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A. Qualified Retirement Plans Under § 401(a)

1. Background

The term "qualified plan" generally refers to a deferred compensation plan that satisfies the specific statutory requirements set forth in § 401(a).[5] These qualification requirements are covered in detail in a number of other portfolios. See, e.g., 350 T.M., *Plan Selection — Pension and Profit-Sharing Plans*. A general summary follows.

[5] Regs. § 1.401-0(b)(1).

A qualified plan must be organized and maintained in the United States[6] for the exclusive benefit of employees and their beneficiaries.[7] There must be a definite written program that is communicated to employees.[8] A qualified plan also must satisfy specific requirements set forth in the Code and regulations with respect to eligibility to participate,[9] vesting and benefit accrual,[10] funding,[11] distribution[12] and alienation of benefits.[13] Most of these rules require that the plan foster the interest of rank-and-file workers in retirement income security in exchange for the favorable federal income tax treatment to which the employer, the qualified plan and the participants are entitled.

[6] § 401(a), introductory language.

[7] § 401(a)(2).

[8] Regs. § 1.401-1(a)(2).

[9] § § 401(a)(3), (6) and 410.

[10] § § 401(a)(4), (5), (7), (10), (17)(16), 411, 415, 416.

[11] § § 401(a)(8), 412.

[12] § 401(a)(9), (11), (14).

[13] § 401(a)(13).

Some special rules apply to plans maintained by tax-exempt organizations, including both special substantive rules and special effective dates. These rules are covered in detail in this portfolio. A plan is considered maintained by a tax-exempt organization if 50% or more of the employees benefiting under the plan are employees of a tax-exempt organization. Thus, for example, if the employer consists of a controlled group of entities that includes both one or more tax-exempt organizations and one or more taxable entities, a plan of the employer is considered maintained by a tax-exempt organization if 50% or more of the employees benefiting under the plan are employees of one or more of the tax-exempt organizations.[14] Multiemployer plans and multiple employer plans may apply this 50% test on an employer-by-employer basis.[15]

[14] Notice 92-36, 1992-2 C.B. 364.

[15] Rev. Proc. 94-13, 1994-1 C.B. 566.

2. Types of Qualified Plans

There are two types of qualified plans of general interest to tax-exempt organizations: pension plans and profit-sharing plans. A third type, the stock bonus plan, requires that benefits be distributable in the form of stock of the employer or an affiliated employer entitled to file a consolidated income tax return with the employer.[16] Stock bonus plans are analyzed in 350 T.M., *Plan Selection — Pension and Profit-Sharing Plans*, and 354 T.M., *ESOPs*. Because most tax-exempt organizations are not organized as corporations that issue stock to shareholders, stock bonus plans are not addressed in this portfolio.

[16] Regs. § 1.401-1(a)(2)(iii).

a. Pension Plans

Tax-exempt organizations can maintain all types of tax-qualified pension plans except stock bonus plans. (A taxable entity in which a tax-exempt organization has an ownership interest could maintain a stock bonus plan.) The requirements imposed on tax-qualified pension plans are analyzed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*. A brief summary follows.

The primary purpose of a tax-qualified pension plan must be to systematically provide for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement, without regard to employer profits.[17] A pension plan also may provide benefits on account of disability and incidental death benefits, through insurance or otherwise.[18] A pension plan cannot provide for nonretirement payments other than retiree health benefits authorized in § 401(h)[19] and incidental death benefits.[20] Layoff benefits and benefits for sickness, accident, hospitalization, or medical expenses other than those provided in § 401(h) cannot be provided under a pension plan.[21]

[17] Regs. § 1.401-1(b)(1)(i).

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

Pension plans include defined benefit plans and defined contribution plans (sometimes called money purchase plans).[22]

[22] *See* § 414(i) and (j); Regs. § 1.401-1(b)(1)(i). For plan years beginning in 2010, small employers can maintain an "eligible combined plan," which is a plan that consists of a defined benefit plan and a defined contribution plan that includes a qualified cash or deferred arrangement. § 414(x), as added by the Pension Protection Act of 2006, P.L. 109-280, § 903(a). For further detailed discussion of an eligible combined plan, see 358 T.M., *Cash or Deferred Arrangements*, and 353 T.M., *Employee Benefits for Small and Mid-Sized Employers*.

Generally, a defined benefit pension plan provides participants with a fixed or determinable retirement benefit at normal retirement age, based on a formula set forth in the plan.[23] The formula generally provides for a monthly or yearly benefit that bears some relationship to the participant's length of service with the employer, and often to the participant's compensation. The minimum and maximum amounts of employer contributions required to fund the plan each year are determined actuarially on the basis of the actuary's best estimate of reasonable mortality, interest rate and turnover assumptions and the plan's actual experience.[24]

[23] Regs. § 1.401-1(b)(1)(i); *see* Rev. Rul. 79-90, 1979-1 C.B. 155. *But see* PLR 9645031 (governmental cash balance plan meets definitely determinable benefit requirement despite managing board's power to set interest rate credited on contributions).

[24] § 412(c)(3). For plan years beginning in 2008, see § 430(h)(1), as added by P.L. 109-280, § 112(a).

A money purchase pension plan provides the participant with a fixed contribution each year, commonly expressed as a fixed percentage of annual compensation on a fixed amount per hour or week or other unit of work, and the employer's obligation is to make the fixed annual contribution in accordance with the plan's formula, regardless of profits.[25] A participant's benefit under a money purchase pension plan solely is based on an individual account established on his or her behalf, consisting of the contributions, forfeitures, income, expenses, gains and losses allocable to the account each year.[26]

[25] Regs. § 1.401-1(b)(1)(i); Rev. Rul. 80-155, 1980-1 C.B. 84.

[26] § 414(i).

A target benefit pension plan is a special type of money purchase pension plan that has some attributes of a defined benefit plan. As under other money purchase pension plans, the employer is obligated to make a fixed contribution each year and the participant's benefit is based upon the value of the individual account at the time of distribution. However, unlike other money purchase pension plans, employer contributions are determined actuarially under a formula designed to cause each participant's individual account to be sufficient at normal retirement age to provide a certain monthly or yearly benefit determined on the basis of such factors as average compensation and years of service, using an investment yield assumption stated in the plan.[27] If the plan's actual investment yield is greater than the plan's assumption, the participant's actual benefit is larger than the target benefit anticipated by the plan; if the plan's actual investment yield is less than the plan's assumption, the participant's actual benefit is smaller than the target benefit.

[27] Regs. § 1.401(a)(4)-8(b)(3) provides a safe harbor testing method for target benefit plans.

A cash balance plan is a defined benefit plan that is designed to provide employees with the ease of explanation of a defined contribution plan and the security of a defined benefit plan. Hypothetical individual bookkeeping accounts are established for participants to which hypothetical employer contributions and earnings are added. As in the case with any other defined benefit plan, however, the investment risk is borne by the employer.

b. Profit-Sharing Plans

Until 1980, the IRS took the position that a not-for-profit employer could not maintain a profit-sharing plan.[28] In GCM 38283 (2/15/80), the IRS revised its position and stated that a tax-exempt organization could maintain and contribute to a profit-sharing plan without affecting its tax-exempt status, even though it lacked the profit motive. Under GCM 38283, an organization had to limit and safeguard the plan and the management of the organization to guard against prohibited inurement to private individuals and interference of the profit motive with the organization's public purpose. For plan years beginning after 1985, whether a plan is a profit-sharing plan is determined without regard to the employer's current or accumulated profits[29] and without regard to whether the employer is a tax-exempt organization.[30]

[28] *See, e.g.*, GCMs 35865, 32518.

[29] § 401(a)(27)(A).

[30] § 401(a)(27)(A).

A profit-sharing plan is an individual account plan.[31] A profit-sharing plan is not required to contain a fixed formula for determining employer contributions or benefits under the plan.[32] An employer maintaining a profit-sharing plan must designate it as such in the plan document.[33]

[31] See discussion in II, A, 2, a, above.

[32] Regs. § 1.401-1(b)(1)(ii).

[33] § 401(a)(27)(B).

Employer contributions may be based on a formula, such as a certain percentage of the employer's current profits or a fixed percentage of participants’ compensation, or they may be determined by the employer from year to year on a discretionary basis. However, if the employer retains full discretion regarding the amount of its contributions, recurring and substantial contributions must be made in order to avoid de facto termination of the plan.[34]

[34] Rev. Rul. 80-146, 1980-1 C.B. 90.

A profit-sharing plan must contain a nondiscriminatory written formula for allocating contributions among the participants'individual accounts,[35] generally on the basis of their current compensation. A profit-sharing plan may provide for lay-off, illness, disability and death benefits, incidental life or health insurance benefits, and in-service distributions, so long as the plan requires significant deferral of income.[36]

[35] Regs. § 1.401-1(b)(1)(ii).

[36] *Id.*; *see* Rev. Rul. 71-224, 1971-1 C.B. 124; Rev. Rul. 68-24, 1968-1 C.B. 150; Rev. Rul. 61-164, 1961-2 C.B. 99; Rev. Rul. 54-51, 1954-1 C.B. 147; and Rev. Rul. 60-84, 1960-1 C.B. 159.

The requirements for tax-qualified profit-sharing plans are analyzed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*, and 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age-Weighted and Hybrids*.

3. Plans with Cash or Deferred Arrangements

This subject is analyzed in complete detail in 358 T.M., *Cash or Deferred Arrangements*.

a. General Description

A participant in a qualified plan that includes a cash or deferred arrangement (CODA) which satisfies the standards of § 401(k) may elect that a portion of his or her compensation from the employer be contributed on his or her behalf to the employer's qualified plan. Such contributions are known as elective salary deferral contributions. These amounts are treated as employer contributions under the plan;therefore, they are not taken into account in determining the participant's current compensation for federal income tax purposes for the year in which they are contributed to the plan. The amount any individual may exclude from income on account of elective salary deferral contributions for a taxable year is subject to the maximum dollar limit under § 402(g).[37]

[37] The annual limit on elective deferrals was $14,000 for 2005, and is $15,000 for 2006 and thereafter, as may be indexed for inflation in $500 increments. § 402(g)(1)(B), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), P.L. 107-16, § 611(d). For 2007, the annual limit is $15,500. Notice 2006-98, 2006-46 I.R.B. 906. The provisions under EGTRRA were set to expire for taxable, plan or limitation years beginning after 2010. EGTRRA § 901. The Pension Protection Act of 2006, P.L. 109-280, repealed the sunset provision in EGTRRA § 901 as it applies to pensions and IRAs. P.L. 109-280, § 811. For current and previous amounts, see the Worksheets in 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.*

Also, participants who have attained age 50 by the end of the year may make additional elective deferrals under a § 401(k) plan.[38] The additional amount of elective contributions that may be made by an eligible individual is the lesser of the applicable dollar amount or the participant's compensation for the year, reduced by any other elective deferrals of the participant for the year.[39] Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. Although catch-up contributions are not subject to applicable nondiscrimination rules, a plan fails to meet the applicable nondiscrimination requirements under § 401(a)(4) with respect to benefits, rights, and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this nondiscrimination requirement, all plans maintained by employers that are treated as a single employer under § 414(b), (c), (m) or (o) are treated as one plan.[40]

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[38] § 414(v), as added by EGTRRA § 631, and as amended by the 2002 Job Creation and Worker Assistance Act (JCWAA), P.L. 107-147, § 411(o), effective for taxable years beginning after 2001. The additional dollar amount was $4,000 for 2005, and is $5,000 for 2006 and thereafter, as may be indexed for inflation in $500 increments. § 414(v)(2)(B). For 2007, the additional dollar amount is $5,000. Notice 2006-98, 2006-46 I.R.B. 906. The catch-up contributions apply to all qualified retirement plans, tax-sheltered annuity plans, SEP and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan, and also to all governmental § 457 eligible deferred compensation plans on an aggregated basis. § 414(v)(2)(D), as added by JCWAA, § 411(o)(3). The total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up contribution limit for that year (and for that type of plan), without regard to whether the individual made catch-up contributions under plans maintained by more than one employer. § 402(g)(1)(C), as added by JCWAA § 411(o)(1). *See* Regs. § 1.414(v)-1, T.D. 9072, 68 Fed. Reg. 40510 (7/8/03), applicable to contributions in taxable years beginning on or after Jan. 1, 2004. For taxable years prior to 2004, taxpayers may rely on the final regulations or proposed regulations in REG-142499-01, 66 Fed. Reg. 53555 (10/23/01).

[39] § 414(v)(2)(A).

[40] § 414(v)(4). The special nondiscrimination rule for mergers and acquisitions under § 410(b)(6)(C)(i) applies for purposes of the nondiscrimination requirement applicable to catch-up contributions. § 414(v)(4)(B), as amended by JCWAA, § 411(o)(b).

A participant is an eligible catch-up participant if the participant otherwise is eligible to make elective deferrals under the plan and the participant's 50th or higher birthday would occur before the end of the participant's taxable year.[41]

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[41] Regs. § 1.414(v)-1(g)(3). The effect of this rule is that all participants who will attain age 50 during a calendar year are treated the same beginning January 1 of that year, without regard to whether the participant survives to his or her 50th birthday or terminates employment during the year and without regard to the employer's choice of plan year. For this purpose, elective deferrals include not only elective deferrals defined in § 402(g)(3) but also any contribution to a § 457 eligible governmental plan. Regs. § 1.414(v)-1(g)(2).

A participant entitled to protections for returning veterans under the Uniform Services Employment and

Reemployment Rights Act (USERRA) [42] must be allowed the opportunity to make additional elective deferrals and earn matching contributions that would have been available if the participant had continued employment with the plan sponsor during the period of military service.[43] The participant has three times the period of military service, up to five years, to make the additional elective contributions.[44]

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[42] P.L. 101-353, 38 USC § 4301 *et seq.*; *see generally* 20 CFR § § 1002.1 *et seq.*, implementing USERRA. RIN 1293-AA09, 70 Fed. Reg. 75246 (12/19/05), effective Jan. 18, 2006.

[43] § 414(u)(2)(A) and (B); 20 CFR § § 1002.261 and .262.

[44] § 414(u)(2)(A)(i); 20 CFR § 1022.262(b).

For further discussion of catch-up contributions, see II, B, 12, b, below.

Effective for tax years beginning in 2006, § 402A permits employers to allow employees to treat elective deferral contributions to a § 401(k) or a § 403(b) plan as after-tax contributions.[45] These contributions are known as "§ 401(k) or § 403(b) Roth contributions"[46] and while similar to the contributions made to a Roth IRA, are more expansive in that individuals earning more than $100,000 may participate.

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[45] EGTRRA § 617, *adding* § 402A. *See* Regs. § § 1.402A-1 and -2 (T.D. 9324, 72 Fed. Reg. 21103 (4/30/07)), generally applicable for tax years beginning on or after Jan. 1, 2007.

[46] *See* Regs. § 1.401(k)-1(f), T.D. 9237, 71 Fed. Reg. 6 (1/3/06), and T.D. 9324, 72 Fed. Reg. 21103 (4/30/07), applicable for tax years beginning after Dec. 31, 2005. Designated Roth contributions are required to be maintained in a separate account. Regs. § 1.401(k)-1(f)(3), as redesignated by T.D. 9324. Notice 2006-44, 2006-20 I.R.B. 889, provides a sample plan amendment that § 401(k) plans may use to include designated Roth contributions. A plan does not fail to satisfy the § 401(k)(12) safe harbor requirements merely because it makes mid-year changes to implement a qualified Roth contribution program. Announcement 2007-59, 2007-25 I.R.B. 1448.

The maximum amount of designated Roth contributions for any year is the same as the maximum annual limit on elective deferrals[47] reduced by the amount of elective deferrals made for the year.[48] Contributions that exceed the applicable limit and that are not distributed by April 15 of the following calendar year will be subject to tax in the year that the contribution is made and in the year that the distribution is made.[49]

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[47] *See* § 402(g)(1)(B).

[48] § 402A(c)(2).

[49] § 402A(d)(3).

Distributions from a Roth § 401(k) or § 403(b) account are tax free if the distributions are made after a "nonexclusion period"and on or after the date the participant attains age 59$^{1}/_{2}$, dies, or becomes disabled.[50] The nonexclusion period is the five-taxable-year period beginning with the earlier of the first taxable year for which the participant first made Roth contributions to any designated Roth account under the plan or, if the distribution is from a rollover of a Roth contribution account, the first taxable year for which the participant made a Roth contribution to the account from which the rollover was made.[51] A participant may roll over distributions from a designated Roth contribution account to another designated Roth contribution account or to a Roth IRA.[52]

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[50] § 402A(d)(2)(B), cross-referencing § 408A(d)(2)(A); Regs. § 1.402A-1, Q& A-2(b).

[51] Regs. § 1.402A-1, Q& A-4. A contribution that is returned as an excess deferral, an excess contribution, or a permissible withdrawal under § 414(w) does not begin the five-taxable-year period. *Id.*

[52] § 402A(c)(3); Regs. § § 1.402A-1, Q& A-5 and 1.408A-10.

A CODA designed to comply with § 401(k) cannot be part of a defined benefit pension plan, and it cannot be added to a money purchase pension plan by an amendment adopted after the enactment of ERISA in 1974. A § 401(k) CODA can be part of a profit-sharing plan, a stock bonus plan, a rural cooperative plan, or a pre-ERISA money purchase plan.[53]

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[53] § 401(k)(1). For plan years beginning in 2010, small employers can maintain an "eligible combined plan," which is a plan that consists of a defined benefit plan and a defined contribution plan that includes a CODA. § 414(x), as added by the Pension Protection Act of 2006, P.L. 109-280, § 903(a). For further detailed discussion of an eligible combined plan, see 358 T.M., *Cash or Deferred Arrangements*, and 353 T.M., *Employee Benefits for Small and Mid-Sized Employers*.

