualification. [This answer is incorrect. Interested parties who receive notification have rights. One of those rights is the ability to submit written comments to the IRS with respect to the plan's qualification. The IRS must receive the comments by the 45th day after the day it receives the application for determination.]

c. The number of interested parties needed for the Department of Labor to comment. [This answer is correct. There is a long list of information that must be provided in the notification to interested party. In addition to the number of interested parties needed for the Department of Labor to comment, other information needed includes the name and taxpayer identification number of the applicant and a statement outlining the procedures under which any other information required will be made available to the interested parties.]

d. A request for issues related to affiliated service groups or leased employees to be considered. [This answer is incorrect. Most determination letters will not consider issues related to affiliated service groups or leased employees. If the employer wants these things considered, it must specifically request such consideration from the IRS and include sufficient information with the application to allow the determination. Form 5300 and Schedule Q are submitted for a request on either one of these issues—Form 5307 cannot be used in this circumstance.]

29. Lariats & Lassos (L&L) recently established its first retirement plan—a standardized prototype plan. Which of the following best illustrates the process L&L must follow to obtain IRS approval for its new plan? **(Page 77)**

a. The company must file for a determination letter from the IRS. [This answer is incorrect. Only a company with a customized or individually designed plan must go through the process of requesting a determination from the IRS.]

b. The company can rely on the plan sponsor's advisory letter. [This answer is incorrect. If the plan will be adopted by at least 30 employers, the sponsor can request an advisory letter for both the specimen plan and any alternate provisions that the company has adopted. A company that adopts a plan identical to the specimen plan and chooses only options permitted under the approved plan's terms can rely on the favorable advisory letter issued to a volume submitter practitioner.]

c. The company can rely on the plan sponsor's opinion letter. [This answer is correct. Master and prototype plans (M&P plans) are written so that they can be adopted by many employers. The sponsor of the plan files a request for an opinion letter for the plan. If the plan is a standardized plan, the adopting employers should be able to rely on the opinion letter as evidence that the plan is a qualified plan. Doing so avoids the need for L&L to file a separate determination letter. However, if L&L had ever maintained a defined benefit plan or a plan that was not part of a paired plan with this prototype, it would need a determination letter from the IRS if the company desired assurance that the plan qualifies in its situation.]

MAINTAINING THE PLAN DOCUMENT

Adopting a plan is not a one-time procedure. The plan document must be maintained and updated for any law changes, new regulatory requirements, or changes the employer wishes to make to the plan. This process of updating the plan document, known as *amending* the plan, is controlled by the provisions of the plan document. Similar to the initial adoption of a plan, any plan amendments must be authorized by the employer and must be in written form. The amendment must be in writing because it is essentially a legal contract between the employer and the plan participants. Unlike an initial adoption, a required "interim plan amendment" may be adopted after the end of the plan year as long as it is adopted by the end of the remedial amendment period, with a retroactive specified date, but discretionary amendments must be adopted by the end of the plan year in which the amendment is effective.

Plan amendments are subject to the following requirements:

a. The plan must be amended for all required legislative and regulatory changes.

b. The amendment cannot decrease a participant's benefit already provided under the plan at the time of amendment.

c. A participant's optional form of benefit generally cannot be decreased or eliminated for benefits accrued at the time of amendment. New guidance has been issued allowing the reduction or elimination of some optional forms of benefits from both defined contribution plans and defined benefit plans.

Discretionary Amendments

A discretionary amendment is *not* required because of a change in the law; rather, it is a change the employer decides to make to the plan. For example, an employer may decide to change the vesting schedule to encourage loyalty among its employees. If employees perceive that the plan is not meaningful because it takes too long to vest, the employer may decide to shorten the vesting schedule. On the other hand, the employer may feel that the schedule does not require enough years and employee turnover would be reduced if the schedule were lengthened. Other features an employer might change include eligibility requirements, the plan's benefit formula, or the plan year-end.

When Must Discretionary Amendments Be Adopted? Generally, discretionary amendments (other than those that qualify for the remedial amendment period) must be adopted in the plan year in which they become effective. Such an amendment cannot reduce a participant's accrued benefit. When an employer wishes to amend the plan in midyear, effective as of the first day of the plan year, the plan must be reviewed to determine whether benefits accrue before the last day of the plan year and, if so, whether the amendment being contemplated would involve such a cutback and whether advance notice is required. However, under certain circumstances, an interim amendment made after the end of the plan year is allowed to have retroactive effect.

Required Amendments

Required amendments are amendments required to maintain the plan's qualified status. For example, a law change affecting qualified retirement plans may make a conforming amendment necessary. An IRS audit of the plan may also result in the need for amendment. Qualification requirements that are violated may be corrected through amending the plan retroactively. Another situation requiring plan amendment is the merger of the plan with that of an acquired company.

When Must Required Amendments Be Adopted? Generally, required amendments must be adopted in the plan year when they become effective. Even if the IRS allows a later amendment of the document, the plan must be operated in accordance with the statutory or regulatory change. Such an amendment cannot reduce a participant's accrued benefit.

For a disqualifying provision or a provision that is integral to a disqualifying provision (even if it would otherwise be a discretionary amendment), an interim amendment must be adopted by the later of (a) the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the remedial amendment period begins, or (b) the last day of the plan year that includes the day on which the remedial amendment period begins.

The Amendment Process

Document amendments are not effective until adopted in a formal, complete, and written form. The plan documents must contain amendment procedures, including the identity of the persons who have authority to amend the plan, and those procedures must be followed. A statement in the plan reserving the sponsor's right to make plan amendments and identifying who has the amendment authority is a valid procedure.

Informal written notices distributed to participants and oral amendments cannot be used to effect an amendment retroactively reducing benefits. In *Smith v. National Credit Union Administration Board*, the corporate board orally amended the plan, increasing the normal retirement age from 62 to 65 and requiring 35 years to earn the maximum benefit under the employer's pension plan. Informal notices distributed to employees did not provide enough information for the participants to determine the effect of the amendments or to protect the interests of the participants and beneficiaries. The plan amendments were formally adopted more than a year later, when an officer of the employer signed a restated version of the plan. The same employer also had a savings plan which, under similar circumstances, was amended to reduce the contribution percentage. An informal notice was distributed to employees, but the plan amendment was not executed until two years later. The 11th Circuit affirmed in both situations that the amendments were not effective until adopted in a formal, complete, and written form.

The conversion of a money purchase plan to a profit sharing plan requires that ERISA 204(h) notice be given to participants. In *Miller Oral Surgery, Inc.*, the company restated its money purchase plan into a discretionary profit sharing plan. Although amendment documents were signed, no notice was given to participants. The court determined that the conversion of the money purchase plan to a discretionary profit sharing plan required that notice be given because the discretionary contribution nature of the amended plan had the potential for substantially reducing the rate of future benefit accruals. Since no notice was given, the court ruled that the pre-amendment terms continued to apply. Further, an egregious failure to give adequate advance notice of reductions in future benefits may entitle affected employees to the better of the prior or amended plans' benefits (*Brady v. Dow Company Retirement Board*, Unpublished 4th Circuit Opinion dated February 18, 2009).

If the amendment is retroactive, the IRS must be notified.

Notifying Employees of Plan Amendments

When a plan is amended, the following notices and reports may need to be given to participants or other interested parties.

a. *Summary Plan Description (SPD).* A notice that must be furnished to each participant explaining the plan, the requirements for participation, benefit accrual and vesting provisions, and its other features.

b. *Updated SPD.* This report must be furnished to plan participants and beneficiaries every fifth year when a plan has been amended in the prior five years or once every ten years when the plan has not been amended.

c. *Summary of Material Modifications (SMM).* This report must be furnished to plan participants and beneficiaries when the terms of the plan are materially modified and an updated SPD is not being provided at that time.

d. *Notice of Plan Amendment to Reduce Future Benefit Accruals.* This notice is required for defined benefit, money purchase pension, target benefit, cash balance, and any other plan subject to the ERISA Sec. 302 minimum funding standards.

e. *Notice to Interested Parties.* If a request for a determination letter is going to be submitted to the IRS, interested parties must be notified.

f. *Notice of Retroactive Plan Amendment to Reduce Accrued Benefits.* This notice is required for plan amendments that retroactively reduce accrued benefits. It must be provided to participants, beneficiaries, employee organizations, and alternate payees. Rev. Proc. 94-42 provides a model statement used as the required notice.

g. *Notice of Plan Merger.* After EGTRRA, many employers no longer needed both a profit-sharing and money purchase pension plan, and so merged the money purchase plan into the profit-sharing plan. Individuals affected by the merger are entitled to prior notice under ERISA Sec. 204(h).

h. *Notice of Safe Harbor Status.* Each employee who is eligible to participate in a safe harbor 401(k) plan must receive written notice within a reasonable period (30–90 days) before the beginning of each plan year. Notice may be given to the effect that a plan may be amended during the plan year to provide that the employer will make a safe harbor non-elective contribution of at least 3% to the plan for the plan year and if the plan is so amended, a supplemental notice will be given to eligible employees 30 days prior to the last day of the plan year informing them of such amendment. The notice must contain specific information set forth in IRS Notices 98-52, 2000-3, and the IRC Sec. 401(k) regulations and include the employee's rights and obligations of the plan.

i. *Notice of Qualified Default Investment.*

j. *Notice of Automatic Enrollment.*

Other reports that may need to be provided to participants when a plan is amended include the following:

a. *Beneficiary Designation.* This form is needed if the amendment adds a death benefit or changes the terms of an existing death benefit.

b. *Self-directed Investment.* This form and explanatory materials meeting the requirements of ERISA Sec. 404(c) are needed if the amendment changes whether self-directed investments are allowed and/or how they are implemented. A form is needed to record a participant's choice of investment options.

c. *Salary Deferral Agreement.* This form is needed if the amendment affects the salary deferrals a participant may make to the plan.

d. *Notice of Blackout Period.* Notice must be provided to participants and beneficiaries under the plan to whom the temporary blackout period applies.

Summary Plan Description (SPD). A Summary Plan Description (SPD) must be furnished to each participant and each beneficiary receiving benefits under a plan. The purpose of the SPD is to explain the provisions of the plan in layman's terms.

A copy of the SPD must be provided to each participant within 90 days after becoming a participant in the plan or first receiving benefits and to each beneficiary within 90 days after first receiving benefits, or (if later) within 120 days after the plan becomes subject to Part 1 (Reporting and Disclosure) of Subtitle B of Title I of ERISA. In general, a plan becomes subject to ERISA when adopted. However, plans excluded from ERISA Title I coverage because they are deemed not to have employees under DOL Reg. 2510.3-3(b) (e.g., plans covering only a sole owner, or a sole owner and spouse, or partners, or partners and spouses) become subject to the SPD requirement when one or more common law employees participate in the plan.

The plan administrator must furnish SPDs to the DOL only if the DOL requests the plan administrator to do so.

Updated SPD. An updated SPD must be furnished to plan participants and beneficiaries every fifth year since the last SPD update if the plan has been amended, even when SMMs have been issued. If it has not been amended, a new SPD must be furnished every 10 years since the last SPD update. The updated SPD must be furnished to participants and beneficiaries within 210 days after the end of the plan year in which the 5- or 10-year period ends.

Example 2-1: Deadline for furnishing an updated SPD for an amended plan.

Craven, Inc., adopts its profit-sharing plan on March 11, 2003, effective January 1, 2003. Plan reporting is done on a calendar year basis. The plan's initial SPD was furnished to the participants on July 9, 2003, the 120th day after the plan became subject to ERISA. The plan was last amended on April 8, 2007, effective as of January 1, 2007.

When must an updated SPD be furnished to the plan participants? Generally, an updated SPD must be furnished every five years. It must include all plan amendments made within that five-year period. The updated SPD must be furnished no later than 210 days after the end of the fifth plan year after distribution of the previous SPD. If no amendments to the plan have been made, another copy of the original SPD must be furnished every 10 years. These notification rules must be followed despite the summary of material modifications (SMM) notification requirements.

Since Craven, Inc.'s plan has been amended, the five-year requirement applies. Thus, an updated SPD must be provided to participants on or before July 29, 2009, the 210th day after the end of the 2008 plan year.

What period is covered by the updated SPD? The updated SPD covers the changes made from January 2, 2003, through January 1, 2009.

Upon receipt of a written request from a participant or beneficiary, the administrator must furnish a copy of the latest updated SPD.

Terminated plans have a special rule about furnishing an SPD or an updated SPD. A plan that has terminated before the due date of an SPD or updated SPD need not furnish an SPD to participants. An employee pension plan is considered terminated when all distributions are completed.

Summary of Material Modifications (SMM). Participants and beneficiaries must be provided with a Summary of Material Modifications (SMM) whenever the terms of the plan have been materially modified, unless an updated SPD is provided. This ensures participants and beneficiaries are notified of changes made to the plan during periods when an updated SPD is not required.

The deadline for furnishing the SMM to participants and beneficiaries is no later than 210 days after the end of the plan year in which the plan change is adopted.

The plan administrator must furnish SMMs to the DOL only if the DOL requests the plan administrator to do so.

Example 2-2: What is a material modification?

Jamescorp has changed the administrator of its defined benefit plan.

Is a change in the administrator a modification to a plan requiring preparation of an SMM? An SMM must be prepared and distributed whenever a material modification to the plan is made or any information that must be included in the SPD is changed. A comprehensive list of basic information relating to the plan must be reported in the SPD, including the name, business address, and telephone number of the plan administrator.

Thus, an SMM must be prepared and distributed reporting the change in plan administrator.

Example 2-3: Deadline for furnishing an SMM for an amended plan.

April Showers, Inc., a fiscal year taxpayer with a June 30 year-end, maintains a money purchase pension plan that also reports on a June 30 year-end.

On July 16, 2009, the plan was amended retroactively to the beginning of the *prior* plan year (July 1, 2008).

When must the SMM showing the amendment to the plan be furnished to the plan participants and beneficiaries? The deadline for furnishing the SMM to the participants and beneficiaries is 210 days after the close of the plan year when the modification to the plan was adopted. It does not matter whether the amendment is made retroactive to a prior plan year.

Thus, the deadline for furnishing the SMM to the participants of April Showers' money purchase pension plan is January 26, 2009, 210 days after the end of the plan year ending June 30, 2009.

