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A. Basic Qualification Requirements

1. Section 401(a)(4):The General Anti–discrimination Rule

Two important discrimination tests must be satisfied before an employee benefit plan and trust will qualify under § 401(a) and § 501(a), respectively. The first is the “coverage”or “eligibility” test. [24] This test requires qualified plans to benefit a substantial percentage of the employer's employees. In particular, a classification determining which employees are to be covered by a qualified plan cannot discriminate in favor of employees who are highly compensated within the meaning of § 414(q). In this respect, qualified plans differ substantially from nonqualified plans, which may benefit only a few key employees.

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[24] Sections 401(a)(3); 410(b).

The second discrimination test is the “contributions or benefits test.” This test requires that contributions to, or benefits under, a qualified retirement plan not discriminate in favor of participants who are highly compensated employees. [25] A plan will not be considered discriminatory for this purpose solely because contributions or benefits are computed as a level percentage of each employee's compensation. [26]

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[25] Section 401(a)(4).

[26] Section 401(a)(5).

Note: Effective for years beginning after December 31, 1996, the Small Business Job Protection Act of 1996 simplified the definition of highly compensated employee for purposes of the Code's nondiscrimination rules. [27] Under the rules as modified by the 1996 Act, an employee is treated as highly compensated if the employee: (1) was a 5% owner of the employer at any time during the current year or the preceding year; or (2) had compensation for the preceding year in excess of $80,000(as indexed for inflation) and, if the employer so elects, the employee was in the top 20% of employees by compensation for such year. [28]

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[27] *See* P.L. 104–188, § 1431.

[28] Section 414(q)(1). In addition, the 1996 Act repealed the rule requiring the highest paid officer to be treated as a highly compensated employee. Further, the Act repealed the family aggregation rules formerly contained in § 414(q)(6)that applied to family members of certain highly compensated employees for purposes of the nondiscrimination rules.

For taxable years beginning before January 1, 1997, the Code defined a highly compensated employee as an employee who during the plan year or the previous plan year:
(1) was a 5%owner of the employer;

(2) received annual compensation from the employer in excess of $75,000 (as indexed for inflation);

(3) received annual compensation from the employer in excess of $50,000 (as indexed for inflation) and was among the top 20% of employees by compensation; or

(4) was at any time an officer of the employer and received compensation greater than 50% of the dollar amount in effect under § 415(b)(1)(A)for that year. If, under (4), above, an employer had no officers for the year who earned the requisite threshold amount of annual compensation, the highest paid officer still was considered an officer. Further, no more than 50 employees were counted as officers for this purpose (or, if less than 50, no more than the greater of three employees or 10% of employees).

2. Top–Heavy Rules for Section 401(a) Plans

In 1982, TEFRA[29] introduced the top–heavy rules to tax–qualified plans. A “top–heavy” plan is one that disproportionately benefits certain “key employees” as defined in § 416(i). If a qualified retirement plan is top–heavy for a particular plan year, it must meet stricter requirements relating to vesting and provide either minimum benefits (in the case of a defined benefit plan) or minimum contributions (in the case of a defined contribution plan). A top–heavy plan satisfies the vesting requirements if it provides for either three–year “cliff” vesting or six–year graded vesting. [30]

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[29] The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97–248).

[30] Section 416(b).

The minimum benefit that must be provided to non–key employees by a top–heavy defined benefit plan must equal, for each year of service, at least 2% of the employee's average compensation over the employee's five highest consecutive years of service in the plan, but in no event is the total minimum benefit required to exceed 20% of the employee's average compensation over such five–year period. [31]

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[31] Section 416(c)(1).

In the case of a top–heavy defined contribution plan, the minimum contribution (allocation) that must be provided to the account of each non–key employee participant generally is equal to 3% of such participant's compensation for the year. However, where the largest allocation for the year to the account of any key employee participant, when expressed as a percentage of compensation, is less than 3%, the minimum contribution requirement can be satisfied by providing an allocation equal to the largest percentage allocated to the account of any key employee participant for the year. [32]

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[32] Section 416(c)(2)(A)–(B).

Legislative Change Note: The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, § 613(b), amended § 416(c)(2)(A) to provide that, effective for years after December 31, 2001, employer matching contributions(as defined in § 401(m)(4)(A)) are taken into account in determining whether the minimum contribution rule has been satisfied. However, any reduction in the minimum contribution under this provision is not taken into account in determining whether the conditional benefit rule of § 401(k)(4)(A) applies.

The top–heavy minimum benefit (or, in the case of a defined contribution plan, the minimum contribution) must be provided by the employer without taking into account Social Security benefits or contributions. [33] In addition, the minimum contribution requirement is determined for a defined contribution plan without regard to any amounts contributed by a participant pursuant to a salary reduction arrangement for either key or non–key employees (employer matching contributions are taken into account, however).

[33] Section 416(e).

In general, a plan will be considered to be top–heavy for a particular plan year if, as of the "determination date"for that plan year (generally the last day of the prior plan year):
(1) the present value of the accumulated accrued benefits (in the case of a defined benefit plan) or the sum of the account balances (in the case of a defined contribution plan) of participants who are key employees for the plan year exceeds 60% of the accumulated accrued benefits or sum of the account balances, as the case may be, of all employees under the plan;or

(2) the plan is a part of a aggregation group of plans in which such group is a top–heavy group. [34]

[34] Section 416(g)(1).

Since the top–heavy rules (vesting, minimum benefits and contributions, etc.) are qualification rules, a § 401(a) plan will only qualify if these rules (which take effect in top–heavy plan years) are included in the plan document. [35] Alternatively, a plan may provide one set of general rules which meet both the § 401(a) and the § 416 requirements. Note that the regulations exempt certain plans (such as collectively bargained plans) from the requirement that they include top–heavy language and also provide simplified compliance procedures for others. [36]

[35] *See* Regs. Section 1.416–1.

[36] Regs. Section 1.416–1, T–36–38.

For a discussion of the rules for top–heavy plans, see 353 T.M., *Employee Benefits for Small and Mid-Sized Employers*.