Except for matching contributions under the plan based upon participants' elective salary deferral contributions, no employee benefit may be conditioned upon an employee's election to defer compensation under a § 401(k) plan.[54]

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[54] § 401(k)(4)(A).

An employer can sponsor a simplified retirement plan for small businesses called the "Savings Incentive Match Plan for Employees" (SIMPLE) retirement plan.[55] SIMPLE plans can be adopted by employers that employ 100 or fewer employees on any day during the year and that do not maintain another employer-sponsored retirement plan during the year. A SIMPLE plan can be either an IRA for each employee[56] or a part of a § 401(k) plan. Generally, a SIMPLE plan is considered to satisfy the nondiscrimination tests for § 401(k) plans if the plan satisfies special contribution requirements set forth in the Code. The plan is subject to the other qualified plan rules.[57]

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[55] § § 408(p) and 401(k)(11).

[56] See II, D, 2, below. For a more complete discussion of SIMPLE plans, see 355 T.M., *IRAs, SEPs and SIMPLEs*.

[57] *See* Regs. § 1.401(k)-4.

b. Nondiscrimination Testing

A § 401(k) arrangement must satisfy special rules designed to limit discrimination[58] and inhibit the use of § 401(k) arrangements as tax-sheltered preretirement savings accounts.[59]

[58] § 401(k)(3).

[59] § 401(k)(2)(B).

A § 401(k) CODA must satisfy a special nondiscrimination test relating to elective contribution percentages.[60] To perform this test, the ratio of each participant's elective contribution to the participant's compensation as determined pursuant to § 414(s) is calculated. The result is called the participant's deferral percentage.[61] Then the average of the deferral percentages of all highly compensated employees (HCEs) who are eligible to defer compensation under the plan, known as their actual deferral percentage(ADP), is compared to the average of the deferral percentages, or ADP of all other participants who are eligible to defer compensation under the plan. The ADP for the HCEs cannot exceed the greater of:(1) 125% of the ADP for all other eligible employees; or (2) the lesser of 200% of theADP for all other eligible employees or the ADP for all other employees plus 2%.[62]

[60] § 401(m).

[61] § 401(m)(3).

[62] § 401(m)(2)(A).

A defined contribution plan providing for after-tax employee contributions and/or employer matching contributions must satisfy a separate but substantially identical ratio test relating to average contribution percentages (ACP).[63] For these plans, the ratios are based on participants' employee contributions and employer matching contributions.

[63] § 401(k)(3).

In general, the special nondiscrimination tests applicable to elective deferrals and employer matching and after-tax employee contributions are determined by reference to the ADP (and ACP) for nonhighly compensated employees for the preceding year, rather than the current year. However, an employer is allowed to elect to use the current year ADP and ACP.[64]

[64] § 401(k)(3)(A).

The 200%/2 percentage point test can be much more favorable than the 125% test otherwise permitted. Effective for years beginning after 2001, if an employer maintains plans subject to both § 401(k) and (m) covering the same HCEs, the use of the 200%/2 percentage points test may be applied in testing both plans.[65] Previously, the two types of plans could be tested in the aggregate, and the aggregate differential between the combined ratios for HCEs and the combined ratios for other employees could exceed two percentage points.[66] In addition, different groups of employees eligible to participate in the same plan, such as hourly employees and salaried employees, may be analyzed as if they were eligible to participate in separate plans.[67]

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[65] § 401(m)(9), as amended by P.L. 107-16, § 666(a).

[66] Former Regs. § 1.401(m)-2(b)(3), before amendment by Regs. § § 1.401(m)-1 through -5, T.D. 9169, 69 Fed. Reg. 78143 (12/29/04), which eliminated this provision pursuant to the amendment of § 401(m)(9) by P.L. 107-16. Regs. § § 1.401(m)-1 through-5 apply for plan years beginning on or after Jan. 1, 2006, but plan sponsors may apply the regulations to any plan year that ends after Dec. 29, 2004, provided the plan applies all the rules for that plan year and all subsequent plan years. For plan years beginning before the effective date of the regulations, the plan must apply the rules of the prior regulations, the statutory provisions of § 401(k) and (m), and applicable IRS notices.

[67] Regs. § § 1.401(a)(4)-1(b)(2)(ii)(B) and 1.401(a)(4)-9(c).

The distribution of excess contributions and excess aggregate contributions must be made on the basis of the amount of contribution by or on behalf of each HCE.[68] Previously, the corrective distribution of excess contributions and excess aggregate contributions was made on the basis of the amount of the contribution as a percentage of compensation.

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[68] § 401(k)(8)(C) and (m)(6)(C).

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c. Safe Harbors

A § 401(k) plan automatically can satisfy the special nondiscrimination tests applicable to employee deferrals and employer matching contributions if the plan satisfies one of two different contribution formulas and provides participants with a notice apprising them of their rights and obligations under the plan.[69] A plan satisfies the contribution requirements:(i) if the plan satisfies a matching contribution requirement; or(ii) if the employer makes a contribution to a defined contribution plan of at least 3% of compensation of each nonhighly compensated employee (NHCE) who is eligible to participate in the arrangement, without regard to whether the employee makes elective contributions under the arrangement.[70]

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[69] § 401(k)(12)(A) and (D); Regs. § 1.401(k)-3(a).

[70] § 401(k)(12)(B), (C); Regs. § 1.401(k)-3(b).

A plan may satisfy the matching contribution requirement in one of two ways. In one way, (1) the employer makes a matching contribution on behalf of each NHCE that is equal to (a)100% of the employee's elective contributions up to 3% of compensation and (b) 50% of the employee's elective contributions from 3%to 5% of compensation; and (2) the rate of match as to any elective contribution for HCEs is not greater than the rate of match for NHCEs.[71] In the other way, (1) the rate of the employer's matching contribution does not increase as an employee's rate of elective contribution increases; and (2) the aggregate amount of matching contributions is at least as great as the aggregate amount of matching contributions that would be made if matching contributions satisfied the 100%/50%requirements.[72] In any event, employer matching and nonelective contributions used to satisfy these requirements must be nonforfeitable and are subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified CODA.[73] Employer matching and nonelective contributions used to satisfy these requirements can be used to satisfy other qualified retirement plan nondiscrimination rules, other than the special nondiscrimination test applicable to employer matching contributions.

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[71] § 401(k)(12)(B)(i); Regs. § 1.401(k)-3(c)(2).

[72] § 401(k)(12)(B)(iii); Regs. § 1.401(k)-3(c)(3).

[73] § 401(k)(12)(E)(i).

The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice, within a reasonable period before the beginning of any year, of the employee's rights and obligations under the arrangement.[74]

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[74] § 401(k)(12)(D);Regs. § 1.401(k)-3(d). A plan does not fail to satisfy the § 401(k)(12) safe harbor requirements merely because it makes mid-year changes to implement a qualified Roth contribution program or hardship withdrawals described in Notice 2007-7, 2007-5 I.R.B. 395, § III. Announcement 2007-59, 2007-25 I.R.B. 1448.

A safe harbor plan satisfies the special nondiscrimination test applicable to employer matching contributions (the ACP test)if the plan meets the contribution and notice requirements applicable under the safe harbor method for qualified CODAs and the plan satisfies a special limitation on matching contributions.[75] The limitation on matching contributions is satisfied if employer matching contributions are limited to 6%of compensation; the rate of the employer's matching contribution does not increase as the rate of an employee's contributions or elective deferrals increases; and the matching contribution for any HCE at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.[76]

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[75] § 401(m)(11)(A); Regs. § 1.401(m)-3.

[76] § 401(m)(11)(B); Regs. § 1.401(m)-3(d)(3).

Any after-tax employee contributions made under the qualified CODA will continue to be tested under the ACP test.[77] Employer matching and nonelective contributions used to satisfy the safe harbor rules for qualified CODAs cannot be taken into account in this test. However, employer matching and nonelective contributions in excess of the amount required to satisfy the safe harbor rules for qualified CODAs can be taken into account in this calculation.

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[77] § 401(m)(11)(A). Under transition rule provisions which ended Dec. 31, 1996, § 401(k) plans adopted by tax-exempt organizations before July 2, 1986, were grandfathered from the general prohibition.

For plan years beginning in 2008, a § 401(k) plan that has a “qualified automatic contribution arrangement” (otherwise known as an automatic enrollment program)is treated as satisfying the ADP test for elective deferrals and the ACP test for matching contributions if certain requirements are met.[78] An automatic contribution arrangement is a CODA that meets certain requirements for automatic deferrals, matching or nonelective contributions, and employee notice.[79]

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[78] § 401(k)(13) and (m)(12), as added by the Pension Protection Act of 2006, P.L. 109-280, § 902(a)and (b), respectively. Plans that may offer an automatic enrollment program include a § 401(a) employees'trust that is tax-exempt under § 501(a), a § 403(b) annuity under which amounts are contributed by the employer, and a § 457(b) deferred compensation plan maintained by a § 457(e)(1)(A) employer. § 414(w)(5), as added by P.L. 109-280, § 903(a).

[79] § 401(k)(13)(B).

• *Automatic Deferrals*. Unless the participant elects otherwise, the participant is treated as making an election to make deferrals equal to a stated percentage of compensation that is not more than 10% but at least equal to 3% of compensation for the first year of participation; 4% for the second year; 5% for the third year; and 6% for the fourth year and thereafter. The automatic election does not apply to a participant who makes an affirmative election not to contribute or to contribute at a different percentage.[80]

• *Contributions*. The employer must either satisfy a matching contribution requirement or make nonelective contributions to a defined contribution plan of at least 3% of the participant's compensation on behalf of each NHCE who is eligible to participate in the automatic enrollment program.[81] The employer meets the matching contribution requirement if it: (i) makes a matching contribution on behalf of each NHCE that is equal to 100% of the participant's elective deferrals as do not exceed 1% of compensation and 50% of the participant's elective deferrals as exceeds 1% but does not exceed 6% of compensation; and(ii) the rate of match for any elective deferrals for HCEs is not greater than the rate of match for NHCEs.[82] The ACP test for matching contributions is satisfied if, in addition to the above: (i) matching contributions are not provided for elective deferrals in excess of 6% of compensation;(ii) the matching contribution rate does not increase as the rate of a participant's elective deferrals increases; and (iii) the matching contribution rate for any rate of elective deferral of an HCE is no greater that the matching contribution rate with respect to the same rate of deferral of an NHCE.[83]

• *Employee Notice*. Each employee eligible to participate in an automatic contribution arrangement must receive notice of the arrangement. The notice must be written in a manner calculated to be understood by the average employee to whom the arrangement applies and must explain:(i) the employee's right to elect not to have elective contributions made on his or her behalf or to elect to have contributions made in a different amount; and (ii) if the arrangement provides two or more investment options, how contributions will be invested by default if the employee does not make an investment election. A reasonable period of time must be given to the employee after receipt of the notice and before the first election contribution to make an election for contributions and investments.[84] Failure to provide the notice is subject to penalty under ERISA.[85]

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[80] § 401(k)(13)(C).

[81] § 401(k)(13)(D)(i).

[82] § 401(k)(13)(D)(i).

[83] § 401(k)(13)(D)(ii) and (iii).

[84] § 401(k)(13)(E).

[85] ERISA § 502(c)(4), as amended by P.L. 109-280, § 902(f)(2), effective Aug. 17, 2006.

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d. Tax-Exempt Employer Sponsorship

Prior to 1997, tax-exempt employers other than rural cooperatives[86] were prohibited from maintaining qualified CODAs.[87] Effective for plan years beginning after 1996, tax-exempt organizations can maintain qualified CODAs.[88] Indian tribal governments, their agencies and instrumentalities or subdivisions thereof, or corporations chartered under federal, state or tribal law that are owned in whole or in part by any of such entities also are permitted to sponsor qualified CODAs.[89] However, state and local governments are prohibited from maintaining qualified CODAs.[90]

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[86] Prior to 1998, a rural cooperative was defined as:

(i) any organization which —

(I)is engaged primarily in providing electric service on a mutual or cooperative basis, or

(II) is engaged primarily in providing electric service to the public in its area of service and which is exempt from tax under this subtitle or which is a State or local government (or an agency or instrumentality thereof), other than a municipality (or an agency or instrumentality thereof),

(ii) any organization described in paragraph(4) or (6) of § 501(c) and at least 80 percent of the members of which are organizations described in clause (i),

(iii) a cooperative telephone company described in § 501(c)(12), and

(iv) an organization which is a national association of organizations described in clause(i), (ii), or (iii). Former § 401(k)(7)(B), prior to amendment by the Taxpayer Relief Act of 1997 (TRA 1997), P.L. 105-34.

For years beginning after 1997, the definition of rural cooperative includes a mutual irrigation or ditch company described in § 501(c)(12) (without regard to the 85% requirement thereof), or a district organized under the laws of a state as a municipal corporation for the purpose of irrigation, water conservation, or drainage, or a national association of such organizations. § 401(k)(7)(B), as amended by TRA 1997.

[87] Former § 401(k)(4)(B), prior to amendment by the Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188, § 1426.

[88] § 401(k)(4)(B), after amendment by SBJPA § 1426.

[89] § 401(k)(4)(B)(iii), as amended by SBJPA. The legislative history indicates no inference is intended with respect to whether Indian tribal governments were permitted to maintain qualified CODAs under prior law.

[90] § 401(k)(4)(B)(ii).

Prior to 1997, a taxable subsidiary of a tax-exempt parent could sponsor a § 401(k) plan because determination of an organization's tax-exempt status is made without regard to the controlled group and affiliated service group rules. Special rules provided that minimum coverage and participation was determined for such plans excluding the employees of the tax-exempt employer, if the plan covered more than 95% of the employees not precluded from participating in a § 401(k) plan.[91]

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[91] Regs. § § 1.410(b)-6(g) and 1.401(a)(26)-1(b)(4). These rules were to have ended after 1996, but were extended through the 1997 plan year. Notice 96-64, 1996-2 C.B. § V.B. In addition, until further guidance is issued, § VII of Notice 96-64 permits tax-exempt organizations (including churches) to apply a reasonable, good faith interpretation of existing law in determining which entities must be aggregated as a controlled group under § 414(b) and (c). *See* Prop. Regs. § 1.403(b)-5(a)(4), which would apply the aggregation rules under § 414, and Prop. Regs. § 1.414(c)-5, which would provide aggregation rules for nondiscrimination requirements. REG-155608-02, 69 Fed. Reg. 67075 (11/16/04). The effective date for the proposed regulations has been extended for tax years no earlier than 2008. IRS News Release IR-2006-136 (8/29/06).

Accordingly, taxable subsidiaries sponsoring a § 401(k) plan need to test the plan for compliance with the minimum coverage rules considering the entire workforce of the controlled group. For controlled groups that sponsor a § 403(b) tax-sheltered annuity program for the employees of the tax-exempt employer and a § 401(k) plan for the employees of the taxable employer, this can require a substantial change in the controlled group's retirement plans. However, § 403(b) plan participants remain excludible employees for purposes of the minimum coverage rules. Under Regs. § 1.410(b)-6(g)(3),[92] employees of a tax-exempt § 501(c)(3) organization who are eligible to make salary reduction contributions under a § 403(b) plan may be treated as excludible employees for purposes of minimum coverage testing under § 410(b) of a § 401(k) plan or a § 401(m) plan that is provided under the same general arrangement as the § 401(k) plan of the employer if: (1) no employee of such § 501(c)(3) organization is eligible to participate in the § 401(k) or § 401(m) plan; and (2) at least 95% of the employees who are not employees of the § 501(c)(3) organization are eligible to participate in the § 401(k) or § 401(m) plan.

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[92] T.D. 9275, 71 Fed. Reg. 41357 (7/21/06), effective for plan years beginning after Dec. 31, 1996.

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4. Who May Participate

Common law employees, former employees and employees on temporary leave may participate in an employer's qualified plan.[93] Leased employees and employees of members of controlled groups and affiliated service groups that include the employer also may participate.[94] Self-employed ministers can participate in a church plan as an employee of the church, and contributions by the church to the plan on behalf of the minister are excludible from the minister's income under the same limits applicable to church employees.[95] Otherwise, independent contractors cannot participate in an employer's qualified plan.

[93] Regs. § 1.401-1(b)(4); *see* Rev. Rul. 69-493, 1969-2 C.B. 88.

[94] *See* § 414(m) and (n).

[95] § 414(e)(5).

5. Ownership of Assets; Investment Media

Generally, assets of a qualified plan must be held in a separate trust.[96] Custodial accounts, nontransferable individual and group annuity and insurance contracts and face amount certificates are permissible substitutes.[97] If a plan satisfies all of the applicable formal and operational requirements of § 401(a), the income of the trust or trust substitute under which the plan's assets are held generally is exempt from federal income tax.[98]

[96] § 401(a)(1); Regs. § 1.401-1(a)(1).

[97] § 401(f) and (g).

[98] § 501(a).

In the case of a defined benefit pension plan, the economic benefit of the tax exemption inures to the benefit of the plan, because the tax-free compound yield increases the plan's pool of assets available to pay its fixed or determinable obligations to employees. In the case of a money purchase pension plan or profit-sharing plan, the economic benefit of the tax exemption inures to the benefit of the employee, because the tax-free compound yield increases the amount of the employee's individual account.

6. Nondiscrimination Requirements

Qualified plans must satisfy rules designed to prevent discrimination in favor of highly compensated employees. This subject is covered in detail in 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*.

a. Highly Compensated Employee

Proper identification of highly compensated employees (HCEs) is crucial to nondiscrimination testing. Plan contributions, benefits, and other rights and features available to HCEs are tested to determine whether the plan is discriminatory. An employee is considered highly compensated for nondiscrimination testing if the employee:(1) was a 5% owner of the employer at any time during the year or the preceding year; or (2) had compensation for the preceding year in excess of $80,000 (indexed for inflation)[99] and (at the employer's election)the employee was in the top paid group of employees for such year.[100]

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[99] The $80,000 amount is subject to cost of living adjustments. For 2007, the inflation-adjusted amount is $100,000. Notice 2006-98, 2006-46 I.R.B. 906. For the current dollar amount, see the Worksheets in 371 T.M., *Employee Plans — Deductions, Contributions, and Funding*.