A plan that is terminated before the due date of an SPD need not furnish an SPD to participants. The regulation does not mention the SMM for terminated plans. However, it is believed that a similar rule would apply.

Notice of Plan Amendment to Reduce Future Benefit Accruals. An amendment to significantly reduce the rate of future benefit accruals, or eliminate or significantly reduce an early retirement benefit or retirement-type subsidy cannot be made to a defined benefit plan, cash balance plan, or other plan for which an individual account is maintained that is subject to ERISA Sec. 302 minimum funding standards unless advance notice is provided to all plan participants and alternate payees. This notice is referred to as a Section 204(h) notice, and must be available in a manner understood by the average plan participant and to supply sufficient information to enable its recipients to understand the effect of the plan amendment.

The notice must be in writing and include a description of the benefit or allocation formula existing prior to the amendment, a description of the benefit or allocation formula under the plan as amended, and the effective date of the amendment. Generally, the notice must be provided at least 45 days prior to the effective date of the plan amendment resulting in the reduction in benefit accruals. However, plans with fewer than 100 participants may provide the required notice up to 15 days prior to the effective date of the plan amendment without violating the rule. This notice may satisfy the summary of material modifications requirement. A special rule exists for business transactions; an amendment reducing accruals that is adopted in connection with an acquisition or disposition can provide the notice as few as 15 days before the effective date of the amendment [ERISA Sec. 204(h)].

The *plan administrator* is responsible for providing the notice to:

a. All participants.

b. All beneficiaries who are alternate payees under a qualified domestic relations order (QDRO).

c. Employee organizations representing plan participants.

There is an exception for certain retroactive amendments for certain benefit reductions in plans subject to minimum funding.

Expanded Notice Requirements and Excise Tax

Expanded notice requirements are effective for plan amendments that take effect on or after September 2, 2003. ERISA Section 204(h) has been modified to require meaningful disclosure of plan amendments that may cause reduction of future benefit accruals, especially when converting to cash balance plan design. The expanded requirements include IRC Sec. 4980F, which also requires notice to participants and provides for an excise tax for failures to provide adequate information regarding plan design changes.

Notice is provided only to participants (and employee organizations representing those participants) or alternate payees whose rate of future benefit accrual might reasonably be expected to be reduced by the amendment. For example, notice is not required for participants who, prior to the amendment, are not entitled to accrue future benefits under the plan (such as former employees with a vested benefit under the plan). Notice is also not required for employees who are not yet participants in the plan.

This notice must be provided by the plan administrator *after adoption of the plan amendment* and not less than 45 days before the effective date of the plan amendment. Any delivery method ensuring actual receipt of the notice is acceptable. For example, notice may be provided by first class mail, hand delivery, or approved electronic means. Posting of the notice is not acceptable.

Small Plan Rule. For small plans that are reasonably expected to have fewer than 100 participants on the effective date of the amendment, notice may be provided as late as 15 days before the effective date. Notice is not required for plans in which no employees are participants under DOL Reg. 2510.3-3(b), such as plans covering only a sole owner, or a sole owner and spouse, or partners, or partners and spouses.

Failure to Provide Notice. An excise tax of $100 for each day in the noncompliance period applied separately for each applicant individual (not to exceed $500,000) may be imposed for failure to provide the section 204(h) notice. If the failure to provide notice is intentional, or egregious, the plan participants are entitled to the greater of the benefit to which they would be entitled with or without regard to the amendment. In *Romero v. Allstate Insurance Corporation*, the statute of limitations did not begin to run on employees' claims under ERISA Sec. 204(g) that certain plan amendments had eliminated or reduced an early retirement benefit until the employees knew or should have known that such amendment disallowed certain employees' rights. Thus, a claim that Allstate had violated the ERISA Sec. 204(h) notice requirement did not begin to run until such time the employees knew or should have known that a plan amendment had the effect of significantly reducing benefits.

Terminating defined benefit plans subject to title IV of ERISA are deemed to have met the ERISA Sec. 204(h) notice requirements no later than the date of termination provided the participants are notified of the termination and the proposed termination date. Thus, no benefits accrue after termination of the plan. Benefit accruals can be ceased before the plan termination date if the plan is amended and an ERISA 204(h) notice is provided. The required notice can be part of the plan termination notice. It is recommended that all terminating plans be amended and the proper notice be made to insure that benefit accruals cease at the desired date in the event the completion of the termination is delayed. ERISA Sec. 204(h) applies to defined benefit plans, money purchase pension plans, cash balance plans, and target benefit plans. Since money purchase plans and target benefit plans are not subject to ERISA Title IV, following the notice requirements of ERISA Sec. 204(h) as part of the termination process is believed to be a good course of action to ensure benefits do not continue to accrue after the date of termination.

Content of Notice. The regulations describe the information to be provided in the notice. The notice must include sufficient information to allow the participants to understand the effect of the amendment. The notice must be written in a manner calculated to be understood by the average plan participant. For a reduction in the rate of future benefit accrual, the notice must include a description of the benefit formula prior to the amendment and a description of the formula as amended. The effective date of the amendment must also be included in the notice.

Neither ERISA nor the DOL regulations define *a significant reduction in benefits*. According to the courts, a significant reduction can occur even if it concerns only one employee when the reduction is significant with respect to that employee. Whether an amendment significantly reduces the rate of future benefit accrual is determined "based on reasonable expectations taking into account all relevant facts and circumstances," including a comparison of the accrual rates before and after the amendments and other changes in the timing and normal form of benefits.

Example 2-4: Notice requirement.

Jones, Inc. maintains a defined benefit plan that covers less than 100 employees. None of the plan participants are represented by a labor organization. On December 1, 2008, an amendment was adopted that reduced the future benefit accruals of all plan participants from 75% of average compensation payable at a normal retirement age of 65 to 70% of average compensation payable at a normal retirement age of 65. The amendment is to be effective January 1, 2009.

On December 10, 2008, the plan administrator provided the required notice of the amendment adoption to all specified parties. The plan in this example is a small plan. Notice to all specified parties was timely provided prior to 15 days before the effective date of the amendment.

Notifying the IRS of Plan Amendments. When a plan is amended, certain reports may need to be filed with the IRS. If the plan amendment reduces previously accrued benefits, the plan administrator must file a notice of amendment with the Secretary of Treasury, and the Secretary must approve the amendment (or within 90 days after the filing date, fail to disapprove it).

Avoiding Discrimination Resulting from Plan Amendments

A plan that discriminates in favor of highly compensated employees (HCEs) does not constitute a qualified trust under IRC Sec. 401(a) and the trust is not exempt from taxation under IRC Sec. 501(a). The timing of an amendment (or series of amendments) must not have the effect of significantly discriminating in favor of HCEs.

Rules are provided for determining whether the timing of a plan amendment results in significant discrimination in favor of HCEs. These rules apply to all plan amendments, including those that terminate a plan or change benefits, rights, or features under a plan.

SELF-STUDY QUIZ

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

30. Plan documents are not static. They must be maintained, which means amending the plan when necessary. Which of the following plan amendments would be considered *discretionary*?

    a. Legislative changes limit the benefit amounts earned by each participant in the plan.

    b. The vesting schedule is shortened to make the plan more valuable to employees.

    c. The benefit formula is changed to decrease benefits for employees with less than 10 years of service.

    d. A plan is merged with the plan maintained by a company acquired by the employer.

31. A plan is amended to change the terms of its existing death benefit. Which of the following reports is required?

    a. Beneficiary designation.

    b. Notice of blackout period.

    c. Salary deferral agreement.

32. On April 30, 2009, Byington Boat Repair (BBR) amends its qualified retirement plan in a way that will cause a significant reduction of future benefit accruals. The amendment will be effective on July 3, 2009. BBR has 23 employees and does not expect that to change by the date of the amendment. To avoid the excise tax for failure to provide adequate information regarding plan design changes, when must BBR provide notice to affected participants?

    a. June 18, 2009.

    b. May 19, 2009.

    c. Notice is not required under these circumstances.

33. Which of the following scenarios regarding plan amendments complies with the regulations?

    a. DMC Enterprises amends its plan to change the benefit formula so that it discriminates in favor of the highly compensated employees.

    b. YRM Productions amends its plan, and the resulting decrease in benefits only affects one employee. This is not a significant reduction in benefits, so notice is not required.

    c. VGB Company amends its plan to reduce future benefits. The notice provided by the company includes descriptions of the original benefit formula, as well as the amended formula.

    d. WYT Manufacturing amends its plan to reduce previously accrued benefits, but because the reduction is not deemed significant, notice is not provided to the IRS.

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.)**

30. Plan documents are not static. They must be maintained, which means amending the plan when necessary. Which of the following plan amendments would be considered *discretionary*? **(Page 83)**

    a. Legislative changes limit the benefit amounts earned by each participant in the plan. [This answer is incorrect. Changing a plan document to reflect legislative and regulatory changes is required, not discretionary.]

    b. The vesting schedule is shortened to make the plan more valuable to employees. [This answer is correct. Changes in vesting, eligibility requirements, benefit formula, and year-end are examples of discretionary plan amendments. Care must be taken not to decrease or eliminate benefits already provided under the plan when the amendment is made. Amendments must be in written form and authorized by the employer.]

    c. The benefit formula is changed to decrease benefits for employees with less than 10 years of service. [This answer is incorrect. Benefits that are provided under the plan at the time of the amendment cannot be decreased.]

    d. A plan is merged with the plan maintained by a company acquired by the employer. [This answer is incorrect. This type of amendment is considered required, not discretionary. Generally, required amendments must be adopted in the plan year for which the amendments become effective.]

31. A plan is amended to change the terms of its existing death benefit. Which of the following reports is required? **(Page 85)**

    a. Beneficiary designation. [This answer is correct. If a plan is amended to change the terms of an existing death benefit or if the plan adds a death benefit, the beneficiary designation form is needed.]

    b. Notice of blackout period. [This answer is incorrect. Participants and beneficiaries must receive notice about whom a temporary blackout period applies to. This type of notice normally applies to a 401(k) plan with investment choices undergoing revision.]

    c. Salary deferral agreement. [This answer is incorrect. If an amendment affects the salary deferrals that a participant can make to the plan, this form is needed.]

32. On April 30, 2009, Byington Boat Repair (BBR) amends its qualified retirement plan in a way that will cause a significant reduction of future benefit accruals. The amendment will be effective on July 3, 2009. BBR has 23 employees and does not expect that to change by the date of the amendment. To avoid the excise tax for failure to provide adequate information regarding plan design changes, when must BBR provide notice to affected participants? **(Page 87)**

    a. June 18, 2009. [This answer is correct. Because BBR is a small employer with less than 100 employees on the date of the amendment, it can provide notice as late as 15 days before the effective date.]

    b. May 19, 2009. [This answer is incorrect. Employers that do not meet the small plan exception are required to provide notice 45 days before the plan amendment's effective date.]

    c. Notice is not required under these circumstances. [This answer is incorrect. BBR is required to make the notification under these circumstances. Each failure to do so could result in an excise tax of up to $100 per day. If BBR had no employees under DOL Reg. 2510.3-3(b) (e.g., if its plan were for a sole owner), then no notice would be required.]

33. Which of the following scenarios regarding plan amendments complies with the regulations? **(Page 88)**

   a. DMC Enterprises amends its plan to change the benefit formula so that it discriminates in favor of the highly compensated employees. [This answer is incorrect. If the plan amendment or its timing significantly discriminates in favor of highly compensated employees, the plan will no longer constitute a qualified plan under IRC Sec. 501(a).]

   b. YRM Productions amends its plan, and the resulting decrease in benefits only affects one employee. This is not a significant reduction in benefits, so notice is not required. [This answer is incorrect. Neither DOL or ERISA regulations define a *significant reduction in benefits*. Based on court decisions, a reduction can be deemed significant even if it only affects one employee.]

   c. VGB Company amends its plan to reduce future benefits. The notice provided by the company includes descriptions of the original benefit formula, as well as the amended formula. [This answer is correct. In addition to the formula descriptions, the notice should include sufficient information to allow the participants to understand the amendment's effect. Additionally, the notice must be written in a way that allows it to be understood by the average plan participant (i.e., layman's terms).]

   d. WYT Manufacturing amends its plan to reduce previously accrued benefits, but because the reduction is not deemed significant, notice is not provided to the IRS. [This answer is incorrect. In this case, the plan administrator would have to file a notice of amendment with the Secretary of Treasury. The Secretary would then have to approve the amendment, or fail to disprove it by 90 days after the filling date.]

THE ANTI-CUTBACK PROVISIONS

The anti-cutback provisions state that a plan generally cannot be amended to decrease an employee's accrued benefit already provided under the plan at the time of amendment. Optional forms of benefit accrued at the time of amendment are also usually not allowed to be decreased or eliminated. Benefits that may not be reduced or eliminated are referred to as *protected benefits*. Generally, protected benefits include the following:

a. Accrued benefits. This includes amounts credited to participants' accounts and amounts they are entitled to under the plan, even if those amounts are not yet credited to their accounts.

b. Early retirement benefits and retirement-type subsidies.

c. Optional forms of benefit attributable to service before the amendment.

When Benefits may be Eliminated or Reduced

Amendments have been made to Regs. 1.411(d)-3 and 1.411(d)-4 which respond to the EGTRRA directive for purposes of both IRC Sec. 411(d)(6) and ERISA Sec. 204(g) by specifying the circumstances under which a plan may be amended to reduce or eliminate early retirement benefits, retirement-type subsidies, and optional forms of benefit. The circumstances specified in the regulations are designed to implement the statutory directive to permit reduction or elimination of IRC Sec. 411(d)(6)(B) protected benefits that create significant burdens or complexities for the plan and its participants, but only if the elimination does not adversely affect the rights of any participant in a more than de minimis manner. These provisions relating to the permissible elimination of benefits protected by IRC Sec. 411(d)(6)(B) are in addition to the rules permitting a plan to be amended to eliminate optional forms of benefit under Reg. 1.411(d)-4.

These regulations provide two permitted methods for eliminating or reducing IRC Sec. 411(d)(6)(B) protected benefits under the EGTRRA directive: eliminating redundant optional forms of benefit and eliminating noncore optional forms of benefits where core options are offered. Either of these two alternative methods can be applied with respect to any optional form of benefit. A plan sponsor may determine that one method of elimination works for some plan participants or some optional forms of benefit, but not for the remaining plan participants or other optional forms of benefit. However, a plan must satisfy all of the requirements of the applicable method with respect to any optional form of benefit being eliminated.