3. The Requirement that Benefits Under a Pension Plan Be "Definitely Determinable"

To qualify as a pension plan, an employee benefit plan must provide "definitely determinable benefits." Specifically, the regulations require that a pension plan be:

A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of Section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase plans, such contributions are fixed without being geared to profits. [37]

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[37] Regs. Section 1.401–1(b)(1)(i).

Example: A money purchase pension plan that permits the board of directors to limit the contributions on behalf of certain employees would not qualify under § 401(a) as the contributions under the plan are not fixed as required by Regs. Section 1.401–1(b)(1)(i) (requiring definitely determinable benefits). [38]

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[38] Rev. Rul. 73–379, 1973–2 C.B. 124. *See also* Rev. Rul. 78–403, 1978–2 C.B. 153.

The IRS ruled in Rev. Rul. 79–90, [39] that a defined benefit plan which provides optional forms of retirement benefits which are actuarially equivalent to the normal form of benefit must specify in the plan the actuarial assumptions used in determining equivalency. This requirement later was codified in § 401(a)(25).

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[39] 1979–1 C.B. 155.

Further, although a qualified pension plan may provide "incidental"death benefits, it cannot pay layoff, sickness, accident, hospitalization, or medical benefits except to the extent permitted under § 401(h). [40] A qualified plan may provide pension benefits in the event of disability or early retirement, however. [41]

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[40] Regs. Section 1.401–14.

[41] *See, e.g.,* TAM 9516005 (plan's assumption of corporate liability to pay supplemental retirement benefits to plan participants of acquired company and designation of list of employees to receive such benefits, which includes a specified annual payment for each employee payable in a form which complies with the requirements of § 401(a)(11), does not violate definitely determinable benefit rule).

Note: In Rev. Rul. 78–56, [42] the IRS considered the requirement that a pension plan provide for "definitely determinable benefits" in the case of insured plans that use current annuity purchase rates for retirees whenever those rates are found to be more favorable than the annuity purchase rates guaranteed by contract. The IRS ruled that this type of adjustment for a favorable change in annuity purchase rates would not necessarily keep a pension plan from satisfying the "definitely determinable" benefit requirement. According to the ruling, four basic requirements must be met in an insured plan for this type if the benefit to be considered "definitely determinable:"
(1) the participant's accrued benefit at all times must be determinable under the insurance contract;

(2) the plan benefit must be "uniquely determinable" based on the (a)accrued benefit, (b) procedures stated in the insurance contract (or established by insurance company practice) and (c) current annuity purchase rate offered by the insurance company;

(3) the current annuity purchase rate must not be affected by forfeitures under the plan;and

(4) none of the above three factors must be within the employer's discretion (other than by plan amendment).

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[42] 1978–1 C.B. 116.

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4. Other Requirements

In addition to the above requirements, a qualified plan must meet any other criteria imposed by the Code and IRS regulations and rulings, including requirements relating to plan permanency, written communication of the plan to employees, computation of benefits, accrual and vesting of benefits, and limitations on suspension, discontinuance, or curtailment of a plan.

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C. Types of Pension and Profit–Sharing Plans

1. Profit–Sharing Plans

a. The Contribution Formula

A profit–sharing plan involves two formulas. One establishes the annual amount of employer contributions. The other allocates that contribution among participants.

The contribution formula may be a fixed one geared to profits, gross sales or any other relevant index chosen by the employer.[43] Alternatively, a qualified profit–sharing plan may have an indefinite formula calling for a contribution to be determined each year (within a specified range) by the sponsoring employer.

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[43] Regs. Section 1.401–1(b)(2). Note that, under Section401(a)(27), contributions to a profit–sharing plan need not be based upon profits.

Regardless of how the amount of the annual employer contributions is determined, the employer may not deduct (except where carryforward contributions, discussed below are concerned) in any year, in respect of contributions to a § 401(a)stock bonus or profit sharing plan, more than 15% of the compensation paid to all employees covered by the plan. [44] If the employer contributes more than 15% in any single year, the excess or (”contribution carryover”) may be deducted in subsequent years. In any subsequent year, the total deduction for both current contributions and the contribution carryover, however, cannot exceed 15% of covered payroll during that year.

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[44] Section 404(a)(3)(A).

Legislative Change Note: Section 616(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, amended § 404(a)(3)(A)(i) by increasing the 15% deduction limit for contributions to profit-sharing and stock bonus plans (and money purchase pension plans, except to the extent the IRS provides otherwise) to 25%, effective for years beginning after December 31, 2001.

Note: For taxable years before 1987, if the employer did not make the full 15% contribution in a given year, it could make a deductible contribution larger than 15% in a succeeding year. The amount deductible in the succeeding year was limited to the lesser of:
(1) 15% of covered compensation plus the excess of the 15%limitation for all prior years over the amounts actually deducted in those years (called “credit carryovers”); or

(2) 25% of covered compensation.[45]

[45] Former § 404(a)(3)(A).

In addition to the maximum allowable deduction limits, there is a ceiling on the annual amount that may be allocated to the account of any participant in a qualified defined contribution plan. In the case of a defined contribution plan, the maximum "annual addition" is the lesser of $40,000 (as indexed for inflation), or 100% of the participant's compensation.[46] An annual addition consists of employer contributions to an employee's account, plus any forfeitures re–allocated to that participant's account, plus the participant's employee contributions.

[46] *See* § 415(c)(1)(A) and (B), as amended by § 611(b)(1)and § 632(a)(1) of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, effective for years beginning after Dec. 31, 2001. The § 415(c)(1)(A) dollar amount is adjusted for inflation in $1,000 increments. *See* § 415(d)(4), as amended by § 611(h)of P.L. 107-16. For the current (and previous) adjusted § 415(c)(1)(A) dollar limit, see the Worksheets in 371 T.M., *Employee Plans — Deductions, Contributions and Funding.*

The § 415(c)(1) limit applies to an employee regardless of the number of defined contribution plans in which he/she participates.