[100] § 414(q)(1). The stock attribution rules are used to determine stock ownership percentages for 5% owners in determining highly compensated employees. Regs. § 1.414(q)-1T, Q& A-8.

The compensation used to determine HCE status is set by § 415 and, for years after 1997, includes elective § 401(k) contributions excludible from the participant's income under § 402(g), amounts contributed to a cafeteria plan under § 125, any qualified transportation fringe benefit not includible in gross income under § 132(f)(4), and amounts deferred under § 457 plan at the employee's election that are not includible in the employee's income.[101]

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[101] § § 414(q)(4) and 415(c)(3)(D). Note that while elective contributions and other similar amounts must be included as compensation for determining HCE status, such amounts can, at the employer's election, be excluded from compensation for nondiscrimination testing purposes under § 414(s)(2).

Notice 97-45[102] explains that HCE status is determined based on the plan year for which a determination is being made (the “determination year”) and the preceding 12-month period (the “look-back year”). Notice 97-45 provides a calendar year data election that an employer may make for a determination year. Under this election, the calendar year beginning with or within the look-back year is treated as the employer's look-back year in determining whether an employee is an HCE for a look-back year. Such an election, once made, applies to all subsequent determination years unless changed by the employer. A calendar year data election does not apply in determining whether the employer's employees are HCEs on account of being 5% owners. If a plan has a calendar year as its determination year, then the immediately preceding calendar year is the plan's look-back year, whether or not a calendar year data election is made.

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[102] 1997-2 C.B. 296.

In a General Information Letter dated December 9, 1999, the IRS noted that Regs. § 1.414(q)-1T, Q& A-3(c)(2), provides that the dollar amount for purposes of determining the HCEs for a particular look-back year is based on the calendar year in which such look-back year begins, not the calendar year in which such look-back year ends or in which the determination year with respect to such look-back year begins. Thus, for example, for plan years beginning in 2000, the look-back year generally begins in the 1999 calendar year, so that the compensation limitation for determining highly compensated status is $80,000 (the limit for 1999). For plan years beginning in 2001, the compensation limitation for determining highly compensated status is $85,000 (the limit for 2000), based on look-back years beginning in 2000. If a calendar year election is made, the calendar year beginning with or within the look-back year is treated as the look-back year for purposes of determining whether an employee is an HCE based on the employee's compensation for a look-back year. Although this election does not change the look-back year for calendar year plans, making this election does change the applicable compensation limitation used in determining highly compensated status for those with noncalendar plan years beginning in 2000 because the look-back year for these plans is the 2000 calendar year. Therefore, if the calendar year data election is made for a plan with a noncalendar plan year beginning in 2000, the compensation limitation for determining highly compensated status is $85,000.

Employers can determine the HCEs as of a “snapshot day.”[103] If a snapshot day is used to determine the HCEs, the lookback year provisions do not apply, the employees’ compensation is projected to an annual amount of compensation (if the snapshot day is not the last day of the year), and the top 100 employee limitation for the determination year is not applied.

[103] Rev. Proc. 93-42, 1993-2 C.B. 540. The application of snapshot day determinations of HCE, in years after 1996 is uncertain. While the revenue procedure is not obsoleted for years after 1996, it is unclear whether or how the snapshot day determination would be done under the revised definition of HCE.

For a more detailed discussion of the § 414(q) definition of an HCE, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

b. Minimum Age and Service Requirements

A qualified plan may require that an employee satisfy certain age and service requirements before becoming eligible to participate. The minimum age generally cannot exceed 21. The minimum age can be greater than 21 but cannot exceed 26 under a qualified plan maintained exclusively for the benefit of employees of an educational institution described in § 170(b)(1)(A)(ii) which requires 100% vesting after one year of service.[104] An educational institution described in § 170(b)(1)(A)(ii) is one that normally maintains a regular faculty and curriculum and a regularly enrolled body of pupils or students in attendance at the place where its educational activities regularly are carried on.[105]

[104] § 410(a)(1)(A)(i), and (B)(ii).

[105] See 521 T.M., *Charitable Contributions: Income Tax Aspects*, for an analysis of § 170(b)(1)(A)(ii) organizations.

A qualified plan cannot prohibit an employee from participation by reason of attainment of a certain age.[106]

[106] § 410(a)(2).

The minimum service requirement cannot exceed one year under a § 401(k) arrangement,[107] a plan maintained by an educational institution described in § 170(b)(1)(A)(ii) with a minimum age requirement greater than 21,[108] or any other plan that does not provide for immediate and full vesting.[109] Except for a § 401(k) arrangement or a plan maintained by an educational institution described in § 170(b)(1)(A)(ii) with a minimum age requirement greater than 21, a plan that provides for immediate full vesting upon commencement of participation can impose a minimum requirement of up to two years of service.[110] Thus, a plan maintained by an educational institution described in § 170(b)(1)(a)(ii) can require minimum service of two years if it has a minimum age requirement of 21 or less, and it provides for immediate full vesting upon commencement of participation.

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[107] § 401(k)(2)(D).

[108] § 410(a)(1)(B)(ii).

[109] § 410(a)(1)(A)(ii).

[110] § 410(a)(1)(B)(i).

An employee's participation must begin by the earlier of the first day of the first plan year beginning after the employee satisfies the plan's age and service requirements or the date which is six months after the date on which the employee satisfies the plan's age and service requirements.[111]

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[111] § 410(a)(4).

This subject is analyzed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

c. Minimum Coverage Rules

Qualified plans are required to meet one of three minimum coverage tests:

(1) the plan must benefit at least 70% of all nonhighly compensated employees (NHCEs);[112]

(2)the plan must benefit a percentage of NHCEs that is at least 70% of the percentage of HCEs benefiting under the plan;[113] or

(3)the plan must meet the average benefit percentage test.[114]

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[112] § 410(b)(1)(A).

[113] § 410(b)(1)(B).

[114] § 410(b)(1)(C), and (2).

The average benefit percentage test requires that the plan benefit a reasonable and nondiscriminatory classification of employees and that the average employer-provided benefit for NHCEs be at least 70% of the average employer-provided benefit for HCEs, all expressed as a percentage of compensation.[115] Employees' benefit percentages generally are taken into account in determining these averages, whether or not they are participants in the particular plan being tested or any plan at all.[116]

[115] § 410(b)(2).

[116] § 410(b)(2)(D), and (3).

The period for determining average benefit percentages must include plan years ending in the current calendar year, and may include plan years ending in the one or two calendar years immediately preceding the current plan year at the election of the employer. An employer must make this election by means of formal notice to the IRS and cannot revoke it without the approval of the IRS.[117]

[117] § 410(b)(2)(C)(ii).

For these purposes, regulations generally require that an employee who has at least 500 hours of service during a plan year be taken into account in determining whether the plan meets one of the first two minimum coverage tests. However, an employee who does not satisfy a plan's minimum service requirement or a requirement to be employed on the last day of the plan year in order to accrue a benefit under the plan may be disregarded for this purpose if the employee has 500 or fewer hours of service for the plan year and is not employed on the last day of the plan year.[118]

[118] Regs. § 1.410(b)-6(f).

In the case of a CODA or a plan that provides for after-tax employee contributions or employer matching contributions, any employee who has the right to make elective salary deferral contributions or after-tax employee contributions under the plan is deemed to benefit under the plan, regardless of the number of hours of service, and regardless of whether the employee elects to contribute.[119]

[119] § 410(b)(6)(E).

Employees who are members of a collective bargaining unit as to whose employment retirement benefits were the subject of good faith bargaining, airline pilots and nonresident aliens[120] generally are disregarded for purposes of the minimum coverage tests. Employees who have not satisfied the plan's age and service requirements also generally are disregarded.[121] However, in conducting the average benefit percentage test, employees may be disregarded on the basis of age and service only on the election of the employer, and only those who have not satisfied the most favorable minimum age and service requirements provided for in any qualified plan maintained by the employer may be disregarded.[122]

[120] § 410(b)(3).

[121] § 410(b)(4)(A).

[122] § 410(b)(2)(D).

An employer may designate two or more qualified plans as a single plan for purposes of the minimum coverage tests. Any plans that are aggregated for this purpose also must be treated as a single plan in testing for discrimination in contributions and benefits under § 401(a)(4).[123]

[123] § 410(b)(6)(B). Under Regs. § 1.410(b)-6(g)(3), employees of a tax-exempt § 501(c)(3) organization who are eligible to make salary reduction contributions under a § 403(b) plan may be treated as excludible employees for purposes of minimum coverage testing under § 410(b) of a § 401(k) or a § 401(m) plan that is provided under the same general arrangement as the § 401(k) plan of the employer if: (1) no employee of such § 501(c)(3) organization is eligible to participate in the § 401(k) or § 401(m) plan; and (2) at least 95% of the employees who are not employees of the § 501(c)(3) organization are eligible to participate in the § 401(k) or § 401(m) plan. T.D. 9275, 71 Fed. Reg. 41357 (7/21/06), effective for plan years beginning after Dec. 31, 1996.

An employer that operates two or more separate lines of business, each of which has at least 50 employees, may apply the nondiscrimination test separately with respect to employees in each line of business. Complicated statutory standards and regulatory requirements govern whether separate lines of business exist.[124] The separate line of business rules apply to tax-exempt employers.[125]

[124] § § 410(b)(5), 414(r); Regs. § 1.414(r)-0, *et. seq*. The separate lines of business regulations do not create special rules regarding the application of the separate line of business rules to government and tax-exempt employers. Regs. § 1.414(r)-1(d)(5). The regulations apply to plan years and testing years beginning on or after Oct. 1, 1997, for plans maintained by organizations exempt from income taxation under § 501(a), including plans subject to § 403(b)(12)(A)(i) (nonelective § 403(b) annuity plans). Notice 96-64, 1996-2 C.B. 229, extending the effective date in Regs. § 1.414(r)-1(d)(9)(i).

[125] *See* Prop. Regs. § 1.403(b)-5(a)(4), which would apply the rules under § 414. The effective date for the proposed regulations has been extended for tax years no earlier than 2008. IRS News Release IR-2006-136 (8/29/06).

This subject is analyzed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

d. Minimum Participation Rule

A defined benefit pension plan must benefit no fewer than the lesser of: (1) 50 employees; or (2) the greater of (a) 40% of all employees of the employer or (b) two employees (one employee if there only is one employee).[126]

[126] § 401(a)(26).

e. Nondiscrimination with Regard to Contributions and Benefits

Contributions or benefits must not discriminate in favor of highly compensated employees (HCEs).[127] Generally, contributions or benefits are not discriminatory if they bear a uniform relationship to participants'annual compensation.[128] For this purpose, compensation in excess of $200,000 is disregarded.[129]

[127] § 401(a)(4).

[128] § 401(a)(5)(B); Regs. § § 1.401(a)(4)-2(b)(2), -3(b)(2).

[129] § 401(a)(17), as amended by P.L. 107-16, § 611(c), effective for plan years beginning after 2001. The $200,000 amount is subject to adjustment for inflation after 2002. For 2007, the inflation-adjusted amount is $225,000. Notice 2006-98, 2006-46 I.R.B. 906. Prior to 2002, the dollar amount was $150,000, as adjusted for inflation. *See* Regs. § 1.401(a)(17)-1. For current or previous dollar amounts, see the Worksheets in 371 T.M., *Employee Plans — Deductions, Contributions and Funding.*

Compliance with the requirement that a plan's contributions or benefits not discriminate in favor of HCEs can be demonstrated either by using a safe harbor formula in the plan or by performing a general nondiscrimination test. Different safe harbors are available for defined benefit plans using unit credit and fractional accrual methods and for defined contribution plans allocating contributions uniformly based on compensation or weighting the allocation for age and/or service.

A general requirement under any of the safe harbors is uniform treatment of all participants under the plan. For example, a uniform normal retirement age must be used and any subsidized early retirement benefits or joint and survivor benefits must uniformly be available to substantially all employees.[130]

[130] Regs. § 1.401(a)(4)-3(b)(2).

The first safe harbor applies to unit credit plans, which provide a specific benefit for each year of service under a uniform benefit formula.[131] Benefit accruals should generally be either level (*i.e.*, the same percentage of pay or dollar amount) for all years of service; or based upon a percentage of pay that varies by years of service in a manner that satisfies the $133^1/_3$ % accrual rule under § 411(b)(1)(B). The $133^1/_3$ % accrual rule permits the rate of benefit accrual to increase as participants earn more service, as long as any year's accrual rate under the plan formula does not exceed the prior year's rate by more than $133^1/_3$ %.

[131] Regs. § 1.401(a)(4)-3(b)(3)(i).

The second safe harbor for defined benefit plans applies to plans using the fractional accrual rule, in which participants accrue benefits ratably over their period of service with the employer.[132] Different types of benefit formulas are eligible for the fractional accrual rule safe harbor as long as no employee can accrue a benefit in a year equal to a rate that exceeds 133$^1/_3$ % of the rate applicable to any other employee (excluding employees with more than 33 years of service). Accordingly, for example, a plan benefit formula under which a participant accrues a benefit of .75% of final average compensation for the first 20 years of projected service, plus 1.25% of final average compensation for projected service in excess of 20 years, multiplied by the ratio of service to projected service to normal retirement age, satisfies the fractional accrual unit credit safe harbor. However, although 1.25% is more than 133$^1/_3$ % of.75%, whether a plan satisfies the safe harbor is determined on the basis of the rate at which employees actually accrue benefits. Thus, an employee with 20 or fewer years of service has an annual accrual rate of .75%, and an employee with 33 years of service has an annual accrual rate of .947% ((.75 x 20) + (1.25 x 13)/33), a figure well below 133$^1/_3$ % of the shorter service employee's annual accrual rate.

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[132] Regs. § 1.401(a)(4)-3(b)(4).

Another safe harbor exists for defined benefit plans using a fractional accrual flat benefit formula in which the full flat benefit can be accrued with less than 25 years of service. In this case, the average accrual rates for NHCEs must be at least 70% of the average accrual rates for HCEs.[133] This rule is not a pure safe harbor because data collection and testing are required, but averaging accrual rates can sometimes expedite testing.

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[133] Regs. § 1.401(a)(4)-3(b)(4).

Two safe harbors are available for defined contribution plans. The first safe harbor covers plans that provide a uniform percentage of compensation (or dollar amount) to every employee under the plan,[134] such as for example, 1% of pay. Another safe harbor is for plans (other than ESOPs) that weight the allocation for items other than compensation.[135] Each employee's allocation is based on the number of “points” assigned to the employee, based on the employee's compensation, age, and/or years of service. In this case, the average allocation rate for HCEs cannot exceed the average allocation rate for NHCEs. This is not a pure safe harbor, but averaging allocation rates can expedite testing.

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[134] Regs. § 1.401(a)(4)-2(b)(2)(i).

[135] Regs. § 1.401(a)(4)-2(b)(3)(i).

A plan that does not satisfy one of the safe harbors must pass the general test to demonstrate nondiscrimination. Under this test, a normal and most valuable accrual rate (for defined benefit plans) or an allocation rate (for defined contribution plans)is determined for each employee. Employees are then put into groups based on their accrual or allocation rates, and each rate group is tested to see if it covers a nondiscriminatory group. A plan passes the general test if every rate group covers a nondiscriminatory group.[136]

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[136] Regs. § 1.401(a)(4)-3(c)(1).

A separate rate group exists for each highly compensated participant in the plan, consisting of that highly compensated participant and all other participants (whether highly or nonhighly compensated) with equal or greater normal and most valuable accrual rates or allocation rates. Employees may be included in more than one rate group.[137]

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[137] Regs. § 1.401(a)(4)-3(c)(1).

The normal accrual rate is the increase in the employee's accrued benefit during a measurement period selected by the plan sponsor.[138] The selected period can be either the current plan year, the employee's total period of service to date, or the employee's total period of service projected to normal retirement age, divided by the employee's service during the period selected.[139] The most valuable accrual rate is the increase in the employee's most valuable optional form of payment of the accrued benefit during the selected period, again divided by the employee's service during the period.[140]

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[138] Regs. § 1.401(a)(4)-3(d)(1)(ii).

[139] Regs. § 1.401(a)(4)-3(d)(1)(iii).

[140] Regs. § 1.401(a)(4)-3(d)(1)(ii).

Allocation rates and normal and most valuable accrual rates can be “grouped” or rounded within a specified range for testing purposes, provided that the allocation or accrual rates of HCEs within the range generally are not significantly higher than the allocation or accrual rates of NHCEs in the range. Allocation rates that fall within 5% of a midpoint or within an increment of 1/2 of a percent may be grouped and treated as equal for testing purposes.[141] Normal accrual rates that fall within 5% of a midpoint or within an increment of 1/10 of a percent may be grouped and treated as equal for testing purposes. Most valuable accrual rates that fall within 15% of a midpoint or within an increment of 1/10 of a percent (assuming accrual rates are determined as a percentage of average annual compensation) may be grouped.[142]

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[141] Regs. § 1.401(a)(4)-2(c)(2)(v).

[142] Regs. § 1.401(a)(4)-3(d)(3)(ii).

A plan may be restructured into component plans by employee groups. A component plan must independently satisfy either the ratio-percentage test or the average benefits test, including both the nondiscriminatory classification test and the average benefits percentage test.[143] If each component plan satisfies both the minimum coverage requirements and the nondiscrimination rules, the plan satisfies § 401(a)(4).[144]

[143] Regs. § 1.401(a)(4)-9(c)(4)(i).