These final regulations also include general guidance on IRC Sec. 411(d)(6), including the meaning of the terms used therein, the scope of the IRC Sec. 411(d)(6)(A) protection against plan amendments decreasing a participant's accrued benefit, and the scope of IRC Sec. 411(d)(6)(B) protection for early retirement benefits, retirement-type subsidies, and optional forms of benefit.

Optional Forms of Benefits

Optional forms of benefits that are not protected and, thus, may be eliminated or reduced by plan amendments, include the following:

a. Ancillary life insurance protection.

b. Accident or health insurance benefits.

c. Social Security supplements as described in IRC Sec. 411(a)(9) [other than qualified Social Security supplements pursuant to Reg. 1.401(a)(4)-12].

d. Availability of plan loans (other than the distribution of an employee's accrued benefit upon default under a loan).

e. Availability of self-directed investments.

f. The right to make after-tax employee contributions or elective deferrals described in IRC Sec. 402(g)(3).

g. The right to a particular form of investment (e.g., investment in employer stock or securities or investment in certain types of securities).

h. The allocation dates for contributions, forfeitures, and earnings; the time for making contributions; and the valuation dates for account balances.

i. Administrative procedures for distributing benefits, such as provisions relating to the particular dates on which notices are given and by which elections must be made.

j. Rights that derive from administrative and operational provisions, such as mechanical procedures for allocating investment experience among accounts in defined contribution plans.

k. Hardship distributions in 401(k), profit sharing, and stock bonus plans.

Defined Contribution Plans. In Reg. 1.411(d)-4, the IRS relaxed some of the IRC Sec. 411(d)(6) requirements protecting optional forms of benefit in defined contribution plans. Most defined contribution plans, other than money purchase plans, target benefits plans, and profit-sharing plans that contain money from a merger with a money purchase plan, can now be amended to eliminate annuity or other installment options so long as after the amendment is effective, a single-sum distribution with otherwise identical terms as the eliminated benefit is available. The IRS has issued five regulations as to when forms of distribution in defined contribution plans may be eliminated. The regulations delete the 90-day prior notice requirement for eliminating benefit forms. The changes are of particular benefit to plan sponsors who inherit plans as a result of a merger or other reorganization of the employer.

Reducing Future Benefits

Plans can be amended to reduce future benefit accruals. However, defined benefit plans and other plans subject to the ERISA Sec. 302 minimum funding standards (e.g., money purchase pension and target benefit plans) cannot be amended to provide for a significant reduction in the rate of future benefit accruals unless notice of the amendment is provided by the plan administrator. An amendment reducing future benefits would be a material modification requiring notice to be provided under the usual timeframes for summaries of material modifications.

The Treasury has issued final revised regulations under Reg. 1.417(a)(3)-1 concerning the disclosure of relative values of optional forms of benefit applicable to explanations of qualified joint and survivor annuities (QJSA) and qualified preretirement survivor annuities payable under certain retirement plans. These final revised regulations provide that the previously issued 2003 regulations generally are effective for QJSA explanations provided for annuity starting dates beginning on or after February 1, 2006. However, these regulations retain the effective date for Reg. 1.417(a)(3)-1 under the 2003 regulations for explanations with respect to any optional form of benefit that is subject to the requirements of IRC Sec. 417(e)(3) if the actuarial present value of that optional form is less than the actuarial present value of the QJSA.

AMENDMENTS MADE RETROACTIVELY

In a specific circumstance, a discretionary amendment may be made retroactive to a prior year, but normally the plan is impacted by the amendment in the year of adoption. An exception exists for minimum funding purposes (which applies to defined benefit and money purchase pension plans, including target benefit plans) and covers not only certain approved benefit reductions, but also contributions attributed to other retroactive benefit changes when benefits are not reduced. For contribution purposes, these amendments must generally be adopted within $2^1/_2$ months after the close of the plan year to which they apply. The plan administrator must elect in writing to apply the amendments retroactively and disclose the action on Schedule R of the 5500 by answering line 4 as "yes." Furthermore, when a benefit reduction is involved, the IRS must approve that amendment.

The latest date a defined contribution plan can be amended to change its allocation formula without violating the protected benefit under IRC Sec. 411(d)(6) is the day before a participant becomes entitled to share under the allocation formula. An allocation becomes a protected benefit when a participant satisfies the hours and/or last day of employment requirements under the plan document.

Example 2-5: Retroactive amendment reducing benefits.

On January 15, 2009, James, Inc., decides to amend its defined benefit plan to reduce benefits provided for its employees. The plan is maintained on a calendar year basis.

Can the plan be amended to reduce benefits for the 2008 plan year or must it be amended prospectively to reduce benefits only for 2009 and subsequent years? An amendment can reduce accrued benefits of a plan subject to the minimum funding standards, but only for the current plan year and only if the administrator makes a written election and the IRS national office approves the amendment (or within 90 days after the filing date, fails to disapprove it). However, the amendment may be adopted within 2$^1/_2$ months after the close of the plan year and still apply to that plan year.

Thus, it is possible for James, Inc., to adopt an amendment to reduce benefits effective January 1, 2008, if that amendment is adopted no later than March 15, 2009, and (a) a written election statement is attached to the plan's 2008 Form 5500, (b) line 4 of Schedule R must be answered "yes" on the Form 5500, and (c) either the IRS approves the amendment or fails to issue a disapproval within 90 days of the filing date.

Filing the Election Statement

Instructions for filing the written election statement as to the retroactive application to the prior plan year are provided in Reg. 11.412(c)-7(b)(2). Basically, a written election statement must be filed with the plan's Form 5500. Also, question 4 on Schedule R (Form 5500) should be answered "Yes."

Getting IRS Approval

For a plan amendment reducing accrued benefits to be effective, the plan administrator must file a notice of amendment with the IRS National Office, and the IRS must approve the amendment (or within 90 days after the filing date, fail to disapprove it). Rev. Proc. 2004-15 outlines the procedures for requesting this approval.

The IRS will approve the amendment only if it is deemed necessary because of a substantial business hardship, and a waiver of the minimum funding standards under IRC Sec. 412(c)(1) or ERISA Sec. 302(c)(1) is determined to be unavailable or inadequate.

The following are some of the factors considered in determining whether business hardship exists:

a. Whether the employer is operating at an economic loss.

b. Whether there is substantial unemployment or underemployment in the trade or business and in the industry concerned.

c. Whether the sales and profits of the industry concerned are depressed or declining.

d. Whether it is reasonable to expect the plan will be continued only if a waiver is granted.

LAW CHANGE PLAN AMENDMENTS

The laws, rules, and regulations governing qualified plans are often changed. When existing laws regarding qualified plans are changed, or when new legislation is passed, a plan must be amended to comply with these laws. The IRS also issues regulations and rulings that clarify the law or its interpretation. For a plan to retain its qualified status, it must comply with these regulations.

The IRS's annual Cumulative List of Changes in Plan Qualification Requirements (Cumulative List) informs plan sponsors of issues the IRS has specifically identified for review in determining whether an individually designed plan has been properly updated. The 2008 Cumulative List reflects law changes under the Economic Growth and Tax Relief Reconciliation Assistance Act of 2001 (EGTRRA) [with technical corrections made by the Job Creation and Worker Assistance Act of 2002 (JCWAA)], the Pension Funding Equity Act of 2004 (PFEA), the American Jobs Creation Act of 2004 (AJCA), the Gulf Opportunity Zone Act of 2005 (GOZA), the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, Iraq Accountability Appropriations Act of 2007, Pub. L. 110-28, and certain other miscellaneous items. To be qualified, a plan must comply with all relevant qualification requirements (all qualification requirements in effect, or guidance published before the issuance of the Cumulative List), not just those on the 2008 Cumulative List. The IRS will not consider in its review of any determination letter application, for the submission period that begins February 1, 2009, any:

a. guidance published after October 1, 2008;

b. statutes enacted after October 1, 2008;

c. qualification requirements first effective in 2010 or later; or

d. statutory provisions that are first effective in 2009, for which there is no guidance identified in IRS Notice 2008-108.

Disqualifying Provision

A change in the law can cause a disqualifying provision. A disqualifying provision occurs when the plan does not satisfy the qualification requirements under the Code because an existing plan provision does not conform to the law change or a plan provision is lacking. Employers are permitted to retroactively amend a plan for a disqualifying provision during the applicable remedial amendment period.

When Amendments Must Be Made—The Remedial Amendment Period

To maintain its qualified status, a plan must comply with a law change as of the effective date stated in the laws or in the clarifying regulations. It must also be formally amended for these changes, generally during the plan year they become effective. However, a longer period of time is allowed in certain circumstances. This additional time is referred to as the remedial amendment period.

A system of cyclical remedial amendment periods for individually designed and pre-approved plans has been established. Under this system:

a. *Individually designed plans* have a five-year remedial amendment cycle. The cycles are staggered over five-year periods and they commence in different years for different plans within a five-year period so that different plans have different cycles. Thus, plan sponsors are generally required to apply for new determination letters only once every five years.

b. *Pre-approved plans* including M&P and VS plans generally have a six-year remedial amendment cycle. Sponsors, practitioners, and adopters of M&P and VS plans should apply for new opinion, advisory, or determination letters once every six years. M&P and VS defined contribution plans have different six-year cycles than M&P and VS defined benefit plans.

c. The IRS is accepting applications for Cycle D individually designed plans beginning February 1, 2009 and ending January 31, 2010 (postmark date). The deadline for defined contribution pre-approved plan applications ended on January 31, 2006.

A remedial amendment period is available if (a) a plan provision (or absence of a plan provision) in relation to a law change causes a plan to fail to qualify and (b) the Commissioner has designated the amendment to qualify under this provision. If the plan complies with the laws as of their effective dates (i.e., retroactively) and formally amends the plan within the remedial amendment period, the plan is treated as being in compliance during the entire period, provided the plan operated in accordance with the new law provisions from the effective dates to the extent required. Thus, disqualification is avoided.

The timing of the remedial amendment period depends on whether the plan is a new or existing plan.

Remedial Amendment Period for New Plans. Unless otherwise provided by the IRS, the remedial amendment period for a new plan of a single employer begins on the plan's effective date and ends on the due date (including extensions) of the employer's federal tax return for the tax year coinciding with that first plan year when both the tax and plan years are the same 12 month period.

Example 2-6: Remedial amendment period for a new plan where employer's tax year and plan year are the same.

May Flowers, Inc., a calendar year corporation, adopted a calendar year profit-sharing plan effective January 1, 2009. The document is a prototype. The corporate return for May Flowers, Inc., is on extension to September 15, 2010.

When does the remedial amendment period end? The remedial period would normally end on September 15, 2010, the extended due date of the employer's corporate return.

If the employer's year-end differs from the plan's year-end, the remedial amendment period for a new plan ends on the due date (including extensions) of the tax return for the tax year in which the plan year begins, but no earlier than the last day of the plan's first year.

Example 2-7: Remedial amendment period for a new plan where employer's tax year differs from plan year.

May Jerdeal, Inc., a corporation with a July year-end, adopts a money purchase plan effective January 1, 2009. The plan has a calendar year-end. The corporation's federal return for the year ended July 31, 2007 was extended to April 15, 2010.

When does the remedial amendment period end? The first plan year begins in the tax year ended July 31, 2009. The remedial amendment period would end on April 15, 2010, because the corporation's federal tax return due date (including extensions) of April 15, 2010, was later than the last day of the first plan year (December 31, 2009).

Remedial Amendment Period for Existing Plans. The remedial amendment period for existing plans is similar to that of new plans. The period begins on the date of the amendment, which is the earlier of (a) the date the employer adopts the amendment or (b) the amendment's effective date. The period ends on the due date (including extensions) of the employer's federal tax return for the tax year containing the amendment date. However, special rules apply when determining the end date for plans maintained by more than one employer.

If the employer's tax year differs from the plan's year-end, the remedial amendment period ends on the due date (including extensions) of the employer's return for the tax year containing the latest of the following:

a. The date the remedial amendment period begins.

b. The date of adoption of the plan amendment.

c. The effective date of the plan amendment.

The IRS distinguishes the deadline for the timely adoption of an interim versus discretionary amendment as follows:

a. For an interim amendment: By the end of the remedial amendment period which ends on the later of (1) the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the remedial amendment period begins or (2) the last day of the plan year that includes the date on which the remedial amendment period begins. A plan maintained by more than one employer should be amended by the last day of the tenth month following the last day of the plan year in which the remedial amendment period begins.

b. For a discretionary amendment: By the end of the plan year in which the plan amendment is effective.

Extending the Remedial Amendment Period

Generally, if a plan must be amended because of a law change, the amendment must take place by the last day of the plan year in which the new law becomes effective. Usually, this deadline can be extended only with consent of the IRS or by Congress.

Final regulations under IRC Sec. 401(b) were issued that delegated the authority to the IRS to extend remedial amendment periods at its discretion. The remedial amendment period for certain disqualifying provisions described in Reg. 1.401(b)-1(b)(1) has been extended to the end of the remedial amendment cycles listed in this section if:

a. The disqualifying provision was a provision of, or absence of a provision from a new plan and the plan was intended, in good faith, to be qualified.

b. The employer adopts an amendment to an existing plan and the amendment was adopted timely and in good faith with the intent of maintaining the qualified status of the plan.

c. The employer (or sponsor or practitioner, if applicable) reasonably and in good faith determines during the period when an interim amendment to reflect a qualification change would otherwise be required that no amendment is required because the qualification change does not impact provisions of the plan document. The IRS will determine whether the adoption or absence of an interim amendment was reasonable and in good faith.

When application for extension is made to the IRS, the IRS considers whether an extension is in the best interests of the participants, whether substantial hardship will result to the employer if it is not granted, and whether an extension is contrary to the interests of the government.

Congress may also extend the remedial amendment period by providing such a period within the legislation.

Establishment of Five-year and Six-year Remedial Amendment Cycles.