Note: The failure to make regular (but not necessarily annual) contributions to a profit–sharing plan may result in a "discontinuance of contributions" within the meaning of § 411(d)(3)(B), requiring that participants be completely vested in the amounts credited to their accounts. An employer's failure to make contributions to its profit–sharing plan for five consecutive years due solely to the lack of current or accumulated earnings and profits was ruled not to be such a "discontinuance of contributions" in Rev. Rul. 74–419,[47] however.

[47] 1974–2 C.B. 135.

Comment: The employer's contribution obligation to a profit–sharing plan may be geared to the compensation of covered employees(e.g., 5% of compensation). This method is sometimes used to avoid disclosing to the employees through the plan the actual amount of corporate profits.

Profit–sharing plans in which contributions are determined annually by the sponsoring employer have become increasingly popular. Note however, that these plans do not qualify under the Fair Labor Standards Act (FLSA). [48] Under that Act, deferred profit–sharing plans are considered "benefit plans" (the term "profit–sharing plans" is restricted to cash bonus plans). Contributions on behalf of an employee to a "benefit plan" that qualifies under the FLSA are not included as compensation in determining an employee's "basic rate." [49] If the plan does not qualify, however, and if contributions are allocated according to basic compensation, the contribution is considered compensation and is included in the "basic rate"upon which time–and–a–half must be paid for hours worked beyond 40 hours per week.

[48] 29 U.S.C. § § 201–219. That Act provides that an employee who is "engaged in commerce or in the production of goods for commerce, or is employed in an enterprise engaged in commerce," will receive overtime pay at one and one–half times the basic rate for time worked beyond 40 hours per week. 29 U.S.C. § 207(a)(1).

[49] *Id.* § 207(e)(4).

Note: If contributions are allocated to employees on the basis of total compensation rather than basic compensation the FLSA will cause no difficulty, because the employee will collect, by reason of the allocation formula, an appropriate amount of extra deferred compensation for any overtime worked. [50]

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[50] Opinion Letter of the Wage–Hour Administrator, dated November 9, 1953.

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b. The Formula for Allocating Contributions to Participants' Accounts

Regardless of the method of determining the contribution to the plan, the formula for allocating that contribution among the accounts of plan participants must be nondiscriminatory. The usual method of doing this is to allocate contributions on the basis of participants' compensation, either total or basic. Profit–sharing plans may also be integrated with Social Security under the Code's "permitted disparity" rules. [51]

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[51] Under § 401(l). *See* 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*.

A profit–sharing plan allocation made on the basis of a uniform percentage compensation will provide greater benefits in absolute dollar terms to more highly–compensated employees. Further, because the total benefit in a profit–sharing plan is generally directly related to years of service and to profits, employee loyalty and diligence are encouraged. Profit–sharing plans also have certain disadvantages. For example, if plan contributions are geared to profits, the employer may have employee relations problems if contributions fall off for reasons which employees cannot clearly relate to declining profits. Moreover, even if employees do not doubt the motives of their employer in cutting back contributions, they may still lose faith in the plan.

Because older employees ordinarily will not be compensated under a profit–sharing plan for their service that was performed before the plan was adopted, allocation formulas have been developed which take into account an employee's years of service in determining contribution levels. This approach does not, by itself, prevent a plan from qualifying, but the IRS takes a strict view of such formulas because they contain the potential for highly compensated employees to arrange for unreasonably large contributions to themselves immediately before they retire, and then have plan contributions curtailed or eliminated for the remaining employees thereafter. The IRS has accepted formulas allocating contributions on the basis of one unit for each year of service in a factual situation in which the IRS found that no discrimination resulted. [52] But a formula that allocated contributions on the basis of compensation times years of service will not qualify unless it can be shown that no discrimination will result. [53] Age–weighted profit–sharing plans have become increasingly popular in recent years and afford some of the benefits for older employees that traditionally were associated only with pension plans. [54]

[52] Rev. Rul. 68–653, 1968–2 C.B. 177.

[53] Rev. Rul. 68–654, 1968–2 C.B. 179; see Bernard McMenamy, Contractor, Inc. v. Comr., 54 T.C. 1057 (1970).

[54] *See* 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age–Weighted and Hybrids*.

c. The Formula for Reallocating Forfeitures

Defined contribution plans often provide that employees who terminate their employment before serving a specified length of time will receive less than the full amount of employer contributions allocated to their account and will forfeit the nonvested balance. A qualified defined contribution plan must provide some method for reallocating these forfeitures. Forfeitures may not revert to the employer except under extremely limited circumstances. [55] Forfeitures may be reallocated to the accounts of participants remaining in the plan or they may be used to reduce employer contributions in future years. [56] In a plan containing a reallocation provision, forfeitures might be reallocated on the same basis as new employer contributions in the year in which the forfeiture occurs. Any nondiscriminatory reallocation formula may be used, however. [57] A provision which is nondiscriminatory on its face may, however, prove to be discriminatory in operation if, over time, a discriminatory pattern of forfeitures emerges. For instance, a plan might allocate forfeitures on the basis of the remaining participants' relative account balances, but, because higher–paid participants usually have built up proportionately larger account balances, the IRS might take the position that such an allocation would cause discrimination, particularly in the case of a smaller plan.[58] Although this type of forfeiture reallocation formula has been found not to be “inherently discriminatory,” [59] the IRS has stated that the determination of whether such a formula, in fact, produces a discriminatory result must be made on a year–by–year basis. [60]

[55] Regs. Section1.401–2(b)(1); Rev. Rul. 71–149, 1971–1 C.B. 118.

[56] Rev. Rul. 71–313, 1971–2 C.B. 203.

[57] Regs. Section 1.401–4(a)(1)(iii).

[58] *See* 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*; and 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age–Weighted and Hybrids*.

[59] Ets–Hokin & Galvan, Inc. v. Comr., T.C. Memo 1962–136.

[60] Rev. Rul. 81–10, 1981–1 C.B. 172.

Where an affiliated group of employers had a common profit–sharing plan in which all employees of all affiliates shared in aggregate profits, the IRS allowed forfeitures to be allocated to all employees of the affiliated group. One reason for allowing this reallocation was that employees were shuttled back and forth between affiliates. It was, therefore, impossible to tell from which employer the forfeitures came.[61]

[61] Rev. Rul. 71–148, 1971–1 C.B. 117.