[144] Regs. § 1.401(a)(4)-9(c)(1).

If two or more plans are aggregated to satisfy certain aspects of the minimum coverage tests, they also must be aggregated for nondiscrimination testing,[145] and plans aggregated for nondiscrimination testing must be aggregated for minimum coverage purposes.[146] If the plans that are aggregated are all of the same type (*e.g.*, all defined benefit plans or all defined contribution plans), the plans are treated as a single plan and generally are tested under the rules applicable to plans of that type, except as discussed below.[147] If the plans that are aggregated contain both defined benefit and defined contribution plans, the aggregate plan must be tested under special "DB/DC plan" rules.[148]

[145] Regs. § 1.401(a)(4)-9(a).

[146] Regs. § 1.410(b)-7(d)(1).

[147] Regs. § 1.401(a)(4)-9(a).

[148] Regs. § 1.401(a)(4)-9(b)(2).

A DB/DC plan generally is tested by converting the benefit under one type to a benefit of the other type, and then testing them in the aggregate as one type or the other.[149] In determining accrual rates, special optional rules must consistently be applied to all employees. For example, measurement periods that include future periods, which are not permitted when testing defined contribution plans, may not be used in testing a DB/DC plan on either a benefits or a contributions basis.[150]

[149] Regs. § 1.401(a)(4)-9(b)(2)(i).

[150] Regs. § 1.401(a)(4)-8(b)(2).

It also is possible to use these principles to test defined contribution plans under defined benefit rules and vice versa. These rules also are important in applying the average benefit test, if both defined benefit and defined contribution plans are involved.[151]

[151] Regs. § 1.401(a)(4)-8(a).

When testing a defined contribution plan as a defined benefit plan, the basic procedure is to convert contributions(other than contributions to an ESOP, § 401(k) or § 401(m) plan) into benefit accrual rates and then test the accrual rates under the defined benefit test.[152] The resulting “equivalent benefit accrual rates” are treated as both normal accrual rates and most valuable accrual rates.

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[152] Regs. § 1.401(a)(4)-8(b).

When testing a defined benefit plan as a defined contribution plan, the annual employer-provided accrual rate generally is first determined by comparing the year-end accrued benefit to the beginning-of-year accrued benefit. Both normal and most valuable accrual rates need to be tested.[153] The present value of each of these accrued benefits for the year is divided by the employee's compensation, and treated as a normal and most valuable allocation rate. The equivalent contribution rates for younger employees will be smaller and for older employees, they will be larger.

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[153] Regs. § 1.401(a)(4)-8(c)(1).

Benefit accrual cannot be cut back by reason of attainment of a certain age.[154] A defined benefit plan may contain a maximum benefit limitation or specify a maximum number of years of service or participation taken into account in determining a participant's normal retirement benefit under the plan, but not by reference to age.[155]

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[154] § 411(b)(1)(H)(i) and (b)(2)(A).

[155] § 411(b)(1)(H)(ii).

If a plan is top-heavy for a plan year, that is, if certain key employees are entitled to 60% or more of the accrued benefits under the plan, minimum contributions or accrued benefits on behalf of nonkey employees are required.[156] This topic is analyzed in detail in 353 T.M., *Employee Benefits for Small and Mid-Sized Employers*.

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[156] § 416.

This matter is addressed in 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified*

Retirement Plans, and 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

f. Other Nondiscrimination Requirements

Optional forms of benefits, ancillary benefits, and other rights or features under a plan generally must be tested on the basis of current availability and effective availability. Although each benefit, right, and feature generally must separately satisfy the nondiscriminatory availability requirements, testing can be done after permissively aggregating two or more benefits, rights, or features. One of the aggregated benefits, rights, or features must inherently be of equal or greater value than the other benefits, rights, or features. The benefit, right, or feature of inherently equal or greater value must separately satisfy the regulation's requirements.[157]

[157] Regs. § 1.401(a)(4)-4(d)(4).

Generally, the current availability standard requires that the group of employees to whom the benefit, right, or feature is available must satisfy the ratio percentage test or the nondiscriminatory classification test of § 410(b).[158] The average benefits percentage test does not apply for this purpose.[159]

[158] Regs. § 1.401(a)(4)-4(b)(1).

[159] Regs. § 1.401(a)(4)-4(b)(1).

Determining whether a benefit currently is available to an employee normally is done on a facts and circumstances basis for each employee. However, age and service conditions are disregarded when testing optional forms of benefits or a Social Security supplement. Therefore, early retirement benefits currently are considered available to all participants, not only those employees who already have earned the benefit or those employees who will qualify for the benefit if they continue to participate in the plan. Age or service conditions that must be satisfied within a specified period of time (*e.g.*, early retirement windows) are not disregarded, but the age and service of employees can be projected to the end of the time period. This makes an early retirement window benefit currently available to all employees who are or will be eligible for it.

Status conditions (*e.g.*, death, disability, marital status, hardship) also are disregarded when testing any benefits, rights, or features.[160] A condition that the value of a participant's benefit be below a certain amount also may be disregarded in current availability testing.[161]

[160] Regs. § 1.401(a)(4)-4(b)(2).

[161] Regs. § 1.401(a)(4)-4(b)(2)(ii)(D).

The group of employees to whom the benefit, right, or feature effectively is available cannot substantially favor HCEs. This is another facts and circumstances test. If, as a general matter, it is impossible for most

NHCEs to satisfy plan conditions that HCEs will satisfy (*e.g.*, years of service or named disabilities), the effective availability test is failed.[162]

[162] Regs. § 1.401(a)(4)-4(c)(1).

If a benefit, right, or feature fails either current or effective availability, its availability must be expanded. If a benefit, right or feature passes currently, but is likely to fail in the future, availability for future accruals can be expanded or eliminated. If an ancillary benefit or other right or feature is failing, it may either be expanded or removed, because it is not protected by the anti-cutback rule.[163]

[163] § 411(d)(6). The anti-cutback rule precludes employers from eliminating or reducing a participant's accrued benefit, early retirement benefit or retirement-type subsidy, or optional form of benefit.

An optional form of benefit is a distribution alternative that is protected under the anti-cutback rule and includes early retirement benefits and retirement subsidies. Differences in the terms of distribution (form, timing, payment schedules and medium of distribution) will cause different optional forms to exist. Also, differences in any terms that affect the value of an optional form, such as the applicable actuarial assumptions or the method of benefit calculation, will produce different optional forms.[164]

[164] Regs. § 1.401(a)(4)-4(e)(1)(i).

Ancillary benefits include Social Security supplements and “qualified” disability benefits;[165] certain life and health insurance; death benefits in a defined contribution plan; preretirement death benefits in a defined benefit plan; and shutdown benefits that are protected by the anti-cutback rule of § 411(d)(6).[166] Certain Social Security supplements, which are a form of early retirement benefits intended to supplement the participants’ income until Social Security payments commence, are considered “Qualified Social Security Supplements”(QSUPPs) and are not ancillary benefits.[167] QSUPPs are Social Security supplements that the plan sponsor has contractually agreed are subject to the anti-cutback rule of § 411(d)(6),[168] in order to include the value of the benefit in participants’ most valuable accrual rates under the general nondiscrimination test.

[165] § 411(a)(9).

[166] Regs. § 1.401(a)(4)-4(e)(2).

[167] Regs. § 1.401(a)(4)-4(e)(2).

[168] Regs. § 1.401(a)(4)-12.

Other rights or features are rights or features that are not optional forms or ancillary benefits, other than rights or features of insignificant value (*e.g.*, administrative details).[169] These include plan loans; the right to direct investments or to a particular form of investment; the right to each rate of elective contributions, matching contributions, and employee contributions under § 401(k) and (m);the right to make after-tax employee contributions to a defined benefit plan that are not allocated to separate accounts; and the right to make rollovers to or transfers to and from the plan.[170]

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[169] Regs. § 1.401(a)(4)-4(e)(3)(i).

[170] Regs. § 1.401(a)(4)-4(e)(3)(i).

This topic is analyzed in detail in 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*.

g. Vesting Requirements

Section 411 requires that qualified plans satisfy certain minimum vesting standards.[171] A participant's accrued benefit derived from his or her own after-tax contributions and elective salary deferral contributions under a § 401(k) arrangement must fully be vested at all times.[172]

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[171] Benefits ordinarily considered to be vested may be forfeited in some circumstances. *See* § 411(a)(3), Regs. § 1.411(a)-4T.

[172] § § 411(a)(1), 401(k)(2)(C).

With respect to the accrued benefit derived from the employer's contributions, the plan must provide that participants fully are vested on attainment of normal retirement age,[173] upon completion of a certain number of years of service with the employer[174] and upon plan termination.[175] Accrued benefits cannot be retroactively decreased by plan amendment except in certain distress situations,[176] nor can accrued benefits be reduced in connection with the merger or consolidation of the plan with another qualified plan or transfer of plan assets to another qualified plan.[177]

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[173] § 411(a). Normal retirement age is the earlier of: (1) normal retirement age provided for under the plan; or (2)the later of age 65 or the fifth anniversary of the date participation commences. § 411(a)(8).

[174] § 411(a)(2).

[175] § 411(d)(3); Regs. § 1.411(d)-2.

[176] § 411(d)(6). *See* § § 411(a)(3)(C), 412(c)(8) (for plan years beginning in 2008, see § 412(d)(2), as amended by the Pension Protection Act of 2006, P.L. 109-280, § 111(a)). This exception applies to a plan amendment adopted within $2^1/_2$ months after the close of a plan year which is effective as of the first day of the plan year and is approved by the Secretary of Labor as necessary because of a substantial business hardship as to which a waiver of the minimum funding standards is unavailable or inadequate.

[177] § 414(l)(1).

The plan's vesting standard based on years of service must meet one of the following minimum vesting requirements:(1) 100% vesting after five years of service; or (2) seven-year graded vesting at the rate of 20% after three years of service, 40% after four years of service, 60% after five years of service, 80% after six years of service and 100% after seven years of service.[178] A top-heavy plan must meet one of the following minimum vesting requirements: (1) 100% vesting after three years of service; or (2) six-year graded vesting, with 20% vesting after two years of service, 40% after three years of service, 60%after four years of service, 80% after five years of service and 100%after six years of service.[179] Naturally, vesting schedules that are more favorable to the participant are acceptable.

[178] § 411(a)(2). For plan years beginning in 2007, see § 411(a)(2)(A), as amended by P.L. 109-280, § 904(a)(1).

[179] § 416(b).

Section 411(a)(12)[180] provides faster vesting schedules for employer matching contributions. Under this provision, employer matching contributions must vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100% after six years of service.

[180] Added by P.L. 107-16, § 633(a), effective for contributions for plan years beginning after 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement, but will not apply to any employee until the employee has an hour of service after the effective date. P.L. 107-16, § 633(c). In applying this vesting schedule, service before the effective date is taken into account. H.R. Conf. Rep. No. 84, 107th Cong., 1st Sess. 144 (2001). For plan years beginning in 2007, § 411(a)(12) is repealed by P.L. 109-280, § 904(a)(2);see § 411(a)(2)(B), as amended by P.L. 109-280, § 904(a)(1).

For plan years beginning in 2007, the faster vesting schedule for employer matching contributions applies to all employer contributions to defined contribution plans.[181]

[181] § 411(a)(2)(B), as amended by P.L. 109-280, § 904(a)(1), with a delayed effective date for plans maintained pursuant to a collective bargaining agreement, and § 411(a)(12), as repealed by P.L. 109-280, § 904(a)(2). Section 411(a)(2), as amended, will not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account. P.L. 109-280, § 904(c)(3). *See* Notice 2007-7, 2007-5 I.R.B. 395, § VII, Q& As-28 through -30.

This matter is analyzed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

7. General Limitations on Contributions and Benefits

In general, § 415 limits contributions to an employer's qualified defined contribution plan and benefits available from an employer's qualified defined benefit plan with respect to any employee. The IRS issued final regulations under § 415, which generally are effective July 1, 2007. The discussion that follows is based on the 2007 regulations.[181.1]

[181.1] T.D. 9319, 72 Fed. Reg. 16878 (4/5/07), adding Regs. § § 1.415(a)-1, 1.415(b)-1, 1.415(c)-1 and -2, 1.415(d)-1, 1.415(f)-1, 1.415(g)-1, and 1.415(j)-1, generally applicable to limitation years beginning on or after July 1, 2007.

This subject is addressed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*. For the special limits on government plans, especially plans for police and firefighters, see 372 T.M., *Church and Governmental Plans*. A brief summary of special rules for employees of tax-exempt organizations follows.

a. Defined Benefit Plans

Defined benefit plans are subject to limitations on the annual employer-funded benefit payable to a participant. Generally, the participant's annual benefit cannot exceed the lesser of 100%of the participant's average compensation in the highest-paid three consecutive years (or 12-month periods, if uniformly and consistently applied in accordance with the plan terms) of compensation from the employer, or $160,000, as adjusted for the cost of living.[182] For this purpose, the annual benefit is the annual employer-funded benefit under a straight life annuity without ancillary benefits.[183] The $160,000 limitation is reduced if payment of the participant's benefit begins before age 62[184] and is increased if payment of the participant's benefit begins after age 65.[185] The maximum benefit based on average compensation is reduced for employees with less than 10 years of service and the maximum benefit based on the $160,000 limitation is reduced for employees with less than 10 years of participation.[186]

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[182] § 415(b)(1) and (d)(1)(A), as amended by EGTRRA § 611(a)(1)(A) and (a)(4), effective for years ending after 2001. The provisions under EGTRRA were set to expire for taxable, plan or limitation years beginning after 2010. EGTRRA § 901. The Pension Protection Act of 2006, P.L. 109-280, repealed the sunset provision in EGTRRA § 901 as it applies to pensions and IRAs. P.L. 109-280, § 811. In addition, P.L. 109-280, § 832, amended § 415(b)(3) to remove the requirement that the participant be an active participant in the plan in determining the high three years of service. *See* Regs. § 1.415(b)-1(a)(1) and (5). A plan may not take into account compensation in excess of the § 401(a)(17) limit in determining a participant's highest three-year average compensation. Regs. § 1.415(b)-1(a)(5). The $160,000 amount is subject to adjustment for inflation after 2002. For 2007, the inflation-adjusted amount is $180,000. Notice 2006-98, 2006-46 I.R.B. 906. Prior to 2002, the statutory dollar amount limit was $90,000, as adjusted for inflation. For the current or previous dollar amount, see the Worksheets in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

[183] § 415(b)(2)(A).

[184] § 415(b)(2)(C), as amended by EGTRRA § 611(a)(1)(B), effective for years ending after 2001. For previous years, the limit was adjusted if benefits began before the Social Security retirement age. *See* Regs. § 1.415(b)-1(d).

[185] § 415(b)(2)(D), as amended by EGTRRA § 611(a)(1)(B), effective for years ending after 2001. For

previous years, the limit was adjusted if benefits began after the Social Security retirement age. *See* Regs. § 1.415(b)-1(e).

[186] § 415(b)(5)(A), (B) and (C).

These limitations were tightened three times between 1982 and 1986.[187] Benefits provided under plans maintained by tax-exempt organizations under prior law were grandfathered from some of the restrictions enacted in 1986.[188] Therefore, as to benefits accrued under such plans, the actuarial reduction applied to the defined benefit dollar limitation only if payment began before the participant attained age 62, rather than Social Security retirement age.[189] The actuarial reduction for payment beginning at or after age 55 and before age 62 could not reduce the limitation on benefits commencing at age 55 below $75,000,[190] and the actuarial reduction for payment beginning before age 55 applied to the $75,000 maximum annual benefit payable at age 55,[191] rather than the generally applicable (formerly$90,000, as adjusted for inflation) maximum annual benefit. Also, any increase in the defined benefit dollar limitation for cost-of-living is applied at age 65, rather than at Social Security retirement age, if later.[192]

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[187] Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248, § 235; Deficit Reduction Act of 1984 (DEFRA), P.L. 98-369, § 713;Tax Reform Act of 1986 (1986 TRA), P.L. 99-514, § 1106.

[188] 1986 TRA § 1106(b)(2).

[189] Former § 415(b)(2)(F)(i)(I), repealed by EGTRRA § 611(a)(5)(A), effective for years ending after 2001.

[190] Former § 415(b)(2)(F)(i)(II), repealed by EGTRRA § 611(a)(5)(A), effective for years ending after 2001.

[191] *Id.*

[192] Former § 415(b)(2)(F)(ii), repealed by EGTRRA § 611(a)(5)(A), effective for years ending after 2001.

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b. Defined Contribution Plans

In the case of a defined contribution plan, effective for years beginning after 2001, annual additions to a participant's account must not exceed the lesser of 100% of his or her compensation or $40,000.[193]

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[193] § 415(c)(1), as amended by EGTRRA § § 611 and 632. The provisions under EGTRRA were set to expire for taxable, plan or limitation years beginning after 2010. EGTRRA § 901. The Pension Protection Act of 2006, P.L. 109-280, repealed the sunset provision in EGTRRA § 901 as it applies to pensions and IRAs. P.L. 109-280, § 811. The $40,000 amount is subject to adjustment for inflation after 2002. For 2007, the inflation-adjusted amount is $45,000. Notice 2006-98, 2006-46 I.R.B. 906. *See* Regs. § 1.415(c)-1(a)(1). If the plan terminates before the end of the limitation year, the plan year is treated as a short year and the dollar limit on annual additions is prorated. Regs. § 1.415(j)-1(d)(2). Prior to EGTRRA, the dollar amount limit was $30,000 (as adjusted for inflation) and the percentage compensation limitation was 25%. Notice 2001-57, 2001-38 I.R.B. 279, contains a sample amendment for the EGTRRA change. For the current or previous dollar amount, see the Table in the Worksheets of 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

The term “annual additions” includes employer contributions, employee contributions and forfeitures.[194] Employer contributions for a year generally include all amounts contributed by the employer for the year, except certain items credited to the employee's account to restore accrued benefits, catch-up contributions, restorative payments, and certain distributions of excess deferrals.[195]

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[194] § 415(c)(2); Regs. § 1.415(c)-1(b)(1).