Five-year Remedial Amendment Cycle for Individually Designed Plans. Generally, an individually designed plan's five-year remedial amendment cycle is determined in accordance with the chart below. For a detailed discussion on the extension of the EGTRRA remedial amendment period and schedule of the next five-year remedial amendment cycle:

Last digit of plan sponsor's EIN is:	The plan's cycle is:
1 or 6	Cycle A
2 or 7	Cycle B
3 or 8	Cycle C
4 or 9	Cycle D
5 or 0	Cycle E

Exceptions to determining a plan's five-year remedial amendment cycle apply to plans maintained by more than one employer and a plan maintained by multiple members of a controlled group under IRC Sec. 414(b) or (c) or employers that are members of an affiliated service group under IRC Sec. 414(m), as follows:

a. The five-year remedial amendment cycle for a multiemployer plan under IRC Sec. 414(f) is Cycle D.

b. The five-year remedial amendment cycle for a multiple employer plan is Cycle B.

c. The five-year remedial amendment cycle for a governmental plan under IRC Sec. 414(b) is Cycle C. However, the IRS announced in a November 5, 2008 special edition of its newsletter, *Employee Plan News*, that a one-time extension would allow governmental plans to choose to submit applications for determinations under Cycle E instead, which has a deadline two years later than their assigned Cycle C deadline.

d. The five-year remedial amendment cycle for a plan maintained by multiple members of a controlled group under IRC Sec. 414(b) or (c) or an affiliated service group under IRC Sec. 414(m) is determined with reference to the last digit of the EIN that is or will be used to report the plan on Form 5500 (Annual Return/Report of Employee Benefit Plan).

e. Notwithstanding the rule under item d., the employers may elect that the five-year remedial amendment cycle for all plans maintained by any members of the group (other than multiemployer or multiple employer plans) will be Cycle A. This election must be made jointly by all members of the controlled or affiliated service group. If more than one plan is maintained by a controlled group under IRC Sec. 414(b) or (c) and the controlled group is a parent-subsidiary controlled group organization, an election may be made that the remedial amendment cycle be determined by reference to the last digit of the parent's EIN. The parent makes this election.

In the case of a merger or acquisition, a change in plan sponsorship, a plan spin-off, or a self-employed person, a plan's five-year remedial amendment cycle is determined as follows regardless of whether this would shorten or extend the five-year remedial amendment cycle of the plan:

a. If plans with different five-year remedial amendment cycles are merged, the five-year remedial amendment cycle of the merged plan is thereafter determined in accordance with the previous two paragraphs on the basis of the EIN, controlled group status, affiliated service group status, etc., of the employer that maintains the merged plan.

b. If one employer acquires another employer and maintains its plan, the five-year remedial amendment cycle of the plan is thereafter determined in accordance with the previous two paragraphs on the basis of the EIN, controlled group status, affiliated service group status, etc., of the employer that is maintaining the plan.

c. If there is a change in the EIN (including its expiration), controlled group status, affiliated service group status, etc., of the employer that maintains a plan, the five-year remedial amendment cycle of the plan is thereafter determined as provided in the previous two paragraphs on the basis of the changed EIN, controlled group status, affiliated service group status, etc., of the employer that maintains the plan.

d. If a portion of a plan is spun off, the five-year remedial amendment cycle of the spun-off plan is determined as provided in the previous two paragraphs on the basis of the EIN, controlled group status, affiliated service group status, etc., of the employer that maintains the spun-off plan.

e. If, as a result of one of the transactions described in items a.–d., a plan's current five-year remedial amendment cycle is shortened such that the period remaining in the cycle following the transaction is less than twelve calendar months, the plan's current cycle is extended for twelve months and the next five-year cycle will be shortened accordingly. This extension does not apply to other plans of the employer that are not similarly affected. Thereafter, the plan's five-year remedial amendment cycles will be determined as provided in the previous two paragraphs.

f. If a self-employed person with no employees submits a determination letter based upon the last digit of the individual's social security number instead of the EIN for the first determination letter submitted, the determination letter application will be processed based on the social security number with the other on-cycle determination letter applications. However, subsequent five-year remedial amendment cycles will be determined based upon the last digit of the employer's EIN as provided in the previous two paragraphs.

g. An employer currently with an individually designed plan that intends to adopt a pre-approved plan should execute Form 8905, evidencing the intent to adopt a pre-approved plan and moving into the amendment and filing cycle for pre-approved plans.

Establishment of Six-year Amendment/Approval Cycle for Pre-approved Plans. Pre-approved plans generally have until January 31 of the calendar year following the opening of the six-year remedial amendment cycle to submit applications for opinion and advisory letters. However, sponsors and practitioners maintaining mass submitter plans and national sponsors generally have until October 31 of the calendar year in which the six-year remedial amendment cycle opens to submit opinion and advisory applications. An extended deadline of January

31, 2006 was provided for the initial EGTRRA application for mass submitter plans and national sponsors who submit applications for defined contribution M&P and VS plans. In addition, the deadline for word-for-word identical adopters and minor modifier placeholder applications is January 31 of the calendar year following the opening of the six-year remedial amendment cycle.

Timeline for Employers Adopting Pre-approved Plans. When the review of a cycle for pre-approved plans has neared completion, the IRS will publish an announcement providing the date by which adopting employers must adopt the newly approved plans. This uniform date will apply to all adopting employers. It is expected that this date will give employers approximately a two-year window to adopt their updated plans. An adopting employer that adopts an approved M&P or VS plan by the announced deadline will have adopted the plan within the employer's six-year remedial amendment cycle. The announced deadline will be the end of the plan's remedial amendment cycle for all disqualifying provisions for which the remedial amendment period would otherwise end during the cycle. If necessary, the Service may revise the schedule to respond to changing circumstances and needs of plan sponsors.

Eligibility for Six-year Amendment/Approval Cycle. An employer's plan is treated as a pre-approved plan and is therefore eligible for a six-year amendment/approval cycle if:

a. The employer is a prior adopter, a new adopter, an intended adopter, or the adopter of a replacement plan.

b. The sponsor or practitioner maintaining the pre-approved plan timely submits an opinion or advisory letter application by the October 31 deadline in the calendar year opening the six-year remedial amendment cycle for mass submitter and national sponsor pre-approved plans, or by the January 31 deadline of the calendar year following the opening of the six-year remedial amendment cycle for non-mass submitter, word-for-word adopter, and minor modifier pre-approved plans.

If an employer was a prior adopter, a new adopter, an intended adopter, or the adopter of a replacement plan, and such employer fails to adopt a pre-approved plan or individually designed plan by the adoption and/or submission deadline established by the IRS for the current six-year remedial amendment cycle and the employer is unable to utilize its five-year remedial amendment cycle (the employer′s submission deadline under the five-year remedial amendment cycle precedes the adoption and/or submission deadline under the current six-year cycle), then the adopting employer may be eligible to correct for late adoption under the Employee Plans Compliance Resolution System.

Impact of Determination Letter Request on the Remedial Amendment Period

If a determination letter is requested by the end of the remedial amendment period, the period is extended through the 91-day period following the date on which (a) the final determination letter is issued, (b) the request is withdrawn, (c) the request is otherwise disposed of by the IRS, or (d) the decision of a petition filed with the U.S. Tax Court regarding the determination becomes final. This 91-day period allows the employer or plan administrator to make required amendments and corrections.

Consequences of Failing to Amend within the Remedial Amendment Period

Generally, if a plan required to be amended is not amended within the remedial amendment period, the plan is disqualified from that point until an amendment is adopted and put into effect to correct the qualification failure. However, the IRS may grant a discretionary exemption to allow an extension of the period. In that situation, the plan is deemed to be qualified for the plan year when the request for a determination letter is made (or is pending with the IRS). A plan is also deemed to be qualified for the plan year prior to that when a determination letter is requested if the request is submitted by the due date of the employer's tax return (including extensions) for the employer's taxable year containing such prior plan year. In addition, the IRS correction program provides a sanction for correcting a document failure of amending after the required deadline.

EGTRRA Amendments

The provisions of these law changes must be followed as of the provisions' effective date, even if the plan is not yet required to be amended.

To retain a plan's qualified status after these law changes, amendments must be made retroactively, effective as of the date on which the qualification changes become effective, even though actual amendment of the plan may occur at a later date. Due to the number of required amendments, plans will need to be totally rewritten (restated) and if applicable a new determination letter will need to be requested.

Extension of the EGTRRA Remedial Amendment Period and Schedule of Next Five-year Remedial Amendment Cycle for Individually Designed Plans. The end of the initial remedial amendment cycle (i.e., EGTRRA remedial amendment period) for individually designed plans is presented below, along with the end dates of the next five-year remedial amendment cycle.

If the EIN of the employer ends in:	The plan's cycle is:	The last day of the initial cycle is:	The next five-year remedial amendment cycle ends on:
1 or 6	Cycle A	1/31/2007	1/31/2012
2 or 7	Cycle B	1/31/2008	1/31/2013
3 or 8	Cycle C	1/31/2009	1/31/2014
4 or 9	Cycle D	1/31/2010	1/31/2015
5 or 0	Cycle E	1/31/2011	1/31/2016

The end of a plan's EGTRRA remedial amendment cycle is the time by which plan sponsors must apply for a new determination letter for qualification changes that have first been listed in the Cumulative Lists at least twelve months before the end of the plan's EGTRRA remedial amendment period.

Extension of the EGTRRA Remedial Amendment Period and Schedule of Next Six-year Remedial Amendment Cycle for M&P or Volume Submitter Plans. The end of the initial remedial amendment cycle (i.e., EGTRRA remedial amendment period) for master/prototype (M&P) or volume submitter (VS) plans is presented below, along with the end dates of the next six-year remedial amendment cycle.

If the plan is:	The last day of the initial cycle is:	The next six-year remedial amendment cycle ends on:
Defined contribution	1/31/2011	1/31/2017
Defined benefit	1/31/2013	1/31/2019

In general, sponsors of M&P plans and practitioners maintaining VS plans must apply for new opinion or advisory letters for the plans every six years, according to the following schedule:

Defined Contribution Plans	Initial EGTRRA Application Due:	Next Application Due:
Non-Mass Submitter Sponsors and Practitioners, Word-for-Word Identical Adopters, and M&P Minor Modifier Placeholder Applications	2/17/2005–1/31/2006	2/1/2011–1/31/2012
Mass Submitters and National Sponsors	2/17/2005–1/31/2006	2/1/2011–10/31/2011
Defined Benefit Plans	**Initial EGTRRA Application Due:**	**Next Application Due:**
Non-Mass Submitter Sponsors and Practitioners, Word-for-Word Identical Adopters, and M&P Minor Modifier Placeholder Applications	2/1/2007–1/31/2008	2/1/2013–1/31/2014
Mass Submitters and National Sponsors	2/1/2007–10/31/2007	2/1/2013–10/31/2013

The end of a plan's EGTRRA remedial amendment cycle is the time by which an employer adopts the approved plan by the end of the deadline as announced by the IRS. An adopting employer that timely adopts the approved plan will be treated as having adopted the plan within the employer's six-year remedial amendment cycle.

Using Model Amendments

The IRS offers employers model amendments as a way to adopt amendments required by certain law and regulation changes. These are intended to clarify the law passed, or to offer guidance when regulations are unavailable or unclear. For example, the IRS has provided a model amendment for plans to modify the definition of compensation for certain purposes to include qualified transportation fringes under IRC Sec. 132(f)(4). IRS Notice 2008-108, updated annually, lists IRS guidance containing model amendments, which includes Notice 2001-57 (miscellaneous EGTRRA amendments), Rev. Proc. 2003-13 (required language for deemed IRAs), and Notice 2005-5 (automatic rollover). Also, a model amendment for the Roth 401(k) provisions to an existing 401(k) plan is provided in Notice 2006-44.

Form 8837. The IRS issued a form to transmit documents for employers adopting model amendments under one or more revenue procedures. Form 8837 (Notice of Adoption of Revenue Procedure Model Amendments) is to be used by sponsors of master or prototype (M&P) plans, M&P mass submitter plans, and volume submitter specimen plans. Sponsors of M&P plans file one form for all plans sharing a common basic plan document. A volume submitter files one form for each specimen plan. However, a sponsor that is an identical adopter of a mass submitter plan does not file Form 8837; the mass submitter files the form. There is no user fee assessed for this form.

Amendment Deadline for Pension Protection Act (PPA) of 2006

The deadline for adopting the amendments relating to the PPA is the last day of the 2009 plan year (2011 plan year for governmental plans). This deadline is defined in the legislation and does not distinguish between required and discretionary amendments. However, the employer must operate the plan in conformance with the law. When the plan is amended the amendments will be retroactively effective to the date of the law change for the required amendments and to the date of adoption for the discretionary changes.

SELF-STUDY QUIZ

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

34. In which of the following scenarios could the IRS approve an amendment that retroactively reduces accrued benefits on the grounds of a substantial business hardship?

    a. Harold & Sons meets the requirements for a waiver of the minimum funding standards under IRC Sec. 412(d)(1).

    b. Tiffani's Tots is a clothing store, and sales and profits related to the clothing industry as a whole have leveled out.

    c. Dave's Diner makes the plan amendment in the year that the retirement plan is adopted.

    d. Leanne Lawn Co. operated throughout all of the plan year at an economic loss.

35. Oakdale Oral Surgery (OOS) is a calendar year partnership. January 1, 2009, it adopted a calendar year profit-sharing plan with a prototype plan document. The plan is effective on January 1, as well. OOS's 2009 tax return was extended until October 15, 2010. What are the dates of OOS's remedial amendment period?

    a. January 1, 2009 – April 15, 2009.

    b. January 1, 2009 – December 31, 2009.

    c. January 1, 2009 – April 15, 2010.

    d. January 1, 2009 – October 15, 2010.

36. Assume the same details as in the question above. In 2009, a law change causes OOS's plan to lose its qualification, and the law becomes effective in 2010. For financial reasons, OOS cannot amend the plan to comply with the new law until 2011, but the discretionary amendment is supposed to be in effect by the end of 2009. What should OOS do?

    a. File with Congress to extend the remedial amendment period.

    b. File with the IRS to extend the remedial amendment period.

    c. File with the IRS to change its remedial amendment cycle.

    d. If OOS does not amend its plan by the end of 2010, it will lose its qualified status.