Comment: As previously noted at III, C, 1, a, above, all annual additions to defined contribution plans are subject to an overall limit under § 415(c)(1)(A) of 100% of the participant's compensation or $40,000 (as adjusted for inflation), whichever is less. Since the definition of annual addition includes the amount of forfeitures reallocated to a participant's account, [62] a profit–sharing plan will have to impose this limitation on the allocation of contributions or forfeitures to prevent such allocations from causing the plan to exceed the § 415(c) limits with respect to any participant in any year (and thereby causing disqualification of the entire plan). Where the employer's goal is to use the plan to promote the interests of highly–compensated employees, contributions or forfeitures which could not be allocated to an employee's account because of the § 415(c) limits might be placed in a suspense account and used to reduce employer contributions in a future year. To such an employer, this alternative may be preferable to reallocating amounts in excess of the § 415 limits with respect to highly–compensated employees to the accounts of nonhighly compensated employees.

[62] Section 415(c)(2).

d. Distribution of Benefits

The distribution of benefits (of up to all of a participant's vested interest in his or her account balance) from a qualified profit–sharing plan, unlike a pension plan, may take place after the passage of a fixed number of years, the "attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death or severance of employment." [63] An appropriate event may be the completion of a certain number of years of participation, [64] or a hardship, if hardship is appropriately defined and the standard is applied in a nondiscriminatory manner. [65] ERISA enacted definite time limits after which the distribution of benefits must begin, unless the employee elects otherwise. [66] § 401(a)(9) restricts further the timing of payments from qualified plans, by providing, for example, that each employee's entire interest in a qualified plan must be distributed, or begin to be distributed, to the employee no later than April 1 of the calendar year following the calendar year in which the employee reaches age 70 1/2 or retires, whichever occurs later (the rule applies to 5% owners without regard to when such individuals retire). § 401(a)(9) also contains rules governing when an employee's beneficiaries must begin to receive benefits after the employee's death.[67]

[63] Regs. Section 1.401–1(b)(1)(ii).

[64] Rev. Rul. 68–24, 1968–1 C.B. 150.

[65] Rev. Rul. 71–224, 1971–1 C.B. 124.

[66] Section 401(a)(14).

[67] *See* 370 T.M., *Qualified Plans—Taxation of Distributions*.

A profit–sharing plan provision permitting employees to elect a distribution of any amount of an employee's nonforfeitable accrued benefit transferred from the same employer's money purchase pension plan after the amount has been in the employee's account for at least two years will cause the profit–sharing plan to fail to satisfy the requirements of § 401(a). However, a profit–sharing plan provision permitting employees to elect a distribution of accrued benefits that are attributable to rollover contributions from the same employer's money purchase pension plan does not trigger disqualification.[68]

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[68] Rev. Rul. 94–76, 1994–2 C.B. 46.

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2. Pension Plans

a. Money Purchase Plans

A money purchase pension plan is a defined contribution plan that, for purposes of the minimum funding requirements of § 412, is treated like a defined benefit plan. The employer's annual contribution is determined by a specific formula, usually involving a percentage of compensation of covered employees or a flat dollar amount. A money purchase pension plan may be integrated with Social Security under the Code's “permitted disparity” rules. Under a money purchase pension plan, unlike a defined benefit pension plan, no definite pension benefit is guaranteed to employees at retirement. Rather, a participant's retirement benefit will be the benefit that can be purchased with his or her vested account balance at retirement. As is the case with a profit–sharing plan, participants benefit directly from good investment performance and bear the risk of poor investment results. A money purchase pension plan resembles a profit–sharing plan in that an employee's benefit is determined based on his or her account balance at any specific time, but differs from a profit–sharing plan in that annual contributions cannot be based on an indefinite i.e., discretionary, formula. If an employer fails to make contributions required under a money purchase plan, the employer will be subject to the two–tiered excise tax on underfunding prescribed by § 412. [69] The § 412 minimum funding standard does not apply to stock bonus or profit–sharing plans. [70]

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[69] Section 4971(a).

[70] Section 412(h)(1).

A certain amount of latitude is permitted in a money purchase pension plan's contribution formula. For instance, the contribution formula may take into account past service. Only a portion of the past service element of a contribution under such a formula is immediately deductible, however, under the § 404and § 412 rules.[71]

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[71] Section 404(a)(1)(A).

Note: A formula under which contributions are based on compensation and weighted by years of service is not per se discriminatory. If the formula's application results in discrimination, however, the plan will be disqualified. [72]

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[72] For further discussion, see 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age–Weighted and Hybrids*.

b. Target Benefit Plans

ERISA recognizes a form of variable defined benefit plan known as the "target benefit plan." Its name derives from the fact that the plan contributions are geared toward attempting to provide participants with a specified or "targeted" retirement benefit. Employer contributions to fund the plan are made on the basis of actuarial assumptions as is the case with respect to defined benefit plans. That is, employer contributions are calculated in a manner that is designed to provide a certain level of benefits at retirement. In a defined benefit plan, however, if the plan's actuarial assumptions prove to be too generous (i.e., the employer contributions called for under the plan plus investment growth result in an actuarial surplus) they will be revised downward. Conversely, in a defined benefit plan, if the plan's original actuarial assumptions prove to be too conservative, they will be adjusted upwards to compensate in future years for any funding deficiency in the plan.

In a target benefit plan, however, a participant's retirement benefit will be whatever the annual contributions together with the accumulated earnings happen to provide. The plan's original actuarial assumptions, once made, will not be revised in light of subsequent experience. Participants will, therefore, bear the risk of a poor investment performance by the plan's portfolio. If the plan's investments perform poorly, participants' retirement benefits will be less than the stated target. Conversely, a strong investment performance will raise retirement benefits above the target level—a potential employee windfall.