[195] Regs. § 1.415(c)-1(b)(2).

Forfeitures for a year include all amounts that are allocated to the participant's account under the plan for the year as a result of a forfeiture from other accounts under the plan.[196]

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[196] Regs. § 1.415(c)-1(b)(6)(i)(D).

Employee contributions for a year generally include all an employee's nondeductible voluntary and mandatory employee contributions for the year.[197] Rollover contributions, loan repayments, repayments of prior distributions to obtain restoration of prior forfeitures, and employee contributions to a qualified cost of living arrangement are not treated as employee contributions.[198]

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[197] Regs. § 1.415(c)-1(b)(3).

[198] § 415(c)(2); Regs. § 1.415(c)-1(b)(3).

For years beginning after 1997, the definition of compensation was expanded to include elective deferrals to a § 401(k) plan that are excluded from income pursuant to § 402(g), amounts contributed to a cafeteria plan under § 125, any qualified transportation fringe benefit not includible in gross income under § 132(f)(4), and amounts deferred under a § 457 plan at the employee's election that are not includible in the employee's income.[199] Under prior law, NHCEs were often limited by the 25% of compensation standard because it excluded elective contributions.

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[199] § 415(c)(3)(D). *See* Regs. § 1.415(c)-2(b)(1). Compensation also includes amounts included in the employee's gross income under § 409A or § 457(f)(1)(A). Regs. § 1.415(c)-2(b)(7). *See also* Regs. § 1.415(c)-2(e) (providing that certain payments made within two and one-half months following later of severance from employment or end of limitation year including the date of severance from employment are considered compensation, and excluding payments to individuals in qualified military service and permanent and total disability payments).

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c. Combined Limitation

The combined plan limit was repealed for limitation years beginning after 1999.[200]

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[200] SBJPA § 1452, repealing former § 415(e).

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8. Distribution Requirements

Complicated rules govern distributions from tax-qualified plans. These rules restrict the time of distribution, the forms of distribution available under the plan and the maximum period of time over which periodic distributions may be made.[201] This matter is addressed in 370 T.M., *Qualified Plans — Taxation of Distributions*. A brief summary follows.

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[201] *See* Regs. § § 1.401(a)(9)-1 through-9 and 1.403(b)-3, T.D. 8987, 67 Fed. Reg. 18987 (4/17/02), which apply for determining required minimum distributions for calendar years beginning on or after Jan. 1, 2003. Defined benefit plans have by the end of the initial five- or six-year remedial amendment cycle to adopt plan amendments for Regs. § § 1.401(a)(9)-1 through- 9. Notice 2005-95, 2005-51 I.R.B. 1172, *clarifying* Rev. Proc. 2005-66, 2005-37 I.R.B. 509; Rev. Proc. 2007-44, 2007-28 I.R.B. __, § 7, *superseding* Rev. Proc. 2005-66. For required minimum distributions for calendar year 2002, taxpayers may rely on the 2002 final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.

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a. Restrictions on Early Distribution

In-service distributions generally are not permitted under pension plans until normal retirement age.[202] For this purpose, a plan's normal retirement age must be an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. Age 62 or later is the safe harbor normal retirement age; age 55 to age 61 may qualify based on the relevant facts and circumstances; and under age 55 is presumed to not qualify unless the facts and circumstances demonstrate otherwise to the IRS. However, if substantially all of the participants in the plan are qualified public safety employees (within the meaning of § 72(t)(10)(B)), age 50 or later is deemed to qualify.[202.1] However, a pension plan may make working retirement distributions to employees who have reached age 62 and who have not separated from employment at the time of the distribution.[202.2]

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[202] *See* Regs. § 1.401-1(b)(1)(i);Regs. § 1.401(a)-1(b)(1)(i), as amended by T.D. 9325, 72 Fed. Reg. 28604 (5/22/07); Rev. Rul. 74-254, 1974-1 C.B. 91; Rev. Rul. 56-693, 1956-2 C.B. 282, *as modified by* Rev. Rul. 60-323, 1960-2 C.B. 148. Section 1400Q(a), as added by the Gulf Opportunity Act of 2005, P.L. 109-135, § 201, allows eligible retirement plans to make early plan distributions to individuals who suffered economic losses due to Hurricanes Katrina, Rita and Wilma. Such distributions are not subject to the 10% penalty tax on early plan withdrawals and may be repaid over a three-year period to avoid income inclusion.

[202.1] Regs. § 1.401(a)-1(b)(2), as added by T.D. 9325, 72 Fed. Reg. 28604 (5/22/07), generally effective May 22, 2007. For governmental plans, the regulations apply Jan. 1, 2009. A plan amendment that changes a plan's normal retirement age to a later normal retirement age pursuant to Regs. § 1.401(a)-1(b)(2) does not violate the anti-cutback rule of § 411(d)(6) merely because it eliminates a right to an in-service distribution before the amended normal retirement age. Regs. § 1.411(d)-4, Q& A-12, added by T.D. 9325.

[202.2] Code § 401(a)(36), as added by P.L. 109-280, § 905(b), and ERISA § 3(2)(A), as amended by P.L. 109-280, § 905(a), effective for distributions in plan years beginning after 2006. *See* Regs. § 1.401(a)-1(b)(1)(i), as amended by T.D. 9325.

Distribution from a profit-sharing plan generally may occur during service before normal retirement age if the plan satisfies definite criteria relating to the intention to defer income. Employer contributions may be distributed after they have been held under the plan for at least 24 months or after a substantial period of participation or occurrence of a significant event.[203] Hardship distributions not in excess of the participant's vested interest are permitted.[204] Employee contributions may be distributed at any time, so long as withdrawals cannot reasonably be expected to result in manipulation of the formula for allocating employer contributions.[205] Elective salary deferral contributions pursuant to § 401(k), certain matching and nonelective employer contributions taken into account in determining whether the plan satisfies the nondiscrimination standards of § 401(k), and earnings on all such contributions can be distributed during service before age 59$^1/_2$ only on account of hardship,[206] as defined in accordance with nondiscriminatory and objective standards set forth in the plan.[207]

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[203] Regs. § 1.401-1(b)(1)(ii); Rev. Rul. 54-231, 1954-1 C.B. 150.

[204] Rev. Rul. 71-224, 1971-1 C.B. 124.

[205] Rev. Rul. 74-55, 1974-1 C.B. 89.

[206] § 401(k)(2)(B)(i) and (ii). Beginning after Sept. 11, 2001, distributions may be made to a reservist (called up between Sept. 11, 2001, and before Dec. 31, 2007, for more than 179 days), before age 59 $^1/_2$. § 401(k)(2)(B)(i)(V), as added by P.L. 109-280, § 827(b)(1), cross-referencing § 72(t)(2)(G), as added by the Pension Protection Act of 2006, P.L. 109-280, § 827(a).

[207] Regs. § 1.401(k)-1(d)(2)(i). Regs. § 1.401(k)-1(d)(3)(i), applicable for plan years beginning on or after Jan. 1, 2006, but generally may be relied upon for plan years ending after Dec. 29, 2004, provided that the plan applies all of the 2004 regulations for that plan year and all subsequent plan years. T.D. 9169, 69 Fed. Reg. 78144 (12/29/04). Plan amendments for the final regulations must be adopted by the later of Dec. 31, 2005, or the end of the plan year in which the final regulations are implemented for a discretionary amendment under Rev. Proc. 2005-66. A discretionary amendment is an amendment that implements the final regulations before their effective date as to that plan. Notice 2005-95, 2005-51 I.R.B. 1172. *See* Rev. Proc. 2007-44, 2007-28 I.R.B. __, § 5.05 to .07 (rules on timing of adoption of discretionary amendments), *superseding* Rev. Proc. 2005-66. For plan years prior to 2006, see former Regs. § 1.401(k)-1(d)(2)(i).

Regulations set forth safe harbor standards for immediate and heavy financial needs that qualify as hardships:(1) the participant's purchase of a principal residence; (2)medical expenses of the participant and his or her dependents; (3)post-secondary educational expenses of the participant and his or her dependents; and (4) the threat of eviction from or foreclosure on the participant's principal residence.[208] The distribution cannot exceed the amount necessary to satisfy the immediate and heavy financial need, and the employee must have no access to other reasonably available resources that can be applied to alleviate the hardship, including insurance proceeds, future forbearance from contributions under the plan, assets belonging to the participant, spouse and children (other than assets held for a minor child in an irrevocable trust or under the Uniform Gifts to Minors Act), other distributions and loans from the employer's qualified plans, and loans on reasonable commercial terms from commercial sources.[209] A plan administrator may rely on the employee's representation respecting the lack of other available resources.[210]

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[208] Regs. § 1.401(k)-1(d)(2)(iii)(B). For plan years prior to 2006, see former Regs. § 1.401(k)-1(d)(2)(iv)(A). The Treasury is directed to revise the hardship regulations under § 401(k)(2)(B)(i)(IV) within 180 days after Aug. 17, 2006, to include a hardship of a plan beneficiary even if the beneficiary is not a spouse or dependent. P.L. 109-280, § 826. *See* Notice 2007-7, 2007-5 I.R.B. 395, § III, Q& A-5. A plan does not fail to satisfy the § 401(k)(12) safe harbor requirements merely because it makes mid-year changes to implement hardship withdrawals described in Notice 2007-7, § III. Announcement 2007-59, 2007-25 I.R.B. 1448.

[209] Regs. § 1.401(k)-1(d)(3)(iv)(A) and (B). For plan years prior to 2006, see former Regs. § 1.401(k)-1(d)(2)(iii)(B).

[210] Regs. § 1.401(k)-1(d)(3)(iv)(C). For plan years prior to 2006, see former Regs. § 1.401(k)-1(d)(2)(iii)(B).

In the alternative, distribution may be deemed necessary to satisfy an immediate and heavy financial need if the amount distributed does not exceed the immediate and heavy financial need, the employee has obtained all other currently available distributions(including loans) from all qualified plans maintained by the employer, the employee refrains from all elective contributions and after-tax employee contributions under the employer's qualified plans for at least six months following the hardship distribution.[211] The amount of the distribution also is limited to the sum of the participant's elective salary deferral contributions at the time of the hardship distribution, plus any earnings on elective salary deferral contributions as of December 31, 1988.[212]

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[211] Regs. § 1.401(k)-1(d)(3)(iv)(E), which amended the prior rule by reducing the suspension time period from 12 months to six months and by eliminating the restriction for making elective deferrals the following tax year of the hardship withdrawal. For plan years prior to 2006, see former Regs. § 1.401(k)-1(d)(2)(iv)(B).

[212] § 401(k)(2)(B)(i)(IV); Regs. § 1.401(k)-1(d)(3)(ii)(B). For plan years prior to 2006, see former Regs. § 1.401(k)-1(d)(2)(ii).

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b. Restrictions on Delay in Distribution

A plan must provide that distribution of a participant's benefit will begin not later than 60 days after the end of the plan year in which the latest of the following events occurs: (1) the participant's attainment of age 65 or normal retirement age (whichever is earlier);(2) the fifth anniversary of the year in which the participant's participation began; or (3) the participant's termination of service.[213] In addition, a plan that permits a participant to elect that distribution begin after separation from service after satisfying specified age and service requirements for early retirement but before attainment of normal retirement age must permit an individual who separates from service after satisfying the plan's service requirement for early retirement but before satisfying the plan's age requirement for early retirement to elect that distribution begin upon satisfaction of the age requirement for early retirement, even though the individual is no longer in the employ of the employer at that time.[214]

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[213] § 401(a)(14). A tax-qualified pension plan may make working retirement distributions to employees who

have reached age 62 and who have not separated from employment at the time of distribution, effective for distributions in plan years beginning after 2006. § 401(a)(36), as added by P.L. 109-280, § 905(b). *See* Regs. § 1.401(a)-1(b)(1)(i), as amended by T.D. 9325 (permitting distribution to participant who has attained age 62 but not separated from employment; discussed in II, A, 8, a, above).

[214] § 401(a)(14). For 1991 and subsequent years, the distribution commencement rule of § 401(a)(14) is not violated if payments under an annuity contract or guaranteed investment contract are reduced or suspended due to state insurer delinquency proceedings. If other assets are available for distribution they must be utilized, and exhausted if necessary, to make distributions from the plan. When the reduction or suspension ceases, in whole or in part, the amount of any shortfall in a prior distribution must be made up on a reasonable basis. Rev. Proc. 92-10, 1992-1 C.B. 661.

Section 401(a)(9) limits the extent to which an employee may elect to delay distribution. For years beginning after 1996, distributions generally are required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70$^1/_2$ or (2) the calendar year in which the employee retires.[215] However, in the case of a 5% owner of the employer, distributions are required to begin no later than April 1 of the calendar year following the year in which the 5% owner attains age 70$^1/_2$.[216] In addition, in the case of an employee(other than a 5% owner) who retires in a calendar year after attaining age 70$^1/_2$, the employee's accrued benefit generally is required to be actuarially increased to take into account the period after age 70$^1/_2$ in which the employee was not receiving benefits under the plan.[217] Neither the actuarial adjustment rule nor the exception for 5% owners applies to church plans defined in § 3121(w)(3).[218]

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[215] For years prior to 1997, distributions were required to begin by Apr. 1 of the calendar year following the calendar year in which the employee attained age 70$^1/_2$. An employee who attained age 70$^1/_2$ in 1996, but who had not retired from employment with the employer maintaining the plan by the end of 1996 was not required to receive a minimum distribution by Apr. 1, 1997. Notice 96-67, 1996-2 C.B. 235.

[216] § 401(a)(9)(C).

[217] § 401(a)(9)(C)(iii).

[218] § 401(a)(9)(C)(iv).

If the participant dies before payment of his or her benefit begins, distribution must be complete by the end of the fifth calendar year beginning after the participant's death occurs,[219] unless it is payable for the life or a period not greater than the actuarially determined life expectancy of the participant's surviving spouse or other beneficiary, commencing not later than the end of the first calendar year beginning after the participant's death occurs.[220] If the beneficiary is the participant's surviving spouse, the spouse must be permitted to elect that payment be delayed until the end of the calendar year in which the participant would have attained age 70$^1/_2$ [221] unless the spouse dies before distribution occurs. In that case, the distribution rules apply as if the spouse were the participant.[222] If applicable, the provisions of § 417(e) requiring that the spouse consent to any distribution commencing before the later of the date the participant would have attained age 62 or normal retirement age also must be satisfied.[223]

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[219] § 401(a)(9)(B)(ii); Regs. § 1.401(a)(9)-3, Q& A-2.

[220] § 401(a)(9)(B)(iii); Regs. § § 1.401(a)(9)-3, Q& A-3, 1.401(a)(9)-5, Q& A-5.

[221] § 401(a)(9)(B)(iv)(I); Regs. § 1.401(a)(9)-3, Q& A-3.

[222] § 401(a)(9)(B)(iv)(II);Regs. § 1.401(a)(9)-3, Q& A-5. In applying this rule, the date of the spouse's death is substituted for the date of the employee's death. If the participant's spouse remarries, the spouse's new spouse is not entitled to elect to delay distribution.

[223] See II, A, 8, c, below.

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c. Other Requirements Respecting Form and Time of Distribution

A tax-qualified defined benefit pension plan or money purchase pension plan must make available a form of retirement benefit consisting of a life annuity for the life of the participant.[224] In addition, if the participant is married on the date payment of the benefit is scheduled to begin, the normal form of benefit must be a “qualified joint and survivor annuity” (QJSA) for the participant and his spouse, with a survivor benefit for the spouse equal to at least 50% but not more than 100%of the annuity payable during the joint lives of the participant and the spouse.[225] If a married participant elects a form of benefit other than the QJSA, the formal written consent of the participant's spouse to the election not to receive the QJSA must be obtained by the plan administrator.

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[224] § § 401(a)(11)(A)(i) and 417(b); Regs. § 1.401(a)-20, Q& A-25.

[225] § § 401(a)(11)(A)(i) and 417(b). A plan is not required to treat a participant as married unless the participant and his spouse have been married for one year as of the annuity starting date or the date of the participant's death. Nevertheless, if the participant has been married for less than one year on the annuity starting date, the plan must provide benefits in the form of a qualified joint and survivor annuity. If the participant then dies or the marriage is otherwise ended before the end of the first year of the participant's marriage, the survivor annuity can be forfeited. § 417(d); Regs. § 1.401(a)-20, Q& As-27 through -30.

The spouse also must consent to the designation of a particular beneficiary or consent to the reservation by the participant of the general power to designate a beneficiary other than the spouse.[226] In addition, if the participant's retirement benefit is paid in a form other than the QJSA and payment begins before the later of the date the participant attains age 62 or the normal retirement age provided for in the plan, the participant's spouse's formal written consent to the time payment begins is required.[227]

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[226] § 417(a)(2); *see* Regs. § 1.401(a)-20, Q& A-27 through -30.

[227] § 417(e)(2); Regs. § 1.417(e)-1(b)(1).