37. Which of the following scenarios correctly reflects the six-year amendment/approval cycle?

    a. Flightways is a new adopter that fails to adopt a plan by the IRS's adoption deadline for the six-year amendment cycle. Flightways cannot utilize its five-year amendment cycle. The company is now ineligible to correct the problem under the Employee Plans Compliance Resolution System.

    b. Holland-Jacobs sponsors a pre-approved plan. The plan's six-year remedial amendment cycle opens on February 1, 2008. Holland-Jacobs applies for an opinion letter on February 1, 2010.

    c. Linsk & Keller sponsors a mass submitter plan. The plan's six-year remedial amendment cycle opens on January 1, 2009. The sponsor submits its application for an opinion letter on October 31, 2009.

    d. Innovative Methods intends to adopt an individually designed retirement plan in 2009. The determination letter application is sent by October 31, 2009; therefore, the plan adopted by Innovated Methods is eligible for the six-year amendment cycle.

38. In all of the following scenarios, Zachariah & Yarborough (Z&Y) is a sponsor of M&P plans. Which scenario best illustrates the use of model amendments?

    a. Z&Y files one Form 8837 for all the plans adopting the model amendment that share a basic plan document.

    b. Z&Y files one Form 8837 for each plan that must adopt the model amendment.

    c. Z&Y has 91 days from the availability of the model amendment to make required corrections to its plans.

    d. When a model amendment is available, the IRS publishes an announcement of the date sponsors, such as Z&Y, must make the adoption.

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.)**

34. In which of the following scenarios could the IRS approve an amendment that retroactively reduces accrued benefits on the grounds of a substantial business hardship? **(Page 96)**

    a. Harold & Sons meets the requirements for a waiver of the minimum funding standards under IRC Sec. 412(d)(1). [This answer is incorrect. The IRS will only approve such an amendment if it is necessary because of a substantial business hardship and if a waiver of the minimum funding standards under IRC Sec. 412(d)(1) or ERISA Sec. 303(a) is inadequate or unavailable.]

    b. Tiffani's Tots is a clothing store, and sales and profits related to the clothing industry as a whole have leveled out. [This answer is incorrect. To be determined a substantial business hardship, sales and profits in the industry would have to be depressed or declining.]

    c. Dave's Diner makes the plan amendment in the year that the retirement plan is adopted. [This answer is incorrect. Amendments can be made retroactive to a prior year; however, generally, the contribution is impacted by the amendment in the year of adoption. The timing of the amendment in relation to the year the plan is adopted does not have any bearing on the determination of a substantial business hardship.]

    d. Leanne Lawn Co. operated throughout all of the plan year at an economic loss. [This answer is correct. This is one of the factors considered by the IRS when determining if a business hardship exists. Another factor considered is whether there is substantial underemployment or unemployment in the industry and in the trade or business.]

35. Oakdale Oral Surgery (OOS) is a calendar year partnership. January 1, 2009, it adopted a calendar year profit-sharing plan with a new prototype plan document. The plan is effective on January 1, as well. OOS's 2009 tax return was extended until October 15, 2010. What are the dates of OOS's remedial amendment period? **(Page 98)**

    a. January 1, 2009 – April 15, 2009. [This answer is incorrect. The remedial amendment period does not end before the last day of the plan's first year.]

    b. January 1, 2009 – December 31, 2009. [This answer is incorrect. The end of the remedial amendment period does not automatically fall at the end of the calendar year. The remedial amendment period also does not have to be exactly 12 months.]

    c. January 1, 2009 – April 15, 2010. [This answer is incorrect. The end of the remedial amendment period is not necessarily the original due date of the company's income tax return.]

    d. January 1, 2009 – October 15, 2010. [This answer is correct. For a new plan, the remedial amendment period begins on the plan's effective date and ends on the due date of the employer's federal tax return for the year that coincides with the first plan year, if both plan years are in the same 12-month period. Since OOS's tax return due date was extended, the remedial amendment period reflects that extension.]

36. Assume the same details as in the question above. In 2009, a law change causes OOS's plan to lose its qualification, and the law becomes effective in 2010. For financial reasons, OOS cannot amend the plan to comply with the new law until 2011, but the discretionary amendment is supposed to be in effect by the end of 2009. What should OOS do? **(Page 99)**

    a. File with Congress to extend the remedial amendment period. [This answer is incorrect. Congress could extend the period by providing a certain period within the legislation. OOS could not file with Congress for an individual extension.]

b. File with the IRS to extend the remedial amendment period. [This answer is correct. Under IRC Sec. 401(b), the IRS has the authority to extend remedial amendment periods at its discretion. If OOS's situation meets certain requirements in Reg. 1.401(b)-1(b)(1), the IRS could grant its extension.]

c. File with the IRS to change its remedial amendment cycle. [This answer is incorrect. In this scenario, OOS is concerned with the remedial amendment period, not the six-year remedial amendment cycle that would apply to OOS's prototype plan.]

d. If OOS does not amend its plan by the end of 2010, it will lose its qualified status. [This answer is incorrect. There is an avenue that OOS could pursue in the hopes of gaining the extension it needs, especially if the extension is in the best interest of the participants or if no extension would cause the employer substantial hardship.]

37. Which of the following scenarios correctly reflects the six-year amendment/approval cycle? **(Page 100)**

a. Flightways is a new adopter that fails to adopt a plan by the IRS's adoption deadline for the six-year amendment cycle. Flightways cannot utilize its five-year amendment cycle. The company is now ineligible to correct the problem under the Employee Plans Compliance Resolution System. [This answer is incorrect. Under these circumstances, Flightways could be eligible to correct for late adoption under the Employee Plans Compliance Resolution System.]

b. Holland-Jacobs sponsors a pre-approved plan. The plan's six-year remedial amendment cycle opens on February 1, 2008. Holland-Jacobs applies for an opinion letter on February 1, 2009. [This answer is incorrect. Holland-Jacobs would only have until January 31 of the calendar year that follows the opening of the six-year remedial period to submit its application (January, 31, 2009).]

c. Linsk & Keller sponsors a mass submitter plan. The plan's six-year remedial amendment cycle opens on January 1, 2009. The sponsor submits its application for an opinion letter on October 31, 2009. [This answer is correct. National sponsors and sponsors of mass submitter plans usually have until October 31 of the calendar year that the six-year remedial amendment cycle opens for submission of opinion and advisory letter applications.]

d. Innovative Methods intends to adopt an individually designed retirement plan in 2009. The determination letter application is sent by October 31, 2009; therefore, the plan adopted by Innovated Methods is eligible for the six-year amendment cycle. [This answer is incorrect. The six-year cycle is available for pre-approved plans, not individually designed plans.]

38. In all of the following scenarios, Zachariah & Yarborough (Z&Y) is a sponsor of M&P plans. Which scenario best illustrates the use of model amendments? **(Page 103)**

a. Z&Y files one Form 8837 for all the plans adopting the model amendment that share a basic plan document. [This answer is correct. Form 8837 (Notice of Adoption of Revenue Procedure Model Amendments) is used in this way by sponsors of M&P plans.]

b. Z&Y files one Form 8837 for each plan that must adopt the model amendment. [This answer is incorrect. If Z&Y were a volume submitter, it would file one form for each specimen plan.]

c. Z&Y has 91 days from the availability of the model amendment to make required corrections to its plans. [This answer is incorrect. When a determination letter is requested by the end of the remedial amendment period, the period is extended 91-days from the date that the final determination letter is issued, the request for the letter is withdrawn, the IRS otherwise disposes of the request, or the decision of a petition filed with the U.S. Tax Court about the determination becomes final.]

d. When a model amendment is available, the IRS publishes an announcement of the date sponsors, such as Z&Y, must make the adoption. [This answer is incorrect. When the review cycle for pre-approved plans nears completion, the IRS publishes an announcement that provides a date by which adopting employers must adopt the newly approved plans.]

PLAN/TRUST YEAR CHANGES

Generally, qualified plans are not required to receive permission from the IRS to change their plan year. However, defined benefit, cash balance money purchase, and target benefit plans must receive permission unless all of the following conditions are met:

a. No plan year is longer than 12 months.

b. The change will not delay the time when the plan otherwise would have been required to conform to the requirements of any statute, regulation, or published position of the IRS.

c. The trust, if any, retains its exempt status for the short period required to effect the change as well as for the taxable period of the year immediately preceding the short period.

d. The trust, if any, has no unrelated business taxable income under IRC Sec. 511 for the short period.

e. All actions necessary to implement the change of plan year, including plan amendments and a resolution of the Board of Directors (if applicable), have been taken on or before the last day of the short period.

f. No change of plan year has been made for any of the four preceding plan years.

g. In the case of a defined benefit plan, income tax deductions for contributions are taken in accordance with Section 5 of Rev. Proc. 87-27.

However, defined benefit, cash balance, money purchase, and target benefit plans not meeting the requirements in the list above must file Form 5308 (Request for Change in Plan/Trust Year) to receive permission from the IRS to change their plan year. Form 5308 must be filed before the end of the short plan year resulting from the change and must be accompanied by a $500 user fee.

HOW TO APPLY FOR A PLAN AMENDMENT DETERMINATION LETTER

If a plan loses its status as a qualified trust because the plan's amendment results in disqualification, contributions to the plan may not be deductible and income earned on the plan's assets is subject to tax. The loss of qualified status may also result in benefits being taxable to plan members. A plan administrator concerned about the impact of an amendment on the qualification of the plan can request a determination letter from the IRS.

Form to Use

Generally, requests for determination of amendments to individually designed plans are submitted on Form 5300 (Application for Determination for Employee Benefit Plan). Form 5307 (Application for Determination for Adopters of Master or Prototype, or Volume Submitter Plans) can be used by an adopter of a master/prototype or volume submitter plan to request a determination on an amendment. However, if the request for determination covers affiliated service group and/or leased employee status, Form 5300 must be used instead of Form 5307.

Form 6406 Has Been Eliminated

IRS Form 6406, "Short Form Application for Determination for Minor Amendment of Employee Benefit Plan," may no longer be used to apply for a determination letter.

HOW TO APPLY FOR A PLAN TERMINATION DETERMINATION LETTER

A terminated plan will not be qualified unless it complies (both in the form of the plan document and the operation of the plan) with all the qualification requirements in effect on the date of plan termination. This includes amendments to conform the plan to new legislation and regulations that would otherwise have a deferred amendment date (e.g., the EGTRRA amendments). Distributions from a plan that is not qualified at its termination date are ineligible for special tax treatment (i.e., averaging or capital gains elections), nor may they be rolled over tax-free to an IRA or another qualified plan.

Filing a request for determination when the plan is terminated is not required. However, doing so is strongly recommended because a determination letter ensures the plan is in compliance with all the laws in effect on the date of termination (including those with a deferred amendment date) and, thus, is a qualified plan at that time.

The IRS has issued examination guidelines covering issues agents should consider when auditing plans that are terminated without a determination letter.

Rev. Proc. 2009-6 provides procedures for requesting a determination letter upon the termination of a plan. Generally, the sponsor files Form 5310 (Application for Determination upon Termination) along with Form 8717 (User Fee for Employee Plan Determination Letter Request) and Schedule Q (Elective Determination Requests) to make its request. Form 6088 (Distributable Benefits from Employee Pension Benefit Plans) should be filed with any defined benefit or underfunded defined contribution plan. For collectively bargained plans, a Form 6088 is required only if the plan benefits employees who are not collectively bargained employees within the meaning of Reg. 1.410(b)-6(d). A plan that has been formally terminated but that does not complete distributions within one year after the termination date will be presumed to be a frozen plan, rather than a terminated plan.

SELF-STUDY QUIZ

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

39. 2XT Company maintains a qualified defined benefit plan for its employees. In 2009, 2XT would like to change the plan year, but unless certain conditions are met, the company will need the IRS's permission to do so. Which of the following is one of the conditions that must be met?

    a. Implementation of plan amendments required for a recent law change will only be delayed by 30 days.

    b. The most recent plan year change for 2XT's plan was in 2006.

    c. The plan year will be no longer than 15 months.

    d. Income tax deductions for contributions are taken according to Section 5 of Rev. Proc. 87-27.

40. Which of the following statements regarding plan terminations is accurate?

    a. A corporation must file a determination request at the time the plan is terminated.

    b. Distributions are eligible for special tax treatment if the plan is qualified as of the termination date.

    c. Agents should refer to the Rev. Proc. 99-23 examination guidelines when auditing plans that are terminated without a determination letter.

41. Wedgewood MRI (WM) is a calendar-year partnership that offers collectively bargain plans to its employees. However, not all of WM's employees are collectively bargained employees according to Reg. 1.410(b)-6(d). WM is terminating their plan. Which of the following series of forms represents a complete package WM can send to the IRS to request a determination letter upon plan termination?

    a. Form 5310 and Form 8717.

    b. Form 5310, Form 8717, Schedule Q, and Form 6088.

    c. Form 5310, Form 8717, and Schedule Q.

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.)**

39. 2XT Company maintains a qualified defined benefit plan for its employees. In 2009, 2XT would like to change the plan year, but unless certain conditions are met, the company will need the IRS's permission to do so. Which of the following is one of the conditions that must be met? **(Page 109)**

    a. Implementation of plan amendments required for a recent law change will only be delayed by 30 days. [This answer is incorrect. The change in plan year is not allowed to delay the time that the plan would have been required to conform to the requirements of any regulation, statute, or published position of the IRS.]

    b. The most recent plan year change for 2XT's plan was in 2006. [This answer is incorrect. No plan year change can have been made in the past four years. For 2XT, that means the most recent change could have been in 2005.]

    c. The plan year will be no longer than 15 months. [This answer is incorrect. No plan year can be longer than 12 months. Therefore, one plan year will be a short year.]

    d. Income tax deductions for contributions are taken according to Section 5 of Rev. Proc. 87-27. [This answer is correct. This is true specifically for a defined benefit plan. Other types of plans that may need to have permission to change the plan year, such as target benefit plans, would not have to abide by this condition.]

40. Which of the following statements regarding plan terminations is accurate? **(Page 109)**

    a. A corporation must file a determination request at the time the plan is terminated. [This answer is incorrect. Filing a request for determination when the plan is terminated is not required. However, this is recommended because a determination letter ensures the plan is in compliance with all the laws in effect on the date of termination (including those with a deferred amendment date) and, thus, is a qualified plan at the time of termination.]

    b. Distributions are eligible for special tax treatment if the plan is qualified as of the termination date. [This answer is correct. Distributions from a plan that is qualified at its termination date are eligible for special tax treatment (i.e., averaging or capital gains elections), and the distributions may be rolled over tax-free to an IRA or another qualified plan.]

    c. Agents should refer to the Rev. Proc. 99-23 examination guidelines when auditing plans that are terminated without a determination letter. [This answer is incorrect. The IRS has issued examination guidelines covering issues agents should consider when auditing plans that are terminated without a determination letter.]