Target benefit plans are classified as defined contribution plans under ERISA. [73] Consequently, the limitation that applies to annual additions to defined contribution plans, i.e., the lesser of 25% of compensation or$30,000 (as adjusted for inflation), applies to target benefit plans. [74] This limits the usefulness of target benefit plans where high pension costs for older employees(usually the principals of the business) are present, since the actuarial cost of funding a defined benefit plan can significantly exceed the target benefit plan contribution limitation when a participant nears retirement age.

[73] *See* H.R. Rep. No. 1280, 93d Cong., 2d Sess. 344 (1974).

[74] Section 415(c).

Comment: A target benefit plan offers the advantages of a defined benefit plan with respect to plan design without many of the administrative complications of ERISA. In particular, a target benefit plan employs simplified actuarial assumptions and is not subject to the PBGC termination insurance provisions and their attendant liabilities. [75] Further, a target benefit plan is easier to administer than a defined benefit plan.

[75] ERISA § 4021(b).

c. Defined Benefit Plans

A defined benefit pension plan provides benefits based on a fixed formula, often a flat dollar amount or a specified percentage of compensation. The employer's annual contribution to the plan is the amount that is actuarially estimated to be required to fund expected plan benefit liabilities. Defined benefit plans enable larger annual contributions on behalf of employees near retirement age in order to yield the plan's guaranteed benefit. Defined benefit plan trusts hold their assets in a single pool upon which employees draw at retirement. Unlike defined contribution plans, defined benefit plans have no individual accounts. Further, unlike defined contribution plans, defined benefit plans cannot make in–service or hardship distributions to participants. Participant loans may be made, however, provided the plan's loan policies satisfy the requirements of § 4975. [76] Many defined benefit plans base their pension benefit on a combination of factors, including covered compensation and years of service. These arrangements are called “unit benefit” plans (in contrast to “flat benefit” plans). Defined benefit plans may be integrated with Social Security under the Code's “permitted disparity” rules.

[76] The dollar limits on loans under § 72(p) can result in constructive receipt of income if they are exceeded, but this will not disqualify the plan.

Defined benefit plans may employ any one of a variety of generally accepted actuarial methods to determine the required amount of plan funding.

The deductibility of employer contributions to a tax–qualified defined benefit pension plan is governed by § 404(a)(1)(A). § 404(a)(1)(A) provides three alternatives for determining the maximum annual amount of deductible employer contributions. Alternative 1, prescribed by § 404(a)(1)(A)(i), permits the employer to contribute and deduct the amount necessary to satisfy the minimum funding standard of § 412 if such amount is greater than the amount determined under § 404(a)(1)(A)(ii) or (iii), whichever applies. Alternative 2, described in § 404(a)(1)(A)(ii), the “individual level premium” method, permits the employer to contribute and deduct the amount necessary to provide, with respect to all covered employees, the remaining unfunded cost of their past and current service credits distributed as a level amount or a level percentage of compensation over the employees' remaining future service (until retirement age). Under this alternative, which tracks the “level funding”actuarial method, discussed infra, if the remaining unfunded cost with respect to any three individuals is more than 50% of the remaining unfunded cost, the amount of unfunded cost attributable to such individuals must be distributed over at least five taxable years. Alternative 3, contained in § 404(a)(1)(A)(iii) is the “normal cost plus 10–year amortization alternative.” It allows an employer to contribute and deduct an amount equal to the plan's normal cost (generally, the cost of current service credits) plus the amount necessary to amortize any supplemental costs (generally, anything except normal costs, such as past service credits) in equal annual installments over 10 years.

For a discussion of the rules governing the funding of qualified defined benefit plans, see 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.*

d. Actuarial Certifications

ERISA generally requires that a defined benefit plan's assets be valued at least annually and that, at that time, there be a new determination of the plan's experience gains and losses and, hence, of the plan's total liability. [77] In general, a plan must receive IRS permission to change its actuarial funding method. [78]

[77] Section 412(c)(9).

[78] Section 412(c)(5). In Rev. Proc. 95–51, 1995–2 C.B. 430, the IRS set forth a list of changes to funding methods used to determine a plan's minimum funding standard that qualified defined benefit plans can make without prior IRS approval. The funding method changes approved by the procedure also apply for purposes of the employer's deduction for contributions made to the plan on behalf of employees under § 404. Rev. Proc. 2000-40, 2000-42 I.R.B. 357, supersedes Rev. Proc. 95-51, as clarified and modified by Rev. Proc. 98-10, 1998-1 C.B. 279, and Rev. Proc. 99-45, 1999-49 I.R.B. 603. Rev. Proc. 2000-40 provides automatic approval for 17 funding method changes for defined benefit plans, including a change in the asset valuation method to one of six asset valuation methods, a change in the valuation date to the first day of the plan year, and a change in the method for valuing ancillary benefits to the method used to value retirement benefits. Rev. Proc. 2000-41, 2000-42 I.R.B. 371, contains procedures that pension plan administrators or sponsors may use to obtain approval of a change in defined benefit plan funding method not approved previously. Rev. Procs. 2000-40 and 2000-41 are effective for plan years beginning on or after January 1, 2000. For a further discussion, see 371 T.M., *Employee Plans—Deductions, Contributions and Funding*.

Note: § 412(c)(5)(B), prohibits certain underfunded plans from changing the actuarial assumptions used to determine current liability for a plan year(other than the interest rate and mortality assumptions) unless the new assumptions are approved by the Secretary of the Treasury. Such approval is required for single–employer defined benefit plans if:
(1) the plan is subject to PBGC termination insurance under Title IV of ERISA;

(2) the aggregated unfunded vested benefits of all underfunded plans maintained by the employer and members of its controlled group exceed$50 million; and

(3) the change in assumptions decreases the plan's unfunded current liability for the current plan year by (a) more than $50 million or (b) more than $5 million and at least five percent of the current liability.

Finally, ERISA requires the plan administrator of a defined benefit or money purchase pension plan to maintain a funding standard account which will permit the IRS to verify the amount of funding deficiencies in the plan and to determine whether the plan is meeting the minimum funding standard. [79]

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[79] Section 412(b).