If a married participant in a defined benefit pension plan dies with a vested interest before payment of his or her pension begins, the spouse must be entitled to a preretirement survivor annuity equal to the 50% survivor benefit available under a QJSA based on the participant's vested benefit on the date of death, commencing as of the earliest date the participant could have elected that payment of his benefit begin if he or she had lived.[228] If a married participant in a money purchase pension plan dies before payment begins, 50% of the value of the vested account balance must be applied to the purchase of a life annuity for the surviving spouse.[229] A plan need not make these benefits available unless the participant and the spouse were married for at least one year on the date of death.[230] In either case, payment of the spouse's preretirement survivor annuity cannot begin before the later of the date the participant would have attained age 62 or normal retirement age under the plan without the surviving spouse's written consent.[231]

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[228] § 417(c)(1); Regs. § 1.401(a)-20, Q& A-18.

[229] § 417(c)(2); Regs. § 1.401(a)-20, Q& A-20.

[230] § 417(d)(1).

[231] § 417(e)(2).

The preretirement survivor annuity can be waived by a participant only with the formal written consent of the spouse,[232] and cannot be waived by the participant until the plan year in which the participant attains age 35, or until the participant's employment terminates, if earlier.[233]

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[232] § 417(a)(2); *see* Regs. § 1.401(a)-20, Q& As-27 through -30.

[233] § 417(a)(6)(B); Regs. § 1.401(a)-20, Q& A-33(b).

The IRS has issued model spousal consent language that can be used to explain to the participant and spouse their rights under the plan and the consequences of these consents.[234] The model spousal consent language is written in a manner calculated to be understood by the average person.

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[234] Notice 97-10, 1997-1 C.B. 370.

A profit-sharing plan need not offer benefits in the form of a life annuity,[235] but if it does offer benefits in the form of a life annuity, the foregoing rules apply if the participant has elected at any time to receive the benefit in the form of a life annuity.[236] If no life annuity option is offered by a profit-sharing plan, or the participant has not elected to receive a life annuity, any portion of a married participant's accrued benefit remaining unpaid under the plan at the time of the participant's death must be paid to the surviving spouse,[237] unless: (1) the participant and the spouse were married for less than one year on the date of death;[238] or (2) the spouse has given formal written consent to the participant's particular beneficiary designation or to the participant's general power to designate a beneficiary other than the surviving spouse.[239] Distribution of a participant's benefit cannot occur during his or her lifetime before the later of the normal retirement age specified in the plan or the participant's attainment of age 62 without the participant's formal written consent.[240] Spousal consent to the time of distribution of death benefits before the later of the date the participant would have attained age 62 or normal retirement age under the plan is not required.[241]

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[235] § 401(a)(11)(B)(iii); Regs. § 1.401(a)-20, Q& A-3.

[236] Regs. § 1.401(a)-20, Q& A-4.

[237] § 401(a)(11)(B)(iii)(I); Regs. § 1.401(a)-20, Q& As-3, -32.

[238] Regs. § 1.401(a)-20, Q& A-26.

[239] § 401(a)(11)(B)(iii)(I); Regs. § 1.401(a)-20, Q& A-32.

[240] § 411(a)(11)(A); Regs. § 1.411(a)-11.

[241] Section 417(e)(2) does not apply if the benefit is not subject to the requirements of § 417, and § 411(a)(11) does not require spousal consent.

If the present value of the participant's vested accrued benefit does not exceed $5,000 at the time distribution is scheduled to begin, the plan may distribute the benefit in a single sum without the consent of the participant or the spouse.[242]

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[242] § 411(a)(11). A plan may provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit attributable to rollover contributions (plus earnings). § 411(a)(11)(D), as added by EGTRRA § 648(a)(1), effective for distributions after Dec. 31, 2001. See Rev. Rul. 2001-62, 2001-53 I.R.B. 632, for the applicable mortality table to be used under § § 415(b)(2)(E)(v) and 417(e)(3)(A)(ii)(I) for distributions with annuity starting dates on or after the earlier of Dec. 31, 2002, or the date specified in the plan for which the use of the mortality table set forth in Rev. Proc. 2001-62 is specified(which may be no earlier than Jan. 1, 2002). For distributions with annuity starting dates prior to those dates, *see* Rev. Rul. 95-6, 1995-1 C.B. 80, *superseded by* Rev. Rul. 2001-62. For plan years beginning in 2008, see § 417(e)(3)(B) for the applicable mortality table to be used. § 417(e)(3), as amended by P.L. 109-280, § 302(b).

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d. Loans to Participants

Loans to participants under all qualified plans and § 403(b) annuities maintained by the same employer are limited to the greater of 50%of the participant's vested benefit or $10,000, but in any event not more than $50,000.[243]

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[243] § 72(p)(2)(D), (p)(4), and (p)(2)(A). Any loan outstanding during the one-year period ending on the day before the date the loan is made is taken into account when determining the amount of loans outstanding on that date. § 72(p)(2)(A)(i)(I). Section 1400Q(c), added by the Gulf Opportunity Act of 2005, P.L. 109-135, § 201, allows eligible retirement plans to make plan loans of up to $100,000 to individuals who suffered economic losses due to Hurricanes Katrina, Rita and Wilma.

The maximum term of any loan other than a loan for the purpose of financing the purchase or improvement of the participant's principal residence is five years,[244] and any loan must be repaid in equal installment payments of principal and interest not less frequent than quarterly.[245]

[244] § 72(p)(2)(B).

[245] § 72(p)(2)(C).

If the limitation on the amount of loan is exceeded, the excess is treated as a taxable distribution to the participant.[246] If the limitations on the terms of the loan are not satisfied, the entire loan is treated as a taxable distribution.[247] In neither case is the participant relieved of the obligation to repay the loan.[248]

[246] § 72(p)(2)(A).

[247] § 72(p)(2)(B).

[248] S. Rep. No. 494, 97th Cong., 2d Sess. at 321, reprinted in 1982 U.S.C.C.A.N. 781 at 1060.

If a participant's elective deferral contributions under a cash or deferred arrangement are pledged as security for a loan that is not treated as a plan distribution, the interest payable on the loan is not deductible.[249] Interest on a loan that is not treated as a plan distribution to a key employee within the meaning of § 416(i) is not deductible.[250]

[249] § 72(p)(3)(B)(ii).

[250] § 72(p)(3)(B)(i).

The minimum loan amount cannot be greater than$1,000,[251] and the maximum portion of a participant's account that may be pledged as security for a loan is 50%.[252] If these limitations are exceeded, the loan is treated as a prohibited transaction, subject to excise tax for the entire period of its existence.[253]

[251] DOL Regs. § 2550.408b-1(b)(2).

[252] § 4975; Treas. Regs. § 54.4975-1; DOL Regs. § 2550.408b-1(a)(1) (flush language).

[253] DOL Regs. § 2550.408b-1(f)(2).

If the plan making the loan is subject to the qualified joint and survivor annuity requirements and the participant's spouse at the time the loan is made consents to the loan, then, upon subsequent distribution of the participant's benefit from the plan, the benefit may be reduced by the amount of the loan then outstanding, even if the participant is married to a different spouse when distribution occurs. Otherwise, the amount of the loan outstanding must be taken into account in determining the spouse's benefit under the qualified joint and survivor annuity rules.[254]

[254] § 417(a)(4) and (f)(5); Regs. § 1.401(a)-20, Q& A-24.

e. Spendthrift Rules

The spendthrift rule of § 401(a)(13) generally prohibits voluntary or involuntary assignment of a participant's benefit before distribution would otherwise occur pursuant to the plan. Certain revocable assignments and federal tax levies and judgments are excepted from this rule by regulation[255] and qualified domestic relations orders (QDROs) issued by state courts are excepted by statute.[256] In addition, a participant's accrued benefit can be reduced or offset in satisfaction of a judgment or settlement arising from crimes against the plan or violations of ERISA. If the survivor annuity protections apply to the plan, the spouse must either consent to the reduction or offset, or the spouse's survivor benefits must be protected.[257]

[255] Regs. § 1.401(a)-13(b)(2) and-13(d) and (e). *See* U.S. v. Sawaf, 74 F.3d 119 (6th Cir. 1996) (ERISA's anti-alienation provision does not bar IRS from garnishing taxpayer's vested interest in ERISA-qualified pension fund in order to satisfy judgment for unpaid taxes under the Federal Debt Collection Procedure Act).

[256] § § 401(a)(13)(B) and 414(p).

[257] § 401(a)(13)(C).

A state court order that satisfies statutory criteria for a QDRO relating to distribution of part or all of a participant's benefit under a qualified plan to an alternate payee under the order must be enforced by the plan administrator.[258] A QDRO cannot require distribution in any form that is not otherwise available under the plan or a greater benefit than the participant is entitled to under the plan's general provisions;[259] however, it may require distribution after the participant has satisfied the plan's age and service requirements for distribution on account of early retirement or age 50, whichever is later, even if the participant has not then separated from service.[260] Also, the plan may contain a provision for immediate distribution pursuant to a QDRO, even if that would otherwise be impermissible, as in the case of a pension plan or a 401(k) arrangement.[261]

[258] § 414(p)(6) and (7).

[259] § 414(p)(3).

[260] § 414(p)(4).

[261] § 414(p)(10). The IRS has issued model language that can be used in drafting and reviewing QDROs. Notice 97-11, 1997-1 C.B. 379.

Section 414(p)(9) provides that, except as provided in regulations, any distribution from a § 403(b) annuity contract pursuant to a QDRO must be treated in the same manner as a distribution from a plan to which § 401(a)(13) applies.[262]

[262] Proposed rules governing § 403(b) contracts would clarify that the QDRO rules apply to § 403(b) contracts. Prop. Regs. § 1.403(b)-10(c), REG-155608-02, 69 Fed. Reg. 67075 (11/16/04).

9. Funding Requirements

Section 412 imposes minimum funding requirements and maximum funding limitations on defined benefit pension plans and money purchase pension plans. Profit-sharing plans, stock bonus plans, employee-pay-all plans, and certain fully insured plans are not required to satisfy these requirements.[263]

[263] § 412(h). For plan years beginning in 2008, see § 412(e)(2), as amended by the Pension Protection Act of 2006, P.L. 109-280, § 111(a).

For defined benefit pension plans, the minimum and maximum contributions are determined actuarially each year.[264] For money purchase pension plans, the minimum and maximum contribution is the amount required under the plan's formula.[265]

[264] § 412(b) and (c). For plan years beginning in 2008, see § § 412(a)(2), 430(a) and (h)(1), as amended by P.L. 109-280, § § 111(a) and 112(a), respectively.

[265] For plan years beginning in 2008, see § 412(a)(2)(B), as amended by P.L. 109-280, § 111(a).

Minimum contributions must be made within 8½ months after the end of the plan year.[266] A waiver may be obtained in certain circumstances.[267] An excise tax is imposed on any deficiency.[268] An excise tax also is imposed on contributions in excess of the amount deductible.[269]

[266] § 412(c)(10). For plan years beginning in 2008, see § 430(j)(1), as amended by P.L. 109-280, § 112(a).

[267] § 412(d). For plan years beginning in 2008, see § 412(c), as amended by P.L. 109-280, § 111(a).

[268] § 4971.

[269] § 4972.

This subject is addressed further in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

10. Prohibited Transactions

Section 4975 forecloses a broad range of transactions between a plan and certain disqualified persons.[270] The transactions prohibited include sale, leasing and exchange of property, loans and other extensions of credit, furnishing goods, services or facilities, and transfer of plan assets or income to or use of the plan's assets or income by or for the benefit of the disqualified person.[271] In addition, disqualified persons who are fiduciaries are prohibited from dealing with the income or assets of a plan for their own account or receiving consideration for their own account from third parties dealing with the plan.[272]

[270] § 4975(e)(2).

[271] § 4975(c).

[272] § 4975(c)(1)(E).

Section 4975 contains exceptions to these broad prohibitions,[273] including an exception for loans to participants under certain circumstances.[274] The Department of Labor has authority to issue additional class and specific exemptions.[275]

[273] § 4975(d).

[274] § 4975(d)(1). The Pension Protection Act of 2006, P.L. 109-280, adds several new prohibited transaction exemptions. For example, effective 2007, fiduciaries of individual account plans can offer investment advice to participants and beneficiaries. § 4975(d)(17), as added by P.L. 109-280, § 601(b)(1). *See generally* § 4975(d)(18) through (23), as added by P.L. 109-280, § § 611 and 612.

[275] Section 4975(c)(2) by its terms gives this authority to the Secretary of the Treasury, after consultation and coordination with the Secretary of Labor. Full responsibility has been given to the Secretary of Labor. Reorganization Plan No. 4 of 1978, § 102(a).

In the absence of a statutory, class, or specific exemption, all disqualified persons who participate in a prohibited transaction (other than fiduciaries acting as such) are jointly and severally liable for an excise tax equal to 15% of the amount involved for each taxable year during which the transaction is in effect for any period of time.[276] If the prohibited transaction involves the use of money or other property, the 15% excise tax accrues on a compound basis;[277] for example, if the prohibited transaction is a loan at market rate, the amount involved for year 1 is the interest for year 1, and the amount involved for year 2 is the interest for year 1 plus the interest for year 2. In addition, an excise tax equal to 100% of the amount involved is imposed if the transaction is not corrected within a certain statutory correction period.[278]

[276] § 4975(a).

[277] Temp. Regs. § 141.4975-13, incorporating Regs. § 53.4941(e)-1. *See* Rev. Ruls. 2002-43, 2002-2 C.B. 85, and 2006-38, 2006-29 I.R.B. 80.

[278] § 4975(b).

Church plans, while not subject to the prohibited transaction rules described in § 4975, are subject to a special set of prohibited transaction rules described in § 503.[279]

[279] See II, A, 18, c, below.

This matter is discussed in detail in 365 T.M., *ERISA —Fiduciary Responsibility and Prohibited Transactions*.

11. Federal Income and Employment Tax Treatment of Employer Contributions

a. Federal Income Tax Treatment

An employer's federal income tax deduction for its contributions to a qualified plan for a taxable year is restricted by quantitative limitations imposed by § 404,[280] the generally applicable standards for reasonable compensation under § 162,[281] the maximum funding limitation imposed by § 412,[282] and the § 415 limitations on annual additions and benefits.[283]

[280] For pension plans and employee annuities, these quantitative limitations are set forth in § 404(a)(1);for profit-sharing plans, they are set forth in § 404(a)(3). For plan years beginning in 2008, see § 404(o) for the deduction limits for single-employer defined benefit plans, and § 404(a)(1)(D) for the deduction limits for multiemployer plans. § 404(o), as added by the Pension Protection Act of 2006, P.L. 109-280, § 801(a)(2), and § 404(a)(1)(D), as amended by P.L. 109-280, § 802(a).

[281] Section 404(a) permits deduction only if contributions “would otherwise be deductible” under Chapter 1 of the Code.

[282] § 404(a)(1)(A) (last sentence). For plan years beginning in 2008, see § 404(o), which cross-references the maximum funding limitation in § 430, as added by P.L. 109-280, § 112(a).

[283] § 404(j).

The deduction generally is available for the employer's taxable year in which the contribution is made.[284] Any contribution made after the close of the taxable year is treated as made on the last day of the taxable year if the contribution is on account of the taxable year and is made on or before the due date (including extensions) of the employer's federal income tax return for the taxable year.[285]

[284] § 404(a)(1)(A) and (3)(A)(i).

[285] § 404(a)(6). *But see* Rev. Rul. 90-105, 1990-2 C.B. 69, limiting deductibility of contributions to § 401(k) plans to compensation earned before the end of the taxable year.

The quantitative limitation on deductibility of employer contributions under § 404 varies with the type of plan. Generally, the limitation on deductions imposed by § 404 for contributions for a taxable year to a defined benefit or money purchase pension plan is governed by the plan's funding standards.[286] Excess contributions for one taxable year may be carried over to succeeding taxable years in order of time, so long as the carryover contributions and current contributions for the succeeding taxable year do not exceed the maximum limitation on deductible contributions for the succeeding taxable year.[287] With respect to contributions to profit-sharing plans, an employer may generally deduct up to 25% of the aggregate current compensation paid to eligible participants during the employer's taxable year.[288] If an employer sponsors two or more profit-sharing plans, they are treated as a single plan for purposes of this limitation.[289] Excess contributions for one taxable year may be carried over to succeeding taxable years in order of time, so long as the deduction for current and carryover contributions does not exceed 25% of compensation of participating employees for any succeeding taxable year.[290]

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[286] § 404(a)(1)(A). For plan years beginning in 2008, see § 404(o) for the deduction limits for single-employer defined benefit plans. § 404(a)(1)(A), as amended by P.L. 109-280, § 801(a)(1).

[287] § 404(a)(1)(E).

[288] § 404(a)(3)(A)(i); *see* Regs. § 1.404(a)-9(b). Except to the extent provided in the regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules. § 404(a)(3)(A)(v). The definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under § 415. § 404(a)(12).

[289] § 404(a)(3)(A)(iv).

[290] § 404(a)(3)(A)(ii).

If any employees participate in both defined benefit and defined contribution plans sponsored by the same employer, the employer may not deduct more than 25% of their current compensation for the taxable year with respect to their contributions and benefits, or, if greater, the amount required to satisfy the minimum funding requirement under § 412 with respect to any defined benefit plan for the plan years ending with or within the employer's taxable year.[291]

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[291] § 404(a)(7)(A). For plan years beginning in 2008, in the case of a single-employer defined benefit plan, the amount necessary to satisfy the minimum funding standard in § 412 cannot be less than the plan's funding shortfall determined under § 430. § 401(a)(7)(A), as amended by P.L. 109-280, § 801(c)(3)(A). For a discussion of the consequences of making contributions to the plan in excess of this limit, see II, A, 12, below.

In determining the limitations on deductible employer contributions imposed by § 404, employees' compensation in excess of $200,000 for years beginning after 2001 is disregarded.[292]

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[292] § 404(l), as amended by EGTRRA § 611(c). The statutory dollar amount limit was previously $150,000, as adjusted for inflation. For the current or previous dollar amount, see the Table in the Worksheets of 371 T.M., *Employee Plans —Deductions, Contributions and Funding*.