41. Wedgewood MRI (WM) is a calendar-year partnership that offers collectively bargain plans to its employees. However, not all of WM's employees are collectively bargained employees according to Reg. 1.410(b)-6(d). WM is terminating their plan. Which of the following series of forms represents a complete package WM can send to the IRS to request a determination letter upon plan termination? **(Page 110)**

    a. Form 5310 and Form 8717. [This answer is incorrect. At least one of the forms WM should file to request the determination letter upon plan termination is omitted from this answer choice.]

    b. Form 5310, Form 8717, Schedule Q, and Form 6088. [This answer is correct. For collectively bargained plans, a Form 6088 is required only if the plan benefits employees who are not collectively bargained employees within the meaning of Reg. 1.410(b)-6(d). All the IRS forms necessary to obtain a favorable letter of determination upon termination of the WM plan are listed.]

    c. Form 5310, Form 8717, and Schedule Q. [This answer is incorrect. The question scenario includes the element of a collectively bargained plan. This answer choice omits a necessary form.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (RETTG091)

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.

20. Hobart Enterprises has established a qualified retirement plan for its employees. The plan has a written plan document. Now the company must provide a Summary Plan Description to which of the following?

    a. The IRS.

    b. The owners of the company.

    c. Employees that desire to participate in the plan.

    d. All employees.

21. Sticks & Wicks (S&W) establishes a qualified retirement plan. John is appointed as the plan's trustee, the assets are held in trust by Prime Investments (PI), and Jason, a broker with PI is appointed the plan's investment manager. Assume that PI and Jason meet the established qualifications for the trust requirement; which of the following correctly illustrates the relationship between the parties related to S&W's plan?

    a. The plan document is responsible for determining the investments, John will communicate the investments, and Jason and PI will make the transactions.

    b. PI is the custodian of the plan assets. John will manage plan assets except to the extent that Jason has authority to manage, dispose of, and acquire plan assets.

    c. Once the plan assets are entrusted to PI, the investment company will be responsible for all asset management.

    d. S&W is required to appoint an investment committee that will be responsible for managing, acquiring, and disposing of all plan assets.

22. Match the following plan types with the correct descriptions.

1. Customized plan	i. A multi-employer plan developed by a sponsoring organization and partially or entirely preapproved by the IRS.
2. Prototype plan	ii. The plan type that allows the most flexibility, but is also the most expensive to develop and maintain.
3. Master plan	iii. A plan developed by the sponsoring organization and partially or entirely preapproved by the IRS. It is a single employer plan.
4. Volume submitter plan	iv. A plan comprised of a standardized document that is submitted to the IRS for preapproval, but that allows the document to be changed to meet the employer's needs.

    a. 1., iv.; 2., ii.; 3., i.; 4., iii.

    b. 1., ii.; 2., iii.; 3., i.; 4., iv.

    c. 1., ii.; 2., iv.; 3., iii.; 4., i.

    d. 1., i.; 2., iii.; 3., ii.; 4., iv.

23. Dorothy has accepted a compliance testing engagement for a qualified retirement plan. How would she determine the type of plan and find information about trustees, vesting, and allocation formulas?

    a. Consult the plan document.

    b. Consult the determination letter.

    c. Review the Form 5500.

    d. Question the plan administrator.

24. BannerCo applied for and received a determination letter from the IRS for its qualified retirement plan. After the letter was received, a law changed. What are the consequences for BannerCo in this situation?

    a. As long as nondiscrimination tests are met, BannerCo will not be adversely affected.

    b. The IRS will audit BannerCo to find out if the determination letter still applies.

    c. BannerCo will be unable to rely on its determination letter.

    d. BannerCo must enroll in the IRS Employee Plans Compliance Resolution System.

25. August Enterprises adopted a volume submitter plan. Which of the following is a condition that must be met for the plan to have reliance on the favorable letter received by the document's sponsors?

    a. August Enterprises adopted the plan before the advisory letter was issued.

    b. The plan reflects the definition of compensation under IRC Secs. 414(s) and 415(c)(3).

    c. August Enterprises changed the plan less than 25% from the standardized version.

    d. In operation the plan continues to apply the family aggregation rules.

26. Joe administers a retirement plan. In 2009, the plan was amended, and now Joe is filing for an updated determination letter. After Joe mails the application, when will the IRS consider the application received?

    a. The date the application is received by the IRS.

    b. The date of the postmark.

    c. The due date (including extensions) of the employer's tax year.

    d. At the end of the plan's remedial amendment period.

27. X-treme X-cellence will terminate its qualified plan at the end of 2009. Interested parties must be notified of the plan termination. Under the IRS's notification requirements, who is considered an interested party in this scenario?

    a. All employees with no regard to their eligibility to participate in the plan.

    b. Current plan participants with accrued benefits or receiving benefits and the beneficiaries of those participants.

    c. Employees eligible to participate in the plan and all highly compensated employees.

    d. Current Employees with accrued benefits, former employees with vested benefits and deceased participants' beneficiaries receiving plan benefits.

28. Hoffman Enterprises files its determination letter application on January 2, 2009. On March 5, 2009, the IRS returns the application because the determination letter does not comply with all the required provisions. The company corrects these errors and resubmits the application on March 29, 2009. Estimate the date by which the IRS must act on this application.

    a. May 29, 2009.

    b. August 21, 2009.

    c. September 28, 2009.

    d. December 24, 2009.

29. Hawthorne Investments sponsors master and prototype plans (M&P plans) for several unrelated employers, and has favorable opinion letters from the IRS for all the plans it sponsors. The Carver Company adopts one of the M&P plans in 2009. This is the company's first retirement plan. In 2009, Carver's plan changes brokers, so Hawthorne ceases to support the plan. Carver relied on the plan's opinion letter and never filed for its own determination letter. Which of the following scenarios best illustrates the consequences of these events?

    a. Because the plan operated under a favorable opinion letter at the time of the company's adoption, Carver can continue to use the plan with no additional actions.

    b. Because the plan is not considered an M&P plan without Hawthorne's sponsorship, Carver will need to replace the plan document or the plan must terminate.

    c. The plan will lose its qualified status immediately, and Carver and Carver's employees will be liable for all taxes related to plan earnings.

    d. The plan will be considered an individually designed arrangement without favorable determination of qualified status. It would be advisable for Carver to apply for a determination letter.

30. Match the following notices and reports with the notice that they give and the individuals they give notice to.

1. Summary plan description (SPD)	i. Notifies interested parties that a request for a determination letter will be submitted to the IRS.
2. Updated SPD	ii. Explains the plan and its features to participants and beneficiaries.
3. Notice to interested parties	iii. Required for defined benefit, money purchase pension, target benefit, cash balance, and other plans subject to the ERISA Sec. 302 minimum funding standards.
4. Notice of safe harbor status	iv. When a plan is amended in the prior five or ten years, this report must be furnished to plan participants and beneficiaries.
5. Notice of plan amendment to reduce future benefit accruals	v. Every employee eligible to participate in a safe harbor 401(k) plan must receive written notice 30 to 90 days before the beginning of each plan year.

    a. 1., iii.; 2., i.; 3., v.; 4., ii.; 5., iv.

    b. 1., v.; 2., iii.; 3., iv.; 4., i.; 5., ii.

    c. 1., ii.; 2., iv.; 3., i.; 4., v.; 5., iii.

    d. 1., iv.; 2., v.; 3., ii.; 4., iii.; 5., i.

31. GeoDome establishes a qualified retirement plan. The plan is subject to Part 1 of Subtitle B of Title I of ERISA. When must participants be furnished with an SPD?

    a. 90 days after first receiving benefits.

    b. 210 days after the end of the plan year.

    c. Every five years.

    d. Only when requested by the Department of Labor (DOL).

32. Optic Analysis maintains a qualified retirement plan that has an administrator. In 2007, the administrator retires and another is appointed to take his place. Does this change require the plan to release a summary of material modifications (SMM)?

    a. Yes, this is a material modification to the plan.

    b. No, this is not a material modification to the plan.

    c. Release of a SMM is up to the plan administrator's professional judgment.

    d. An SMM is only required if requested by the DOL.

33. Crumbtastic Cakes maintains a target benefit plan. Due to a recent decline in profits, the company wants to amend the plan document to significantly reduce the rate future benefits will accrue. Apply ERISA guidelines to determine whom Crumbtastic Cake's plan administrator must notify if this change is made.

    a. All current employees, all former employees and their beneficiaries currently receiving benefits from the plan, and the DOL.

    b. All plan participants, all beneficiaries who are alternate payees under a qualified domestic relations order (QDRO), and employee organizations representing plan participants.

    c. All plan participants, all beneficiaries who are alternate payees under a qualified domestic relations order (QDRO), and the DOL.

    d. All current employees, all former employees who were plan participants, all affected beneficiaries, and the DOL.

34. Which of these qualifies as a *protected benefit* under the anti-cutback rules?

    a. Early retirement benefits and retirement-type subsidies.

    b. Accident or health insurance benefits.

    c. Hardship distributions in 401(k), profit-sharing, and stock bonus plans.

    d. Availability of self-directed investments.

35. Simply Elegant establishes a defined contribution plan. The first plan participant will become entitled to plan benefits on August 1. If the employer decides to change the allocation formula, what is the last date it can amend the plan before the allocation formula becomes a protected benefit?

    a. July 1.

    b. July 31.

    c. August 1.

    d. December 31.

36. Maverick Manufacturing maintains an individually designed plan. What is the length of its remedial amendment cycle?

    a. One year.

    b. Four years.

    c. Five years.

    d. Six years.

37. Match the following individually designed plans with the correct remedial amendment cycle.

1. A governmental plan under IRC Sec. 414(b)—last EIN digit, 1.	i. Cycle A
2. A plan with a last EIN digit of 6.	ii. Cycle B
3. A multiemployer plan under IRC Sec. 414(f)—last EIN digit, 7.	iii. Cycle C
4. A multiple employer plan—last EIN digit, 4.	iv. Cycle D
5. A self-employed person with no employees who just submitted a determination letter—last social security number digit, 5.	v. Cycle E

    a. 1., ii.; 2., iii.; 3., i.; 4., v.; 5., iv.

    b. 1., i.; 2., v.; 3., ii.; 4., iv.; 5., iii.

    c. 1., iv.; 2., ii.; 3., v.; 4., iii.; 5., i.

    d. 1., iii.; 2., i.; 3., iv.; 4., ii.; 5., v.

38. Charismatic Capers maintains a volume submitter defined contribution plan. If the end date of its initial EGTRRA remedial amendment period is January 31, 2011, what is the end date of the next cycle?

    a. January 31, 2012.

    b. January 31, 2014.

    c. January 31, 2017.

    d. January 31, 2019.

39. A company would like to change its qualified retirement plan's plan year. The plan will not need permission from the IRS to make this change if it is which of the following?

    a. 401(k) plan.

    b. Cash balance money purchase plan.

    c. Defined benefit plan.

    d. Target benefit plan.

40. All of the following forms may be used to apply for a determination letter **except**:

    a. Form 5300.

    b. Form 5307.

    c. Form 6406.

    d. Do not use.

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.

412(i) plan: A defined benefit qualified plan that is funded entirely by life insurance or annuity contracts. It is appropriate for businesses that need to "catch up" on retirement funding.

Age-weighted profit-sharing plan: This type of plan takes into account both age and compensation in determining contribution allocations to participants. Age-weighted plans satisfy the nondiscrimination tests using safe harbor plan designs. The safe harbor designs are uniform allocation formulas that take into account points for age. The nondiscrimination requirements are satisfied if the plan meets the uniform allocation safe-harbor.

Anti-cutback rules: The anti-cutback provisions state that a plan cannot be amended to decrease an employee's accrued benefit already provided under the plan at the time of amendment. Optional forms of benefit accrued at the time of amendment are also not allowed to be decreased or eliminated.

Cash balance plan: A defined benefit plan having certain defined contribution characteristics. It falls into the defined benefit category because the benefits it provides are not related to the investment experience of the plan's fund.

Cross-tested plan: Cross-tested plans are based on equivalent future benefits, rather than equivalent contributions. They are commonly referred to as new comparability plans. Cross-tested plans are age-weighted by groups of employees, not by individuals.

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.

Designated Roth Account (DRA): A 401(k) plan may offer special DRAs that are part of a 401(k) plan. They will be taxed under the Roth IRA rules but must be considered in the nondiscrimination testing for the 401(k) plan. They are also subject to the required minimum distribution rules. There are no income limits for making contributions to DRAs. These accounts may be of value to high income individuals that can not otherwise make Roth IRA contributions.

Determination letter: A written statement by the IRS in response to a written inquiry about whether a plan is qualified under IRC Sec. 401(a) (i.e., the plan qualifies in form). Among other things, qualification means that the employer's contributions to the plan are deductible, and the plan's investment earnings are exempt from regular income tax, and participants are not taxed until they receive distributions from the plan. In addition, submission of a Schedule Q can secure a determination with respect to various operational issues.

Disqualifying provision: A disqualifying provision occurs when the plan does not satisfy the qualification requirements under the Code because an existing plan provision does not conform to the law change or a plan provision is lacking.

Employee stock ownership plan (ESOP): A stock bonus plan that is qualified, or a stock bonus and a money purchase plan, both of which are qualified under IRC Section 401(a) and that are designed to invest primarily in qualifying employer securities. In addition, the participant is entitled to demand that benefits be distributed in the form of employer securities. If the stock is not readily tradable on an established market, the participant has a right to require that the employer repurchase the securities under a fair valuation formula.

Fixed benefit plan: This type of defined benefit plan provides a uniform stated, or fixed, retirement benefit for all plan members.

Flat benefit plan: This type of defined benefit plan provides a set benefit stated by the plan and based on participants' compensation.

Individually designed plan: This type of retirement plan can be customized to meet the employer's needs. It allows the most flexibility but can be quite costly to develop and maintain. The determination letter process can be expensive for such plans.

Keogh plan: The term *Keogh* is now used to refer to any plan that covers at least one self-employed individual and does not refer to a specific type of plan.

Master plan: A single trust or custodial account that combines several employer plans in a single account. It can be a standardized or nonstandardized arrangement.

Nonstandardized plan: Master or prototype plans with more design options that tend to rely on testing to pass the coverage and nondiscrimination requirements.