In addition to the actuarial funding method chosen, the individual actuarial assumptions used can have a significant impact upon the employer's annual contribution limitation in a defined benefit plan.[80] Indeed, besides the choice of the plan's benefit formula and its method of funding, the choice of actuarial factors will have the most direct impact on the cost of funding the plan. For example, if a plan's investment earnings assumption were 8% instead of 7%, the employer's liability would be substantially reduced because higher interest factor assumes that more of the plan assets needed to pay the retirement benefits will be provided by fund earnings. Similarly, the assumptions as to employee turnover, mortality, and the purchase rate for the retirement annuities, will influence the cost of the plan.

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[80] Section 412(c)(3). Actuarial assumptions are subject to a requirement that they must be reasonable. *Id.*

Thus, an employer should carefully select the plan actuary and carefully review the plan's actuarial assumptions in designing a defined benefit plan. In general, actuarial assumptions are not fixed, but may vary within an industry–accepted range, and, therefore, the actuary's assumption can produce different contribution requirements for the same rate of benefits.

e. Unit Benefit Pension Plans

A defined benefit plan, rather than establishing retirement benefits as a flat dollar amount or a specified percentage of compensation, may employ a unit benefit formula. Under a typical unit benefit formula, benefits are based upon both an employee's compensation and years of service. A typical unit benefit plan might provide a pension of 1% of annual compensation times the employee's number of years of service with the company. This formula rewards long–term service with the employer. Note that, in many cases, long–term employees will tend to be highly–compensated employees. Using a unit benefit formula will not, by itself, cause a plan to discriminate, however.

Example: A company has a defined benefit plan that provides a pension of 30% of compensation. The employer might hesitate to hire a valuable 60–year–old employee at $50,000 a year if in five years it would have to fund a $15,000 a year pension, at an annual cost of approximately$30,000. If the plan provided a pension of 1% of compensation times years of service at normal retirement age (65), however, the employee would earn a 5% pension ($2,500 a year), at an annual cost of about $4,900.

Variations are permitted to help reduce a plan's past service cost. For example, a plan might provide a pension of 0.5% of compensation for each year of service before the plan was established, and 1% of compensation for each subsequent year of service. If it desired, an employer could gear retirement benefits only to years of participation in the plan. Unit benefit formulas may be stated in terms of flat dollar amounts, e.g., $30 a year times years of service, instead of a percentage of compensation times years of service. Moreover, the formula could provide a pension based on a percentage of compensation times years of service, subject to a minimum or a maximum benefit of X dollars a year times years of service.

f. Variable Defined Benefit Plans

Before ERISA, a flat benefit pension plan (as well as a unit benefit plan or offset plan) could be designed to provide benefits that would reflect the investment performance of a fund but would still be sufficiently predictable to satisfy the definitely determinable benefits test. [81] Thus, an employer could offset inflation by allowing its employees to participate in the growth of a fund of common stocks. Similarly, the benefit could be made “variable”by relating it to a recognized cost–of–living index.

[81] *See* Rev. Rul. 185, 1953–2 C.B. 202.

While ERISA does not appear to prevent the adoption of these variable defined benefit plans, the statutory recognition given target plans may eliminate the usefulness of these variable plans.

g. Past Service Liability

Although an employer may wish to contribute an amount equal to all of the past service liability upon plan establishment, the employer's annual deduction may not exceed the amount necessary to amortize the past service liability plus accrued interest over 10 years. [82] This maximum annual deductible amount cannot be exceeded even though deductions taken in prior years were less than the maximum deductible amount allowed during those years. [83] The employer generally must fund the past service liability over 30 years, [84] however, a non–multiemployer plan with an unfunded current liability must, [85] fund its "unfunded old liability amount" (the plan's unfunded current liability, including amounts attributable to past service costs, as of the first plan year beginning after 1987) over 18 years. As with the rules on the funding of normal costs, a failure to fund past service liability will lead to imposition of the excise tax and penalties.

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[82] Section 404(a)(1)(A)(iii).

[83] Rev. Rul. 70–30, 1970–1 C.B. 109.

[84] Section 412(b)(2)(B)(i). The amortization period for unfunded past service liabilities is 40 years for plans in existence on January 1, 1974.

[85] Section 412(l).

Observation: Funding a pension plan on the basis of the unfunded past service liability may be useful in providing relief to a corporation that might otherwise be subject to the accumulated earnings tax. Even though the entire amount of the past service liability cannot be contributed immediately, some or all of such amount will be deemed "a reasonable need of the business" for accumulated earnings tax purposes. [86] Remember, however, that the pension contribution for the principal stockholders will be added to their other compensation; this total compensation must be reasonable under § 162 to be deductible. Contributions used to fund the past service liability, however, will be attributed to services rendered in prior years. [87]

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[86] Sections 531–37.

[87] Regs. Section 1.404(a)–1(b).

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h. Forfeitures

Defined benefit pension plans may not use forfeitures to increase the level of benefits of employees remaining in the plan. [88] Defined contribution plans are not subject to this restriction.

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[88] Section 401(a)(8).

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3. Benefit and Contribution Limitations

a. General Rule

An employer may maintain any number of pension or profit–sharing plans, or a combination of such plans. An employer's annual deduction for contributions to a combination of one or more profit–sharing or stock bonus plans and one or more pension plans, however, may not exceed the greater of 25% of participants' annual compensation or the amount required to satisfy the minimum funding standard for any defined benefit plans maintained by the employer for the plan year that ends with or within the employer's taxable year (or any prior year plan). [89]

[89] Section 404(a)(7).

b. Defined Contribution Plans

Under a defined contribution plan, the maximum “annual addition” that may be made to an employee's account for the year cannot exceed the lesser of $40,000 or 100% of the participant's compensation.[90] The $40,000 amount is adjusted for inflation in $1,000 increments.[91] An annual addition with respect to a participant for a year is the sum of employer contributions allocated to the participant's account, forfeitures allocated to the participant's account, and employee contributions. [92]

[90] *See* § 415(c)(1)(A) and (B) and § 415(d)(4), as amended by § 611(b)(1), § 632(a)(1)and § 611(h) of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, effective for years beginning after December 31, 2001.