If a tax-exempt organization has no taxable income, the tax deductions for qualified plan contributions are not important. However, there are some circumstances under which deductibility of qualified plan contributions may be of concern to tax-exempt organizations.

A tax-exempt organization that must recognize income from an unrelated trade or business is entitled to deductions for expenditures proximately and primarily connected with production of the income of the unrelated trade or business.[293] Therefore, it may deduct contributions to a qualified plan from unrelated business taxable income if the contributions are attributable to the conduct of the unrelated trade or business.

[293] Regs. § 1.512(a)-1(b).

However, if an organization that is exempt from tax for one year loses its exemption for a subsequent year, its qualified plan contributions which would be deductible for the exempt year but for the exemption cannot be carried over for deduction in the subsequent year, because the income of the organization was not subject to tax when the expense was incurred.[294]

[294] Rev. Rul. 63-102, 1963-1 C.B. 96.

If a tax-exempt organization is part of a controlled group of employers that includes any taxable organizations,[295] the taxable organizations may deduct qualified plan contributions from their taxable income.

[295] *See* § 414.

This matter is analyzed in detail in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

b. Federal Employment Tax Treatment

Elective salary deferral contributions to qualified plans are subject to FICA and FUTA taxes for the year of contribution.[296] Otherwise, an employer's qualified plan contributions are not subject to FICA or FUTA taxes.[297]

[296] § § 3121(v)(1)(A), 3306(r)(1)(A).

[297] § § 3121(a)(5)(A), 3306(b)(5)(A).

12. Excise Taxes on Employer

Generally, § 4980 imposes a minimum excise tax equal to 20% of the amount that reverts to an employer on termination of a qualified defined benefit pension plan with assets in excess of liabilities to plan participants. There is an additional excise tax equal to 30% of the reversion amount, unless the employer establishes or maintains a qualified replacement plan or the terminated plan provides certain minimum benefit increases. The excise taxes imposed by § 4980 do not apply if the employer maintaining the plan was exempt from income tax at all times.[298] As discussed more fully below, to the extent that the employer has been subject to tax on unrelated business income or has otherwise derived a tax benefit from the qualified plan, the exception does not apply.[299]

[298] § 4980(c)(1)(A).

[299] Conf. Rep. No. 841, 99th Cong., 2d Sess. (hereinafter "Statement of the Managers, Tax Reform Bill of 1986") at 483, reprinted at 1986-3 C.B. (Vol. 4) 483.

To discourage employers from using their tax-qualified plans as repositories for tax-leveraged savings, § 4972 imposes an excise tax on an employer equal to 10% of its nondeductible contributions to any plans governed by § § 401(a) and 403(a) and simplified employee pension plans described in § 408(k).[300] Generally, amounts contributed to a qualified plan by the employer in excess of the amount allowable as a deduction for the current and prior taxable years are subject to the tax.[301] Tax-exempt organizations generally have no incentive to make qualified plan contributions solely to receive the benefit of tax-free growth, because they can hold assets for investment outright, without incurring federal income tax on any income or gain derived from the assets.[302] Therefore, a plan maintained by an employer that has at all times been a tax-exempt organization is excluded from the definition of qualified employer plan for this purpose.[303] According to the legislative history, this exclusion does not apply to the extent that the employer has been subject to unrelated business income tax (UBIT) or has otherwise derived a tax benefit from the qualified plan.[304]

[300] § 4972(b), (d).

[301] § 4972(c).

[302] S. Rep. No. 445, 100th Cong. 2d Sess. at 188, reprinted at 1998 U.S.C.C.A.N. at 4704.

[303] § 4972(d)(1)(B). *See* FSA 200020009 (exempt organization not liable for § 4972 excise tax even though it was liable for proxy tax under § 6033(e)(2)).

[304] S. Rep. No. 445, 100th Cong. 2d Sess. at 188, reprinted at 1998 U.S.C.C.A.N. at 4704.

The participation of for-profit subsidiary employees in the qualified plan subjects any contributions in excess of the § 404 limits to the excise tax, regardless of whether any deduction was claimed on the contribution.[305] The for-profit subsidiary does not have to be an adopting employer under the plan; the mere participation of the employees of the for-profit subsidiary is sufficient to trigger application of the excise tax. There is no allocation of the contribution between the for-profit subsidiary and the tax-exempt parent; the excise tax applies to any portion of the contribution that exceeds the deductible limits. The fact that the for-profit subsidiary may be an extremely small portion of the controlled group also is disregarded.[306]

[305] PLR 9236026.

[306] TAM 9616003. Apparently, this has not always been the IRS's position. In PLR 9304033, the IRS ruled that the excise tax could be calculated by prorating the deduction between the taxable subsidiary and the tax-exempt organization.

The payment of any amount of UBIT also potentially subjects the plan to the excise tax, for the year the UBIT is paid and any following year.[307] Whether a deduction against the UBIT was taken for the plan contribution is disregarded, as is the relative size of the unrelated business income subject to tax compared to the total revenue of the tax-exempt employer.

[307] PLR 9622037.

The presence of UBIT at any point in time in the organization's history, or the participation of any employees of a for-profit subsidiary in the plan, eliminate the exception for all future years.[308]

[308] *See* PLR 9304033.

The legislative history indicates that the excise tax exemption does not apply to the extent the employer has been subject to UBIT or has otherwise derived a tax benefit from the qualified plan.[309] The IRS apparently ignores the “to the extent” phrase, and disregards whether a tax benefit has been derived from the contribution. While it can be argued that the employer is deriving a tax benefit from the plan merely by funding a benefit that the employees are not taxed on until receipt, this is true for all tax-exempt employers, whether or not they have UBIT, and the legislative history supports the view that a tax benefit must directly be derived from the contribution for application of the excise tax.

[309] S. Rep. No. 445, 100th Cong. 2d Sess. at 188, reprinted at 1998 U.S.C.C.A.N. at 4704.

In PLR 200334043, the employer (M), a § 501(c)(7) tax-exempt organization that maintained a defined benefit plan, had been subject to UBIT on income from nonmember use of club facilities and investment income but had never received a tax benefit from its pension contributions to the plan due to its tax-exempt status. M planned to terminate the plan without establishing a replacement plan, which would result in a substantial reversion of excess plan assets under § 4980(c)(2)(A). M sought rulings that (1) the § 4980 excise tax would not be imposed, and (2) the reversion would not be included in its unrelated business income. The IRS ruled that M was subject to the 50% reversion excise tax under § 4980(d)(1) because its payment of UBIT meant that it was subject to tax under Subtitle A of the Code, thus, failing to satisfy § 4980(c)(1)(A). However, the IRS also ruled that M did not have to include the reversion in its unrelated business taxable income. The IRS resolved the second issue by analyzing whether the reversion (or any part thereof) was income as defined in § 61, as modified by the tax benefit rule of § 111, and concluded that M never received a tax benefit from plan contributions because it was tax-exempt.

To encourage employers to be diligent in enforcing the special nondiscrimination tests imposed by § 401(k) and (m), § 4979 imposes a 10% excise tax on the employer with respect to contributions in excess of the limitation imposed by the nondiscrimination rules unless the excess amount and any income thereon are distributed to the affected participants within $2^1/_2$ months after the close of the plan year for which the excess contributions were made.

Section 4971 imposes excise taxes on failure to meet the minimum funding standards of § 412. The initial excise tax for a single-employer plan is 10% of the plan's accumulated funding deficiency as of the end of the plan year ending with or within the employer's taxable year;[310] a 100% excise tax is imposed on failure to correct the minimum funding deficiency by the earlier of the date of mailing of the notice of deficiency with respect to the initial tax or the date the initial tax is assessed.[311] This tax is imposed on all controlled group members unless the plan is a multiemployer plan.[312]

[310] § 4971(a). For plan years beginning in 2008, see § 4971(a)(1), as amended by P.L. 109-280, § 114(e)(1).

[311] § 4971(b). For plan years beginning in 2008, see § 4971(b)(2), as amended by P.L. 109-280, § 114(e)(1).

[312] § 4971(e)(2).

13. Pension Liability Overstatement Penalty

Section 6662(a) provides for a 20% penalty on an employer in case of underpayment of income tax attributable to a substantial overstatement of pension liabilities.[313] A substantial overstatement of pension liabilities exists if the actuarial determination of the liabilities taken into account for purposes of computing the amount of the deduction under § 404(a)(1) or (2) is 200% or more of the amount determined to be the correct amount of the liabilities.[314] The penalty is increased to 40% of the underpayment if the stated pension liabilities are 400% or more of the correct amount.[315] No penalty is imposed if the portion of the underpayment attributable to the overstatement is $1,000 or less.[316] No penalty is imposed if there is reasonable cause for the overstatement and the taxpayer acted in good faith.[317]

[313] § 6662(b)(4). See 634 T.M., *Civil Tax Penalties*.

[314] § 6662(f)(1). Note that for plan years beginning in 2008, the deduction limit for single-employer defined benefit plans is in § 404(o). § 404(a)(1)(A), as amended by P.L. 109-280, § 801(a)(1).

[315] § 6662(h).

[316] § 6662(f)(2).

[317] § 6664(c)(1).

To avoid or reduce the amount of the understatement penalty, a taxpayer must disclose the relevant facts on the return or a statement attached to the return, and have a reasonable basis for the claimed tax treatment.[318] Similarly, a taxpayer can avoid the penalty that applies to disregarding rules or regulations by adequately disclosing a return position only if the position has at least a reasonable basis.

[318] Revenue Reconciliation Act of 1993, P.L. 103-66, § 13251.

14. Federal Income and Employment Tax Treatment of Distributions

a. Federal Income Tax Treatment

This matter is analyzed in detail in 370 T.M., *Qualified Plans — Taxation of Distributions*.

(1) Lump-Sum Distributions

For taxable years beginning on or before December 31, 1999, recipients of qualifying lump-sum distributions from qualified plans were entitled to favorable federal income tax treatment.[319] For taxable years after 1999, there is no favorable tax treatment for lump-sum distributions.[320]

[319] *See generally* former § 402(d) (former § 402(e) for distributions before 1993).

[320] P.L. 104-188, § 1401, repealed five-year averaging for lump-sum distributions from qualified plans effective for taxable years beginning after Dec. 31, 1999.

(2) Eligible Rollover Distributions

If part or all of a distribution is rolled over in accordance with § 402(c), the amount rolled over is not subject to federal income tax for the year of distribution. Any part of an eligible rollover distribution can be rolled over tax free to an eligible retirement plan. If the participant does not elect a direct rollover, mandatory 20% income tax withholding is imposed on the eligible rollover distribution, though the participant can avoid taxation by rolling over the full amount of the eligible rollover distribution within 60 days.

For distributions after 2001, eligible rollover distributions from qualified retirement plans, § 403(b) annuities and governmental § 457 plans generally may be rolled over to any of such plans or arrangements, but all such plans are not required to accept rollovers.[321] Under § 402(c)(2), employee after-tax contributions may be rolled over into a qualified defined contribution plan or a traditional IRA.[322] However, a qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon).[323] After-tax contributions (including nondeductible contributions to an IRA) are not permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or § 457 plan. In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution must be attributed first to amounts other than after-tax contributions.[324]

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[321] P.L. 107-16, § 641, adding or amending Code § § 457(e)(16), 402(c) and (f), and 403(b). Rollover distributions from a designated Roth § 401(k) or § 403(b) account only can be rolled over to another designated Roth § 401(k) or § 403(b) account or to a Roth IRA. § 402A(c)(3), effective for tax years beginning after Dec. 31, 2005. For distributions made after Dec. 31, 2007, direct rollovers may be made from qualified retirement plans, § 403(b) annuities and governmental § 457 plans to a Roth IRA subject to the rollover limitations that apply to rollovers from a traditional IRA to a Roth IRA. § 408A(e), as amended by the Pension Protection Act of 2006, P.L. 109-280, § 824(a). See the rollover chart in the Worksheets in 370 T.M., *Qualified Plans—Taxation of Distributions*.

[322] The 2002 Job Creation and Worker Assistance Act, P.L. 107-147, § 411(q), further amended § 402(c)(2) to provide that if a distribution includes pre- and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pre-tax amounts, effective for distributions after 2001. For tax years beginning after Dec. 31, 2006, after-tax contributions can be rolled over from a qualified retirement plan to another qualified retirement plan or to a § 403(b) annuity provided the rollover is a direct rollover and the plan that accepts the rollover separately accounts for after-tax contributions (and earnings thereon). § 402(c)(2)(A), as amended by P.L 109-280, § 822.

[323] § 401(a)(31)(C).

[324] § 408(d)(3)(H), added by P.L. 107-16, § 643(c).

An eligible rollover distribution is any distribution to a participant of all or any portion of the balance to the employee's credit in a qualified plan,[325] with the following exceptions:

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[325] § 402(c)(4).

• a distribution that is one of a series of substantially equal periodic payments made over the life of the employee or joint lives of the employee and the employee's designated beneficiary, or periodic payments made for a specified period of 10 years or more;[326]

•a required distribution from a qualified plan under § 401(a)(9);[327] or

•effective for distributions after 2001, any distribution made upon hardship of the employee.[328]

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[326] § 402(c)(4)(A).

[327] § 402(c)(4)(B).

[328] § 402(c)(4)(C), as amended by P.L. 107-16, § 636(b)(1). A distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed

period of years)could be treated as made upon hardship of the employee if the plan treats it that way. P.L. 107-16, § 636(b);H.R. Conf. Rep. No. 84, 107th Cong., 1st Sess. 149-50 (2001).

Prior to amendment by P.L. 107-16, former § 402(c)(4)(C) provided that effective for plan years beginning after 1998, hardship distributions of elective deferrals under § 401(k)(2)(B)(i)(IV) were not eligible rollover distributions. Notice 99-5, 1999-3 I.R.B. 10, modified by Notice 2000-32, 2000-26 I.R.B. 1274, provided guidance with respect to hardship distributions made during 1999 through 2001. Notice 99-5 provided that a plan sponsor could elect to treat a distribution made before Jan. 1, 2000, as an eligible rollover distribution within the meaning of former § 402(c)(4) for all purposes to the extent that the distribution would have been an eligible rollover distribution under the definition of eligible rollover distribution under former § 402(c)(4)immediately before its amendment by the 1998 IRS Restructuring and Reform Act. Notice 99-5 further provided that for distributions after Dec. 31, 1999: (1) the portion of a distribution from a qualified plan that is ineligible for rollover treatment because it is a hardship distribution described in § 401(k)(2)(B)(i)(IV) is the amount described in former Regs. § 1.401(k)-1(d)(2)(ii); (2)if another event occurs, such as the employee's attainment of age $59^1/_2$, so that distribution of an amount is permitted without regard to hardship, no amount distributed after that event is ineligible for rollover treatment on account of being a hardship distribution;and (3) if a portion of a distribution that includes a hardship distribution is not includible in gross income, that portion is first allocated to the hardship distribution and then any remaining portion not includible in gross income is allocated to the portion of the distribution that is not a hardship distribution. Notice 2000-32 provided that if a plan's records were not reasonably available to determine whether a portion of a distribution was an amount described in former Regs. § 1.401(k)-1(d)(2)(ii), then those amounts were to be treated as a hardship distribution and therefore ineligible for rollover.

A surviving spouse may rollover an eligible rollover distribution into a qualified plan, a § 403(a) qualified annuity, a governmental § 457 plan, a § 403(b) annuity, or an IRA.[329] Such a distribution rolled over by the surviving spouse is not eligible for capital gains or special averaging treatment.[330] Also, pursuant to a qualified domestic relations order, an alternate payee who is a spouse or former spouse of a participant is treated as the distributee (and, thus, subject to tax as if he or she were the participant receiving a plan distribution) of any distribution received under the order,[331] and also is eligible to roll over the distribution under the same rules. Distributions to other alternate payees, such as children of the participant, are taxable to the participant and cannot be rolled over.

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[329] § 402(c)(9), as amended by P.L. 107-16, § 641(d), effective for distributions after Dec. 31, 2001. Prior to 2002, the surviving spouse could only roll over such a distribution to an IRA. Distributions after Dec. 31, 2006, from an eligible retirement plan received by a nonspouse beneficiary may be directly rolled over to an IRA. The IRA is treated as an inherited IRA of the nonspouse beneficiary. § 402(c)(11), as added by P.L. 109-280, § 829(a)(1). An eligible retirement plan includes a qualified retirement plan, a governmental § 457 plan, or a § 403(a) or (b) annuity. § § 402(c)(11), 403(a)(4)(B), as amended by P.L. 109-280, § 829(a)(2); § § 403(b)(8)(B), 457(e)(16)(B), as amended by P.L. 109-280, § 829(a)(3) and (4), respectively. *See* Notice 2007-7, 2007-5 I.R.B. 395, § V, Q& As-11 through -19.

[330] P.L. 107-16, § 641(f)(3).

[331] § 402(e)(1)(A).

A qualified plan that accepts rollover contributions from other plans will not be disqualified because the plan making the distribution is, in fact, not qualified at the time of the distribution if, prior to accepting the rollover, the receiving plan reasonably concludes that the distributing plan was qualified.[332] That conclusion can be made if, for example, the distributing plan provides a statement that the distributing plan has a favorable determination letter issued by the IRS. The receiving plan is not required to verify this information.[333]

[332] TRA 1997 § 1509.

[333] Statement of Managers for Taxpayer Relief Act of 1997, H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. (1997).

(3) Annuity or Installment Distributions

Other distributions from qualified plans are subject to the provisions of § 72.[334] In general, the rules relating to taxation of distributions under annuity contracts apply, including proration relating to recognition of tax-free return of capital derived from after-tax employee contributions and taxable income derived from employer contributions and investment yield.[335]

[334] § 402(a). Special rules apply to net unrealized appreciation in employer securities attributable to employee contributions.