Protected benefit: Benefits that may not be reduced or eliminated, including accrued benefits, early retirement benefits and retirement-type subsidies, and optional forms of benefit attributable to service before the amendment.

Prototype plan: A plan developed by the sponsoring organization (typically banks, credit unions, regulated investment companies, lawyers, accountants, or third-party administrators) and either partially or completely preapproved by the IRS. It is typically in a check-the-box format with a preprinted plan document.

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.

Payroll deduction IRAs: This is merely a payroll deduction and not a qualified plan, so there are no filing or nondiscrimination requirements. Employees instruct the employer to automatically deposit part of their pay into their IRA account. It has the same tax advantages available to the individual employee under the normal IRA rules.

Permitted disparity plan: Plans that allow for maximization of contributions for highly compensated employees (i.e., owners and key employees) through a design-based safe harbor.

Remedial amendment cycle: A system of cyclical remedial amendment periods for individually designed and pre-approved plans.

Remedial amendment period: The period of time allowed for a plan to be formally amended when a law is changed and a mandatory amendment is required.

Simplified employee pension plans (SEPs): A written arrangement that allows employers to make tax-deductible contributions without having to meet all the qualification requirements of a qualified retirement plan. The employer has the employees establish individual retirement accounts or annuities. The main advantage of a SEP is that it is easier to administer and does not require the filing of an annual report with the IRS, so administration costs are significantly lower than those of a qualified plan.

Savings incentive match plans for employees (SIMPLE) 401(k) plan: SIMPLE 401(k) plans are easier to operate than the typical 401(k) plan. They do not have to satisfy the special nondiscrimination tests that apply to 401(k) plans, and the top-heavy rules do not apply. However, they are subject to all other qualified plan rules and must file the annual Form 5500 report.

SIMPLE IRA plans: SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. They are designed to be much easier to operate than qualified retirement plans. SIMPLE IRA plans are available to employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year.

Standardized plan: A master or prototype plan that meets specific requirements relating to coverage, eligibility, participation, contributions, and allocation methods. They are designed to guarantee the coverage and nondiscrimination requirements are met, so design options are fairly limited.

Summary plan description (SPD): A notice explaining the plan and its features to the participants and beneficiaries.

Summary of material modifications (SMM): A report furnished to plan participants and beneficiaries when the terms of the plan are materially modified and an updated SPD is not being provided.

Target benefit plan: A hybrid between a defined benefit plan and a money purchase pension plan. The annual contribution amount needed to fund a projected retirement benefit is actuarially determined, but, if the investment performance of the plan differs from the actuarial assumptions used, the employer does not increase or decrease its future contributions so as to provide the promised benefits.

Volume submitter plan: This specimen plan has features of both an individually designed plan and a prototype plan. The bulk of the document is standardized and is submitted to the IRS for preapproval. However, the document can be changed to meet an employer's specific needs. The IRS user fee for a determination letter for a volume submitter plan is significantly lower than that of a customized plan since it has been previously approved in part.

Unit credit plan: This type of defined benefit plan provides a benefit based on the number of years of service a participant has accumulated, or been given credit for.

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COMPANION TO PPC'S GUIDE TO SMALL EMPLOYER RETIREMENT PLANS

COURSE 2

CONTRIBUTION LIMITS AND DEDUCTIONS (RETTG092)

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 2009

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 **September 30, 2010**

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.

TO COMPLETE THIS LEARNING PROCESS:

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

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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.

Qualified plans generally must be amended to comply with the final Section 415 regulations by the deadline for filing the employer's tax return (including extensions) for the year that includes the effective date of the final regulations. Calendar-year plans should be amended by the due date of the 2008 plan year. Corrective action may need to be taken for plans not amended by the prescribed deadline.

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 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 2009. 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 2009.

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 $15,500 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 $46,000. Though Dr. Sue's total allocations for the year are $65,500, she has not exceeded the Section 415 limits because the $46,000 contributed to the profit-sharing plan is considered the hospital's plan while the contribution of $19,500 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 meet the Section 415(c) limits 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. Annual additions.

    b. Pension benefits.

    c. 401(m) matching contributions.

    d. 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 2010, 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 127)**

   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 129)**

   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 130)**

   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 130)**

   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 2009.]**

   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 2009.]

   d. Don works for Daysmith LLC and participates in its money purchase pension plan. The money purchase plan was scheduled for termination in 2010, and a 401(k) plan was established. In 2009, 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, 2009. 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, 2009, and ends December 31, 2009, even though the plan itself has a short first year of July 1, 2009–December 31, 2009.

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 2009, 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, 2009, and ending June 30, 2009. 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 2009 must be multiplied by $^{6}/_{12}$ to equal a limit of $24,500 for the short period ending June 30, 2009.

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.

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 [as described in IRC Sec. 401(c)(2)]. 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).

(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 $2^1/_2$ 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).

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.

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 2009).

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 2009. 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 2009 for use in determining the Section 415 limit.

    d. Sam's employer includes a *de minimis* amount of accrued compensation earned in 2009 but paid in the first week of 2010.

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 136)**

   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 136)**

   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 138)**

   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 2009. Because the plan's limitation year is the calendar year, only compensation he earned from June to December of 2009 is included. [This answer is incorrect. Though Jake has less than a full year of participation in the plan at the end of 2009, 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 2009 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 2009 but paid in the first week of 2010. [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 2009 (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 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. 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 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, 2009?

The plan's adjusted dollar limit for its limitation year ending June 30, 2009 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 to 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 2009). 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 2009 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 2009); 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 2009 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 violating 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 2009 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 (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 contributions 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.

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 2009 limitation year. For 2009, 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 2009 and, therefore, is properly credited to Bob's account.

Example 1-12: Calculating the allowed annual addition for 2009 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 2009, 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 2009? 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 2009 is $49,000. However, for 2009, 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 2009 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 such an individual 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, 2009, is due August 17, 2009. The company contributes to the plan on July 31, 2009, and allocates this contribution to participants' accounts as of December 31, 2008. 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, 2009, and allocated to participants' accounts within the 2008 limitation year, the contributions are considered annual additions for the 2008 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, 2009, is allocated to participants' accounts as of March 31, 2009. Because the last day of the plan year is in the 2009 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 2009 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 2010, Shellco discovers that it erroneously failed to properly credit an employer contribution to Nancy's account for the 2008 year. In 2010, it allocates an amount to correct this error. The amount is considered an annual addition for the 2008 limitation year. If Shellco also allocates an amount to take into account plan investment gains for 2009 and 2010, 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 2006, Desk experienced severe cash flow problems, and was unable to make its required contribution to the plan. In 2009, Desk makes a contribution to make up the 2006 deficiency. The contribution is allocated to those persons who were participants on December 31, 2006. The contribution is considered an annual addition for the 2006 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, 2009. 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 2009 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 2009 limitation year was $175,000. Purrfect Prospects contributed $8,800 to the plan on her behalf in 2009. Lynne contributed $17,500 to the plan in 2009, as well. During the course of the year, Lynne repays a $18,000 loan that she took out against her plan benefits in 2008. Plan forfeitures of $5,000 are allocated to her account during the year. Calculate Lynne's 2009 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. 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' 2009 annual addition?

    a. In 2009, the firm discovers an error; it failed to credit an employer contribution to Sam's account during the 2006 year. In 2009, the firm allocates the amount to correct the error.

    b. The firm makes contributions to all participants' accounts as of January 1, 2010.

    c. The firm could not make required contributions to the plan in 2005. In 2009, the firm contributes amounts to employees who were plan participants in 2005 to make up the deficiency.

13. 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.

14. The defined contribution plan maintained by Columnar Industries made matching contributions to excess employee contributions in 2008. 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 141)**

   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, 2009. 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 141)**

   a. Yes. [This answer is incorrect. 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 2009 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 2009 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 2009 is limited to what amount? **(Page 144)**

    a. $45,000. [This answer is incorrect. This was the annual addition dollar limit for 2007. It has been adjusted for 2008.]

    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 2009 limitation year was $175,000. Purrfect Prospects contributed $8,800 to the plan on her behalf in 2009. Lynne contributed $17,500 to the plan in 2009, as well. During the course of the year, Lynne repays a $18,000 loan that she took out against her plan benefits in 2008. Plan forfeitures of $5,000 are allocated to her account during the year. Calculate Lynne's 2009 annual addition, and determine if she has exceeded the Section 415 limit. **(Page 144)**

    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 2009 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 2009.]

    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 2009 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 2009 Section 415 limit; however, the $18,000 loan repayment should not have been included while calculating the annual addition.]

12. 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' 2009 annual addition? **(Page 146)**

    a. In 2009, the firm discovers an error; it failed to credit an employer contribution to Sam's account during the 2006 year. In 2009, the firm allocates the amount to correct the error. [This answer is incorrect. The contribution would be considered part of annual addition for the 2006 limitation year, not the 2009 limitation year.]

    b. The firm makes contributions to all participants' accounts as of January 1, 2010. [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 2010, they would still be includable in the annual addition under this rule.]

    c. The firm could not make required contributions to the plan in 2005. In 2009, the firm contributes amounts to employees who were plan participants in 2005 to make up the deficiency. [This answer is incorrect. The contributions would be considered part of the annual addition for the 2005 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.]

13. A defined contribution plan will correct excess annual additions by distributing employee after-tax contributions. Which of the following applies in this situation? **(Page 148)**

    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.]

14. The defined contribution plan maintained by Columnar Industries made matching contributions to excess employee contributions in 2008. How should the matching contributions be treated after the Section 415 violation? **(Page 149)**

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.]

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.]

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 2009. 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 2009 allowed under a 401(k) plan.

XYZ, Inc., adopts a profit-sharing plan with a 401(k) arrangement on November 30, 2009, with an effective date of January 1, 2009. 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 2009? The plan cannot permit elective deferrals of any compensation available to a given participant before the date the plan is adopted (November 30, 2009), as this date is later than the plan's effective date (January 1, 2009). 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 2009? 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 $7,200 (6,000 × 12 × 10%), or (c) the compensation earned after adoption of the plan of $7,000. Thus, the maximum elective deferral Bob can make for 2009 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 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 2009 is $5,500. This amount is increased for inflation. For SIMPLE IRA and SIMPLE 401(k) plans, the amount for 2009 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 2009, 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 2009) 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 2009, 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 2009?

Teddy's total elective deferral limit for 2009 is $16,500. Therefore, Teddy's elective deferral limit for the 401(k) plan for 2009 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 2009). 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. For tax years beginning on or after January 1, 2007, the adjustment for gains and losses generally must include gains and losses that occurred during the *gap period* (the period beginning immediately after the tax year and ending up to seven days before the distribution).

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.

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. 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.

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.

How to Allocate Net Income to Excess Deferrals

The plan's net income allocable to excess deferrals is equal to the sum of (a) allocable gain or loss for the individual's tax year and (b) if the plan so provides, allocable gain or loss for 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 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 2009. The contribution was within Tracy's Section 415 limit, but drastically exceeded the 2009 $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)	$	125,500
Tracy's elective deferrals for the plan year	$	30,000
Elective deferral limit for 2009	$	16,500
Tracy's excess deferral for 2009 ($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 ($14,500 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 2009 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, 2010.

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 2010 Forms 1099-R. One is used to report the $1,000 excess deferral indicating it is taxable in the year of the deferral (2009) 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 (2010) 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, 2009, for the 2009 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, 2009.

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 2009 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 (2009) 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 2009 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, 2010.

How is the excess deferral and allocable loss reported to Tom? The 2010 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 (2009), and that the loss may be reported as a bracketed amount on the "Other Income" line, Form 1040, for the distribution year (2010).

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 2009. Thus, he has an excess deferral of $1,000 includable in his 2009 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, 2010, with allocable income. Normally, Tim would report the $2,000 of excess contributions as 2010 income. However, $1,000 of the $2,000 is treated as a distribution of the excess deferral (which is already included in Tim's 2009 income). Thus, Tim will report the remaining $1,000 of the excess contributions (plus the allocable income on the $2,000) as 2010 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 (amounts in excess of the allowable amounts under the ADP test) must be returned. For corrective distributions made with respect to plan years beginning prior to January 1, 2008, a corrective distribution made in the first $2^1/_2$ months of the 12-month correction period is generally included in income for the taxable year that precedes the taxable year in which the distribution occurs. The employer is liable for an excise tax when corrective distributions are made after the first $2^1/_2$ months of the correction period. However, for post-2007 plan years, in the case of a 401(k) plan with an eligible automatic contribution arrangement, corrective distributions may be made within the first six months of the correction period. Corrective distributions in post-2007 plan years are taxable in the taxable year of the employee in which distributed. For post-2007 plan years, a plan with an eligible automatic contribution arrangement is eligible to make ADP/ACP refunds up to six months after the close of the plan year without incurring the 10% excise tax.

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. The typical 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 2009 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 2009?

    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 2009, 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 2009, 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 2009.

    c. The plan can provide for distribution of excess deferrals and related earnings by March 1, 2010.

    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 2009 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 2009 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, 2010. How is this reported to Leslie?

a. On two 2010 Forms 1099-R.

b. On one 2009 Form 1099-R.

c. On a 2010 Form 1099-R accompanied by a separate statement.

d. On a 2010 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 2009 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 156)**

    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 2009? **(Page 156)**

    a. $2,500. [This answer is incorrect. This is the allowable catch-up contribution limit for SIMPLE IRAs and SIMPLE 401(k) plans in 2009.]

    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 2009.]

    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 2009, she contributes $2,500 to Honest Eugene's 401(k) plan. Calculate the amount of wages for FICA and FUTA purposes. **(Page 157)**

    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 2008 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 2009, he has excess deferrals of $500. Which of the following scenarios best illustrates appropriate consequences for the excess deferrals? **(Page 158)**

   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.]

   b. The plan can provide for distribution of excess deferrals and related earnings in 2009. [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, 2010. [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. 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 159)**

   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 2009 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, 2010. How is this reported to Leslie? **(Page 160)**

   a. On two 2010 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 2008 (the year of deferral), and one reporting the distribution of $50 income indicating that it is taxable in 2009 (the year of distribution).]

   b. On one 2009 Form 1099-R. [This answer is incorrect. One Form 1099-R would be used if the distribution was made to Leslie in 2009.]

   c. On a 2010 Form 1099-R accompanied by a separate statement. [This answer is incorrect. If the $50 in this scenario was loss instead of income, a 2010 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 2009 Form 1040.]

   d. On a 2010 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 162)**

    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 (RETTG092)

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 2009. The plan document specifies that the plan year will run from May 1 through April 30. What is the plan's limitation year for 2009?

   a. January 1 – December 31, 2009.

   b. May 1, 2009 – April 30, 2010.

   c. June 1, 2009 – December 31, 2009.

   d. June 1, 2009 – April 30, 2010.