[91] For the current (and previous) inflation-adjusted § 415(c)(1)(A) dollar limit, see the Worksheets in 371 T.M., *Employee Plans — Deductions, Contributions and Funding.*

[92] Section 415(c)(2).

c. Defined Benefit Plans

The maximum annual benefit that may accrue to a participant under a qualified defined benefit plan is the lesser of $160,000 (as adjusted for inflation), or 100% of the participant's average compensation for his three consecutive most highly–compensated years of service with the employer. [93]

[93] *See* § 415(b)(1)(A) and (B), as amended by § 611(a)(1)of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, effective for years ending after December 31, 2001. For the current (and previous)inflation-adjusted § 415(b)(1)(A) dollar limit, see the Worksheets in 371 T.M., *Employee Plans —Deductions, Contributions and Funding.*

The maximum benefit limit is expressed as a benefit payable in the form of a straight–life annuity with no ancillary benefits, under a plan to which no employee contributions have been made and to which no rollover contributions have been made. If the benefit in the plan under consideration is payable some other form, appropriate adjustments must be made in testing the benefit against this limit. [94]

[94] Section 415(b)(2)(B).

d. Dual Participants in Defined Contribution and Defined Benefit Plans

For tax years beginning before January 1, 2000, an employer that maintained a defined benefit plan (or plans) and a defined contribution plan (or plans) covering one or more of the same participants was subject to a special combined limit.[95] The combined plan limit was repealed for tax years beginning after December 31, 1999.[96]

[95] Former § 415(e).

[96] Former § 415(e), repealed by the Small Business Job Protection Act of 1996, P.L. 104-188, § 1452(a).

[Footnote 97 is reserved.]

The Small Business Job Protection Act of 1996 repealed the “combined plan limit” of § 415(e) for limitation years beginning after December 31, 1999.

e. Top–Heavy Plan Rules

A top–heavy plan must provide a minimum benefit or minimum contribution (allocation) for each non–key employee participant.

For a plan year for which a defined benefit plan is top–heavy, each participant who is not a key employee for the year generally must accrue a benefit which, when expressed as an annual retirement benefit, is not less than 2% of the employee's average annual compensation from the employer during the employee's “testing period,” multiplied by the employee's years of service with the employer. An employee's total minimum benefit, however, generally is not required to exceed 20% of such average annual testing period compensation. [98]

[98] Section 416(c)(1).

“Annual retirement benefit” for this purpose means a benefit payable annually in the form of a single–life annuity(with no ancillary benefits) beginning at the plan's qualified normal retirement age. [99] An employee's testing period is the employee's consecutive years of service (not to exceed five) during which the employee earned the greatest aggregate compensation from the employer. A year of service need not be included in the employee's testing period, however, if it: (i) ends in a plan year beginning before 1984;or (ii) begins after the close of the last year in which the plan was a top–heavy plan.

[99] Section 416(c)(1)(E).

Legislative Change Note: The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, § 613(e), amended § 416(c)(1)(C) to provide that, effective for years beginning after December 31, 2001, a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under § 410).

The minimum benefit must be a nonintegrated benefit, i.e., an employee's Social Security benefit is disregarded in determining whether the minimum benefit rules have been satisfied.

Note: Any accruals of employer–derived benefits, whether or not attributable to years for which the plan is top–heavy, may be used to satisfy the defined benefit minimums. Accrued benefits attributable to employee contributions are not counted, however. [100]

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[100] *See* Regs. Section 1.416–1, M–2.

For a plan year for which a defined contribution plan is top–heavy, the employer generally must contribute on behalf of each participant who is a non–key employee for the year not less than 3%of such participant's compensation. [101] If the employer's contribution rate for each participant who is a key employee for the plan year, when expressed as a percentage of compensation, is less than 3%, however, the required minimum contribution for non–key employees need not exceed the highest contribution rate for any key employee. [102]

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[101] Section 416(c)(2).

[102] Section 416(c)(2)(B).

The special rule providing for a less than 3% top–heavy minimum contribution rate does not apply, however, to any defined contribution plan that is included in a top–heavy “required aggregation group”if such plan is needed for a defined benefit plan to meet the coverage or nondiscrimination rules of § 410or 401(a)(4), respectively.[103]

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[103] Section 416(c)(2)(B)(ii)(II). The definition of a required aggregation group is set forth in § 416(g)(2)(A)(i).

Note: In applying the top–heavy minimum contribution rules, all defined contribution plans maintained by an employer that are included in a top–heavy required aggregation group are treated as one plan.[104]

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[104] Section 416(c)(2)(B)(ii)(I).

Amounts paid by the employer for the year to provide Social Security benefits are disregarded in computing the minimum contribution rate. [105] Also, any employer contribution attributable to a salary reduction or similar programs are not taken into account. [106]

[105] Section 416(e).

[106] *See* § 416(c)(2)(A), referencing the definition of compensation contained in Section415.

Legislative Change Note: The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, § 613(b), amended § 416(c)(2)(A) to provide that, effective for years after December 31, 2001, employer matching contributions(as defined in § 401(m)(4)(A)) are taken into account in determining whether the minimum contribution rule has been satisfied. However, any reduction in the minimum contribution under this provision is not taken into account in determining whether the conditional benefit rule of § 401(k)(4)(A) applies.

If a non–key employee participates in both a defined benefit plan and a defined contribution plan maintained by an employer, the employer is not required to provide the employee with both the minimum benefit and the minimum contribution.

For any plan year for which a plan is top–heavy, the plan must satisfy one of two top–heavy vesting schedules contained in § 416:
(1) three–year "cliff" vesting; or

(2) six–year "graded" vesting.[107]

[107] Section 416(b)(1)(A)–(B). For a discussion of the top–heavy rules and their application, see 353 T.M., *Employee Benefits for Small and Mid-Sized Employers.*

4. Individual Retirement Arrangements (IRA)

The term "Individual Retirement Arrangement"refers to any one of three vehicles that are accorded favorable federal income tax treatment: an individual retirement account, an individual retirement annuity, and a group individual retirement account sponsored by an employer or labor union.

An individual retirement account is a trust or custodial account established by an individual with a bank or similarly qualified firm acting as trustee or custodian. An individual retirement annuity is an annuity contract issued by an insurance company into which the individual pays premiums instead of contributions. A group individual retirement account is basically a single account established with a bank or custodian by an employer or a labor union. The account is then invested collectively, although each employee's interest must be separately valued and accounted for. (Federal securities laws and the availability of Simplified Employee Pension (SEP) arrangements since 1979 have reduced the popularity of such group accounts). [108]

[108] For a discussion of Individual Retirement Arrangements, see 355 T.M., *IRAs, SEPs and SIMPLEs.*

Note: Effective for years beginning after December 31, 1996, the Small Business Job Protection Act of 1996 created a simplified retirement plan for small businesses known as a savings incentive match plan for employees (SIMPLE plan) and repealed the Code's provisions relating to salary reduction simplified employee pensions (SARSEPs). [109] A SIMPLE plan can be adopted by employers who employed 100 employees or less with at least $5,000 in compensation for the preceding year and who do not maintain another employer–sponsored retirement plan. [110] A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement (§ 401(k) plan). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top–heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn. Employers that cease to qualify under the above standard are given a two–year grace period to continue to maintain the plan. [111] Employers still may maintain SEPs that do not call for salary reduction contributions and may continue to maintain "grandfathered" SARSEPs. However, in any taxable year in which an employer maintains a SIMPLE plan, it may not also maintain a SEP (or other plan described in § 219(g)(5)(A) or (B)). § 408(p)(2)(D).

[109] *See* P.L. 104–188, § § 1441–42.

[110] Section 408(p)(2)(C)(i)(I).

[111] Section 408(p)(2)(C)(i)(II).

For a discussion of SIMPLE plans in IRA form, see 355 T.M., *IRAs, SEPs and SIMPLEs.*

Source: U.S. Income Portfolios: Compensation Planning > Portfolio 350-1st: Plan Selection — Pension and Profit-Sharing Plans > Detailed Analysis > III. Section 401(a) Plans: Types and Attributes of Benefit Formulas > E. Section 401(k) Cash–or–Deferred Arrangements (CODAs)

E. Section 401(k) Cash–or–Deferred Arrangements (CODAs)

As the cost of providing benefits to employees under traditional qualified plans has increased, employers have been turning to salary reduction arrangements as a means by which employees may effectively “co–insure”their retirement benefits. The most popular and widely used tax–qualified salary reduction vehicle has been the § 401(k) cash–or–deferred arrangement (CODA). Others include SIMPLE plans, tax–deferred annuities under § 403(b) (TDAs), and certain plans for governmental employees and the employees of tax–exempt organizations(§ 457 plans). In addition, individual retirement arrangements provide a means by which employees may save for their retirement on a tax–favored basis.

CODAs under § 401(k) were given tax–favored status by the 1978 Revenue Act. In general, a CODA may be established as part of a profit–sharing or stock bonus plan. [116]

[116] Section 401(k)(1). Pre–ERISA money purchase plans and plans of rural electric cooperatives may also contain a § 401(k)cash–or–deferred feature.

To qualify as a CODA, the plan must be an arrangement under which a covered employee may elect to have the employer make annual payments to the plan's trust or to take those amounts in cash. [117]

[117] Section 401(k)(2).

CODAs, in addition to satisfying the regular plan qualification rules of § 401(a)must satisfy certain special nondiscrimination rules with respect to employee salary reduction deferrals under § 401(k).

For a discussion of § 401(k) cash or deferred arrangements, see 358 T.M., *Cash or Deferred Arrangements.*

Source: U.S. Income Portfolios: Compensation Planning > Portfolio 350-1st: Plan Selection — Pension and Profit-Sharing Plans > Detailed Analysis > IV. Section 401(a) Plans: Coverage and Integration — Certain Employees > C. The Coverage Test

C. The Coverage Test

1. Minimum Coverage Requirements

A qualified retirement plan must cover at least a specified portion of an employer's non–highly compensated employees. [124] If the plan covers all employees, the Code's coverage requirements certainly are met. An employer that wishes to exclude one or more categories of employees can do so only if those exclusions do not cause the plan to fail to satisfy the minimum coverage requirements. A qualified plan must satisfy one of three alternative coverage tests: a “percentage” test, a “ratio” test, or an “average benefits” test. [125]

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[124] Section 410(b).

[125] *Id.*

Under the “percentage” test, a plan must benefit 70% or more of all non–highly compensated employees. For this purpose, all eligible employees are considered to benefit under the plan. In a § 401(k) plan, or a plan under which employees may voluntarily contribute or receive employer matching contributions, employees who are eligible to contribute (or to elect to have contributions made to their account) will be considered to benefit. [126]

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[126] Section 410(b)(1)(A) and (6)(E).

Under the “ratio” test, a plan must benefit a classification of employees which does not allow more than a reasonable difference between the percentage of highly compensated employees who are covered and a similarly computed percentage for non–highly compensated employees. [127]

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[127] Section 410(b)(1)(B).

A plan will satisfy the “average benefits” test, a plan will qualify if:
(1) it benefits employees under a classification that the IRS find not to be discriminatory; and

(2) the average benefit percentage for non–highly compensated employees is at least 70% of the average benefits percentage for highly compensated employees. [128]

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[128] Section 410(b)(2).

2. 50/40 Minimum Coverage Test

A qualified plan, on each day of the plan year, generally must benefit at least 50 employees, or, if less, 40% of all employees of the employer. [129] This requirement applies separately to each qualified plan. It may not be satisfied by aggregating comparable plans. Further, if a plan consists of one or more current benefit structures, each current structure must meet the test. [130]

[129] Section 401(a)(26).

[130] Regs. Section 1.401(a)(26)–2.

Note: For years beginning after December 31, 1996, the minimum participation rule of § 401(a)(26) applies only to defined benefit pension plans. [131]

[131] Section 401(a)(26)(A), as amended by P.L. 104–188, § 1432.

For a discussion of the coverage tests and their operation, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans.*