6. Assume the same details as in the question above. In May 2010, 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 2009, Home Harmony contributes $6,000 on behalf of Mike, who has been employed by Home Harmony for 25 years. Mike's salary for 2009 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 2009, which adds $12,000 to his account. Calculate Mike's 2009 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 2009 income tax return is due March 15, 2010. The return will not be extended. In which of the following scenarios would the contribution be included in the 2009 annual addition for Section 415 purposes?

    i. Steve makes a contribution to the plan on January 15, 2010.

    ii. Bread Company makes a contribution to the plan for Sarah on June 1, 2010.

    iii. Joan makes a contribution to the plan on February 1, 2010.

    iv. Bread Company makes a contribution to the plan for Joe on March 15, 2010.

    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 2008 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. 2008.

    b. 2009.

    c. 2010.

    d. 2011.

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, 2009. The plan effective date is January 1, 2009. 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 2009?

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 2009?

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 2009, 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 2009 only if it is made by December 31, 2009.

    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 2009, 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 2009 income.

    b. As $2,500 of 2010 income.

    c. As $1,500 of 2009 income and $2,500 of 2010 income.

    d. As $1,500 of 2009 income and $1,000 of 2010 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 2008 plan year, the profit-sharing plan maintained by Fiction Ltd. had investment losses due to a breach in fiduciary duty. In 2009, 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 176)**

    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 176)**

    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.]

24. During its 2008 plan year, the profit-sharing plan maintained by Fiction Ltd. had investment losses due to a breach in fiduciary duty. In 2009, 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 176)**

    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 2009, 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 $230,000 for 2008. 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 2009.

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 2009 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 2009 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 2009.

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.

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 2009, its profits were $750,000. Based on the 11% rate, its contribution for 2009 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 2009 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 2009 ($22,000 for 2009 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 2009 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 2009 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 2009, 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 2009 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 2004 through 2008, resulting in contribution carryovers. The plan maintained its qualified status throughout. The schedule below illustrates the use of those carryovers.

	2004	2005	2006	2007	2008
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 2004, $800 for 2005, 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 2009) 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 2009) 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 2009, 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 2009.

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 2009 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 2009 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 2009 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 2009 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) is the accrued liability full funding limit. However, for plan years beginning in 2008 and after, the full funding limitations apply only to multiemployer plans.

Understanding the Minimum Funding Standard Rule

The minimum funding standards are contained in IRC Sec. 412 and ERISA Sec. 302. The PPA made extensive changes to the requirements for plan years beginning after 2007. 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. For taxable years beginning after 2007, the PPA has revised the minimum funding standards so that most plans will be subject to a single set of funding rules.

Under the revised 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

The PPA has substantially changed the funding requirements for defined benefit plans. 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 2008 within 8½ months of the plan year end ($8,000 on March 15, 2009, and $2,000 on September 15, 2009 (IRC Sec. 412). However, only $8,000 was deductible for 2008 because $2,000 was paid subsequent to the tax filing of March 15, 2009 and therefore is not deductible for 2008. Assuming that the full funding limitation does not otherwise limit the deduction, this $2,000 is deductible as an "includible contribution" in 2009, even though when added to the 2009 required minimum funding contribution of $11,000, it causes the deduction to exceed the minimum funding requirement for 2009. Although the 2008 contribution was $10,000 and the 2009 contribution was $11,000, the deduction for 2008 was $8,000 and the 2009 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 8½ 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, 2009.

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 2$^{1}/_{2}$ months (24 months for multiemployer plans) following the close of the plan year for which the waiver is requested. Also, a user fee of $15,000 ($9,000 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. 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.

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 2009) 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 2009. Joan's 2009 Form 1040 has been extended until October 15, 2010.
>
> When must Joan make the $10,000 contribution and when can she deduct it? Technically, if Joan makes the contribution by October 15, 2010, she can claim the $10,000 deduction on her 2009 tax return. However, for minimum funding purposes, Joan must make the contribution by September 15, 2010.

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 2009) 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 2009. 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 2009 plan year, Deuce makes no contributions to the defined contribution plan. The only contributions made to that plan in 2009 are elective deferrals by employees. Thus, the combined plan deduction limit of 25% of compensation does not apply for 2009. 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 2009. 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 2009.

    a. $12,000.

    b. $25,000.

    c. $49,000.

    d. $90,000.

26. Butterfield International runs a profit-sharing plan for its employees. In 2009, Butterfield has no current or accumulated profits. How will this affect the plan?

    a. Butterfield will not contribute to the plan in 2009.

    b. Butterfield must make a contribution to the plan in 2009 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 2009, 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 $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.

    d. An equation that reduces a self-employed participant's maximum contribution percentage (based on precontribution earned income).

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 2008 within 8½ months of the plan year end—$15,000 on March 15, 2009, and $5,000 on September 15, 2009. The company made the 2009 minimum funding contribution of $9,000 on December 15, 2009. Calculate the amount that Mandolins Limited can deduct as an "includable contribution" in 2009.

    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 2009 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 2009. Which of the following scenarios applies?

    a. $245,000 is TGBT's deduction limit for 2009.

    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 2009. 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 2009. **(Page 179)**

    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 2009 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 2009 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 2009, Butterfield has no current or accumulated profits. How will this affect the plan? **(Page 180)**

    a. Butterfield cannot contribute to the plan in 2009. [The answer is incorrect. Profits are not required to be eligible to contribute to the plan.]

    b. Butterfield must make a contribution to the plan in 2009 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.]

    c. Butterfield can determine whether or not to make a contribution on an annual basis. [The answer is incorrect. 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 2009, 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 181)**

    a. Jessica has a limit problem and must receive $1,500 to correct it. [This answer is correct. Jessica has exceeded her 2009 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.]

    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.]

    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.]

28. Which of the following accurately defines the term *contribution formula*? **(Page 181)**

    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.]

    d. An equation that reduces a self-employed participant's maximum contribution percentage (based on precontribution earned income). [This answer is incorrect. This is the recalculated percentage used when calculating earned income for self-employment individuals. This percentage is used when applying the annual compensation limit.]

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 184)**

    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.]

    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 187)**

    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 2008 within 8½ months of the plan year end—$15,000 on March 15, 2009, and $5,000 on September 15, 2009. The company made the 2009 minimum funding contribution of $9,000 on December 15, 2009. Calculate the amount that Mandolins Limited can deduct as an "includable contribution" in 2009. **(Page 190)**

   a. $9,000. [This answer is incorrect. The $9,000 contributed in 2009 would be the regular deduction for 2009.]

   b. $14,000. [This answer is correct. The $5,000 that was contributed after the company's tax filing was not deductible in 2008 and can be deducted in 2009 as an "includable contribution" even though it causes the 2009 deduction to exceed the minimum funding requirement. The $9,000 regular deduction for 2009 is also timely made and deductible in 2009.]

   c. $15,000. [This answer is incorrect. The $15,000 was deducted in time to include in the 2008 deduction.]

   d. $20,000. [This answer is incorrect. The entire $20,000 minimum funding contribution for 2008 would not be deducted as an "includable contribution" in 2009.]

32. In which of the following scenarios would the plan be exempt from the ERISA portion of the minimum funding standards? **(Page 191)**

   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.]

33. The Garden Outlet maintains a defined benefit plan, and in 2009 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 194)**

   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 195)**

    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 2009. Which of the following scenarios applies? **(Page 197)**

    a. $245,000 is TGBT's deduction limit for 2009. [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 2009.]

    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 197)**

    a. DWI contributes only $10,000 to both plans during the plan year. [This answer is incorrect. 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. 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.]

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 2009 year, it extends its return until September 15, 2010. The return is actually filed on July 15, 2010, 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 2008 year be made on or before July 15, 2010, to be deductible? No. The contribution is deductible if made on or before September 15, 2010, 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 2009 return to September 15, 2010. Boxcorp mailed its profit-sharing contribution to the trust on September 1, 2010. However, the trust did not receive it until September 19, 2010.

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, 2010 (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, 2009, 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, 2009, Alpha claims the contribution deduction for its tax year ending June 30, 2010. The plan must be qualified for the 2010 plan year ending December 31, 2010, to enjoy a tax deduction under the qualified plan rules for the tax year ending June 30, 2010. The deduction limit will be based on the participants who share in the contribution as of December 31, 2009, 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, 2009, based on projected wages for eligible participants through June 30, 2010. If, during the period from January 1, 2010, through June 30, 2010, 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, 2008. Harris, Inc. pays the $2,000 excise tax on this excess contribution. For the 2009 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 2009 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 2009 plan year? The excise tax for the 2009 plan year is $1,500 (10% × $15,000).

If Harris, Inc. contributes $125,000 for 2010, and the maximum deductible amount for that year is $140,000, what is the 2010 excise tax? No excise tax is due for the 2010 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 2009. XYZ accrues $20,000 of additional contributions at December 31, 2009, but actually makes this contribution January 15, 2010. The employer contribution deduction limitation for XYZ for 2009 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 2009 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, 2010. In which of the following scenarios, can TJ&H deduct a contribution to the stock bonus trust in the 2009 tax year?

    a. The contribution is made on September 13, 2010, and is based on service performed from March 1 to April 30, 2010.

    b. TJ&H causes a delay in the handling of the check, so the trust does not receive it until September 16, 2010.

    c. TJ&H mails the contribution to the trust on September 10, 2010, but the trust does not receive it until September 17, 2010.

    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 2009 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 2009. The employer accrues additional contributions of $12,000 at December 31, 2009, and contributes them on January 15, 2010. The employer contribution deduction limitation for Roy's Autos in 2009 is $60,000. How much excise tax will Roy's Autos owe for the 2009 tax year?

   a. $200.

   b. $5,000.

   c. $12,000.

   d. Roy's Autos does not owe excise tax for the 2009 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 2009 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 2009, 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, 2010. In which of the following scenarios, can TJ&H deduct a contribution to the stock bonus trust in the 2009 tax year? **(Page 206)**

    a. The contribution is made on September 13, 2010, and is based on service performed from March 1 to April 30, 2010. [This answer is incorrect. Contributions based on services performed after the firm's tax year is closed would not be deductible in 2009, even if the contribution was made before the due date of the return. Therefore, this contribution will not be deductible by TJ&H in 2009.]

    b. TJ&H causes a delay in the handling of the check, so the trust does not receive it until September 16, 2010. [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 2009 in this scenario.]

    c. TJ&H mails the contribution to the trust on September 10, 2010, but the trust does not receive it until September 17, 2010. [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, 2010, (which is the due date of the return) the contribution will be considered timely made. Therefore, TJ&H can deduct this contribution in 2009.]

    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 2009 in this scenario.]

38. In which of the following scenarios does the employer correctly determine its deduction limit? **(Page 208)**

    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.]

    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.]

    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. 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 2009 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 208)**

    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. 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. 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.]

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 209)**

    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.]

    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.]

    c. A mistake of law. [This answer is incorrect. 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 2009. The employer accrues additional contributions of $12,000 at December 31, 2009, and contributes them on January 15, 2010. The employer contribution deduction limitation for Roy's Autos in 2009 is $60,000. How much excise tax will Roy's Autos owe for the 2009 tax year? **(Page 210)**

    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.]

    b. $5,000. [This answer is incorrect. This is 10% of $50,000. Roy's Autos would not need to pay excise tax on the entire $50,000 of actual contributions made to the plan in 2009.]

    c. $12,000. [This answer is incorrect. This is 10% of $12,000. Roy's Autos would not need to pay excise tax on the entire amount of additional contributions that accrued in 2009.]

    d. Roy's Autos does not owe excise tax for the 2009 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 2009, 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 210)**

   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.]

   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.]

   c. BenCorp maintains a defined benefit plan, and in 2009 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 2009, the same year that the company will terminate its qualified plan. [This answer is incorrect. 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 (RETTG092)

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. Does the plan have 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 2009, 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 2008 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 2009 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 2009 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 2009.

    c. The $6,000 can be carried over to Tale Weaver's 2010 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 2009, 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. $17,806.

    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 2009 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, 2010, and the company pays the excise tax on May 31, 2010, 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, 2010, 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 2009. Lavinia's 2009 Form 1040 has been extended until October 15, 2010. If Lavinia wants to claim the deduction on her 2009 tax return and meet the minimum funding requirements, when must she make the $7,000 contribution to the plan?

    a. December 31, 2009.

    b. April 15, 2010.

    c. September 15, 2010.

    d. October 15, 2010.

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 2009. 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 2009).

    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 2009.

    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, 2010. Is it possible for the company to deduct this contribution in 2009?

    a. Yes, the company will always be able to claim this deduction for the 2009 tax year.

    b. No, the contribution was made too late for the company to claim the deduction in 2009.

    c. The company can claim the deduction in 2009 if it claims the contribution as a deduction on its 2009 tax return.

    d. The company can claim the deduction in 2009 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 used 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 2009, 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 2009. 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 2009 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.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Small Employer Retirement Plans—Course 1—Choosing and Maintaining a Qualified Retirement Plan (RETTG091)

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.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   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 **September 30, 2010**. 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.

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EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Small Employer Retirement Plans—Course 1—Choosing and Maintaining a Qualified Retirement Plan (RETTG091)

CTEC Course No. 3039-CE-0218
Price $79

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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.	○	○	○	○
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7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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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—Choosing and Maintaining a Qualified Retirement Plan

Course Acronym: RETTG091

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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?	○	○	○	○	○	○	○	○	○	○

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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 (RETTG092)

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Small Employer Retirement Plans—Course 2—Contribution Limits and Deductions (RETTG092)

CTEC Course No. 3039-CE-0219
Price $79

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1.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
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11.	○	○	○	○															

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Self-study Course Evaluation

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Course Title: Companion to PPC's Guide to Small Employer Retirement Plans—Course 2—Contribution Limits and Deductions Course Acronym: RETTG092

Your Name (optional): ____________________ Date: ____________

Email: ____________________

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Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
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2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
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7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
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