[335] § 72(e)(5)(D) and (e)(8).

However, the sum of all of an employee's after-tax employee contributions under a plan that provided for in-service withdrawal of employee contributions on May 5, 1986, as of the last day of the last plan year beginning before January 1, 1987, may be treated as held under a separate contract from all employer contributions and all earnings accrued on behalf of the participant and all employee contributions after the end of that plan year.[336] Amounts held under the contract consisting solely of the after-tax employee contributions through the end of the last plan year beginning before January 1, 1987, may be deemed distributed first and, therefore, may be distributed without recognition of taxable income.[337]

[336] § 72(e)(8)(D). *But see* PLR 9310035 where in-service distributions of accumulated employee after-tax contributions received before annuity starting date from plan that was not maintained by a state, were taxable under § 72(e)(8)(A) and (e)(2)(B), not § 72(e)(8)(D). In addition, at the time taxpayer transferred to a different benefit structure within the plan, the plan did not allow participants to transfer or elect to receive distributions of their accumulated employee contributions.

[337] Notice 87-13, 1987-1 C.B. 432, Q& A-13. In PLR 200115040, a state amended a § 414(d) defined benefit plan to provide a partial lump-sum distribution (PLSD) that permitted a participant who was eligible to retire and receive an unreduced service retirement annuity to elect an optional retirement annuity together with a PLSD. The amount of the PLSD could not exceed an undisclosed number of months of a standard service retirement annuity computed without regard to the PLSD option, and the service retirement annuity was actuarially reduced to reflect the PLSD. Participants who retired after a certain date could elect the PLSD, which was paid to a participant with the first annuity payment. Because the plan permitted a withdrawal option on May 5, 1986, and because the PLSD was received within the window of eligibility specified in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), P.L. 100-647, § 1011A(b)(11), it met the criteria for special tax treatment accorded to participants in a plan maintained by a state government. Thus, the IRS ruled that a participant who elected to receive a PLSD from the plan in exchange for a reduced retirement annuity, and who received the PLSD before or with the first annuity payment, will be taxed on the PLSD only to the extent that the distribution exceeds the investment in the

contract as of Dec. 31, 1986, in accordance with § 72(e)(8)(D), as modified by TAMRA § 1122(h)(9) and Code § 72(e)(5)(A). The IRS further ruled that to the extent that the PLSD exceeds the investment in the contract as of Dec. 31, 1986, the excess is taxable to the annuitant in the plan on a pro rata basis as provided by § 72(e)(8)(A) and (e)(2)(B). *See* PLRs 20040053 and 20040056.

For distributions with annuity starting dates after November 18, 1996, the rules governing recovery of basis have changed.[338] The portion of each annuity distribution that represents a return of basis is calculated by dividing the employee's total basis as of the annuity starting date by the number of anticipated payments specified in the table below.

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[338] § 72(d)(1)(B), as amended by the Small Business Job Protection Act (SBJPA), P.L. 104-188, § 1403(a).

Age of primary annuitant at starting date	Number of anticipated payments
Not more than 55	360
More than 55 but not more than 60	310
More than 60 but not more than 65	260
More than 65 but not more than 70	210
More than 70	160

For distributions based on more than one life with annuity starting dates beginning after 1997, a different basis recovery table is used.[339] The portion of each annuity distribution that represents a return of basis is calculated by dividing the employee's total basis as of the annuity starting date by the number of anticipated payments specified in the table below.

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[339] § 72(d)(1)(B), as amended by the Taxpayer Relief Act of 1997 (TRA 1997), P.L. 105-34, § 1075(a).

Combined ages of annuitants	Number of anticipated payments
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210

b. Federal Employment Tax Treatment

There are no FICA or FUTA tax obligations with respect to distributions from qualified plans.[340]

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[340] § § 3121(a)(5)(A), 3306(b)(5)(A).

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c. Excise Taxes on Distributions

Distributions before age 59$^1/_2$ are subject to a 10% excise tax unless they are rolled over or they meet specific standards for exception set forth in § 72(t). These exceptions include distribution after the employee's death,[341] distribution on account of the employee's permanent and total disability,[342] substantially equal annual or more frequent payments commencing after separation from service from a qualified plan over a period measured by the lives or life expectancies of the employee or the employee and his beneficiary (unless substantially modified before age 59$^1/_2$ or within five years of the first payment other than by reason of disability or death),[343] distributions after separation and after age 55,[344] distributions to alternate payees under QDROs,[345] distributions for medical expenses deductible under § 213,[346] IRA distributions to unemployed individuals for health insurance premiums,[347] timely refunds of excess contributions for purposes of satisfying the limitations imposed by § § 401(k), 401(m) and 402(g),[348] and amounts taxable to the employee representing the cost of current life insurance protection.[349]

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[341] § 72(t)(2)(A)(ii).

[342] § 72(t)(2)(A)(iii).

[343] § 72(t)(2)(A)(iv), (3)(B) and (4).

[344] § 72(t)(2)(A)(v).

[345] § 72(t)(2)(C).

[346] § 72(t)(2)(B).

[347] § 72(t)(2)(D).

[348] § § 401(k)(8)(D), 401(m)(7)(A), 402(g)(2)(C).

[349] Notice 89-25, 1989-1 C.B. 662, Q& A-11.

Beginning after September 11, 2001, the 10% excise tax also does not apply to distributions made to a reservist (called up between September 11, 2001, and before December 31, 2007, for more than 179 days), before age 59 $^1/_2$.[350] Nor does the 10% excise tax apply to distributions from a § 414(d) governmental defined pension plan to a qualified public safety employee who separates from service after age 50.[351]

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[350] § 72(t)(2)(G), as added by P.L. 109-280, § 827(a).

[351] § 72(t)(10)(A), as added by P.L. 109-280, § 828, effective for distributions after Aug. 17, 2006. A qualified public safety employee is an employee of a state or political subdivision of a state if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such state or political subdivision. § 72(t)(10)(B). *See* Notice 2007-7, 2007-5 I.R.B. 395, § IV, Q& As-6 through -10.

Distributions made after December 31, 1999, on account of a levy under § 6331 on a qualified retirement plan are exempted from the 10% excise tax.[352]

[352] § 72(t)(2)(A)(viii).

The excise tax on excess distributions is repealed for distributions received after 1996,[353] and the additional estate tax on excess accumulations is repealed for the estates of decedents dying after 1996.[354] Prior to those dates, a 15% excise tax applied to annuity distributions from qualified plans exceeding $112,500, on lump-sum distributions on the value of decedent's qualified plan interests exceeding $562,500 (both amounts indexed for inflation).[355]

[353] TRA 1997 § 1073(a) and (c)(1).

[354] TRA 1997 § 1073(a) and (c)(2).

[355] § 4980A. See II, B, 14, g, below.

d. Excise Tax on Failure to Receive Minimum Required Distribution

Section 4974 imposes an excise tax on the payee if the amount distributed during the year from a qualified retirement plan is less than the required minimum distribution under § 401(a)(9). The tax is equal to 50% of the difference between the minimum required distribution and the amount actually distributed. Under § 4974(d), the tax may be waived if the taxpayer establishes that the shortfall was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.[356]

[356] See discussion on minimum distribution requirements in II, A, 8, b, above.

15. ERISA

Employee retirement plans generally are subject to ERISA, whether or not they are designed to satisfy the requirements for favorable federal income tax treatment set forth in § 401(a).[357]

[357] ERISA § 3(2).

ERISA imposes requirements that substantially are identical to those imposed on qualified plans respecting age and service,[358] vesting,[359] benefit accrual,[360] spendthrift,[361] spousal rights relating to joint and survivor annuities and preretirement survivor annuities,[362] mergers, consolidations and transfers of assets,[363] mandatory distributions,[364] controlled groups of employers,[365] funding[366] and prohibited transactions.[367] However, ERISA does not impose any requirement comparable to the restrictions on tax-qualified cash or deferred arrangements,[368] nondiscrimination rules regarding benefits and contributions,[369] the minimum coverage rules,[370] the minimum distribution rules,[371] the top-heavy rules,[372] the § 415 limitations,[373] the minimum participation requirements,[374] or the aggregation rules respecting affiliated service groups and leased employees,[375] except with respect to affiliated service group members'liability for funding single-employer plans.[376]

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[358] Code § 410(a); ERISA § 202.

[359] Code § 411(a); ERISA § 203.

[360] Code § 411(b) through (d); ERISA § 204.

[361] Code § 401(a)(13); ERISA § 206(d).

[362] Code § § 401(a)(11) and 417; ERISA § 205.

[363] Code § 401(a)(12); ERISA § 208.

[364] Code § 401(a)(14); ERISA § 206(a).

[365] Code § 414(a), (b) and (c); ERISA § 210.

[366] Code § 412; ERISA § § 302 through 308. For plan years beginning in 2008, see the funding rules in Code § § 412, 430 and 431, as amended by P.L. 109-280, § § 111(a), 112(a), and 211(a), respectively, and in ERISA § § 302 through 305, as amended by the Pension Protection Act of 2006 (2006 PPA), P.L. 109-280, § § 101(a)and (b), 102(a), 201(a) and § 202(a), respectively.

[367] Code § 4975; ERISA § § 406 through 408.

[368] Code § 401(a)(4) and (k).

[369] Code § 401(a)(4).

[370] Code § 410(b).

[371] Code § 401(a)(9).

[372] Code § 416.

[373] Code § 415.

[374] Code § 401(a)(26).

[375] Code § 414(m) and (n).

[376] ERISA § 302(c)(11). For plan years beginning in 2008, see ERISA § 302(b).

ERISA imposes independent requirements relating to reporting and disclosure,[377] fiduciary conduct,[378] and, for defined benefit pension plans, plan termination insurance.[379]

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[377] ERISA § § 102, 103 and 104.

[378] ERISA § § 404, 405 and 409.

[379] ERISA § § 4021 through 4071.

The plan termination insurance requirements are set forth in Title IV of ERISA. This matter is addressed in detail in 357 T.M., *Pension Plan Terminations — Single-Employer Plans*.

The Pension Benefit Guaranty Corporation (PBGC)guarantees payment of certain minimum benefits provided for in defined benefit plans governed by Title IV. Plans subject to Title IV are required to pay annual premiums to the PBGC for this protection. The PBGC premium consists of two elements: a flat premium based solely on the number of participants;[380] and a variable premium based in part on the number of participants and in part on the extent to which the plan is underfunded.[381]

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[380] ERISA § 4006(a)(3)(A). The flat rate premium amount is increased to $30 from $19, effective for plan years beginning in 2006 and later. ERISA § 4006(a)(3)(A)(i), as amended by the Deficit Reduction Act of 2005 (DRA 2005), P.L. 109-171, § 8101(d)(1). The premium amount will be adjusted for inflation for each plan year beginning in a calendar year after 2006. ERISA § 4006(a)(3)(F), as added by DRA 2005 § 8101(a)(1)(B).

[381] ERISA § 4006(a)(3)(E)(i),(ii), (iii) and (iv)(I). The variable rate portion is equal to $9 per $1,000 of unfunded vested benefits. ERISA § 4006(a)(3)(E)(ii). For plan years beginning in 2008, unfunded vested benefits are determined under ERISA § 4006(a)(3)(E)(iii) and (iv), as amended by P.L. 109-280, § 401(a)(1), and ERISA § 4006(a)(3)(E)(iv)(I), as repealed by P.L. 109-280, § 401(a)(1). For plan years beginning after Dec. 31, 2006, for plans with 25 or fewer employees on the first day of the plan year, the variable rate premium for each participant is limited to no more than $5 multiplied by the number of plan participants in the plan at the end of the preceding tax year. ERISA § 4006(a)(3)(H), as added by P.L. 109-280, § 405.

A bankruptcy premium applies to single-employer plans that terminate after December 31, 2005, in bankruptcy or insolvency proceedings under ERISA § 4041(c)(2)(B)(ii) or (iii), or ERISA § 4042.[382] The per participant premium in the plan just before a termination is $1,250, in addition to other premiums, and is payable annually for each of the three years following the plan's termination date, or, if later, the employer's exit from bankruptcy. Plans terminated in a bankruptcy reorganization are exempt from the premium until the plan sponsor emerges from bankruptcy.[383]

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[382] ERISA § 4006(a)(7), as added by DRA 2995 § 8101(b), generally applicable to plans terminated after Dec. 31, 2005, but not to plans terminated in a bankruptcy reorganization if the proceeding was filed before Oct. 18, 2005. DRA 2005 § 8101(d)(2)(A) and (B). The premium provision in ERISA § 4007(a)(7) would have expired at the end of 2010, but ERISA § 4007(a)(7)(E) was repealed by P.L. 109-280, § 401(b)(1), effective for plans terminated after Dec. 31, 2005. P.L. 109-280, § 401(b)(2)(B).

[383] ERISA § 4006(a)(7)(B). In applying the termination premium in ERISA § 4006(a)(7)(A) to a bankrupt commercial passenger airline that chooses the alternative funding schedule in 2006 PPA § 402(a)(1), the

premium is $2,500 instead of $1,250 if the plan terminates during the 5-year period beginning on the first applicable plan year with respect to the plan. ERISA § 4006(a)(7)(A) is applied without regard to the grandfather rule in DRA 2005, § 8101(d)(2)(B). Thus, the increased termination premium applies even to plans terminated during bankruptcy proceedings before Oct. 18, 2005. P.L. 109-280, § 402(g)(2)(B).

In addition to the obligation to pay premiums on an ongoing basis, the employer under an underfunded terminated single-employer plan has an obligation (and members of the controlled group that includes the employer have a joint and several obligation)to pay the PBGC the amount of all unfunded benefit liabilities under the plan at the time of termination, plus interest.[384] Payment is to be made on commercially reasonable terms prescribed by the PBGC, which must include a provision for deferral of 50% of any liability otherwise payable for a year if no person subject to the liability has individual pre-tax profits for the person's fiscal year ending during the year. For this purpose, a tax-exempt organization's pre-tax profits consist of the excess of income over expenses, determined under generally accepted accounting principles, before provision for or deduction of federal or other income tax, any contributions to any single-employer plan at any time between the termination date and the end of the affected fiscal year and any amounts payable on account of the plan termination for the affected fiscal year.[385]

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[384] ERISA § 4062.

[385] ERISA § 4062(b)(2) and (d)(2).

ERISA also preempts state laws that relate to employee benefit plans other than state laws regulating insurance, banking and securities,[386] and gives the federal district courts jurisdiction over civil actions brought under Title I of ERISA, without regard to the amount in controversy or diversity of citizenship. State courts have concurrent jurisdiction over claims for benefits under a plan; otherwise, the federal courts' jurisdiction is exclusive.[387]

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[386] ERISA § 514(b)(2)(a) and (b)(2).

[387] ERISA § 502(e).

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16. Obtaining IRS Approval

a. In General

The IRS has established formal procedures for reviewing the form and operation of retirement plans designed to comply with § 401(a). This matter is addressed in detail in 360 T.M., *Qualified Plans — IRS Determination Letter Procedures*.

An employer is not required to obtain approval of its plans by the IRS. However, sponsors of individually designed plans generally take part in this process because of the significant potential federal income tax liability to the employer, employees, and the trust in the event of defects in the form or operation of the plan.

b. The Employee Plans Compliance Resolution System

In addition to the determination letter program, the IRS maintains the Employee Plans Compliance Resolution System(EPCRS), a comprehensive system of correction programs for retirement plan sponsors that are intended to satisfy the requirements of § § 401(a), 403(a), or § 403(b) but have not met these requirements for a period of time. EPCRS permits plan sponsors to correct certain failures and thereby continue to provide their employees with retirement benefits on a tax-deferred basis. If the plan sponsor satisfies the EPCRS requirements, the IRS will not pursue plan disqualification.

EPCRS is comprised of three components: the Voluntary Correction Program (VCP); the Self-Correction Program (SCP);and the Audit CAP Program. The eligibility requirements and procedures for these programs are set forth in a revenue procedure.[388]

[388] *See* Rev. Proc. 2006-27, 2006-22 I.R.B. 945.

There are four basic types of types of "qualification failures" that may be corrected under EPCRS: (a) plan Document failures; (b) operational failures; (c) demographic failures; and(d) employer eligibility failures. Plan Document failures concern a plan provision (or absence thereof) that, on its face, violates the requirements of § 401(a) or § 403(a). Operational failures are those that solely arise from failing to follow plan provisions. Demographic failures concern a failure to satisfy the requirements of § 401(a)(4), (a)(26), or § 410(b). Employer eligibility failures address situations where the employer intended to adopt a qualified plan but failed to satisfy the employer eligibility requirements of § 401(a) or § 401(k).[389]

[389] *See generally* Rev. Proc. 2006-27, § 5.01. More specific definitions of § 403(b) failures are provided in § 5.02 of the revenue procedure.

Note: SCP, VCP, and Audit CAP are not available to correct failures relating to the diversion or misuse of plan assets.[390]

[390] *See* Rev. Proc. 2006-27, § 4.12.

VCP allows a plan sponsor to pay a limited fee for IRS approval of a correction made before an audit. VCP includes special procedures that apply to anonymous ("John Doe")submissions and group submissions.[391] SCP generally allows a plan sponsor that has established compliance practices and procedures to correct operational failures without paying a fee or sanction. In addition, significant operational failures of a qualified plan that is the subject of a favorable determination letter or of a § 403(b) plan may be corrected without paying a fee or sanction. The Audit CAP program is used to correct failures (other than those corrected through SCP or VCP) identified on audit. The plan sponsor is permitted to correct the failure and pay a sanction. The sanction imposed is intended to bear a reasonable relationship to the nature, extent and severity of the failure, taking into account the extent to which the correction occurred before audit.[392]

[391] *See* Rev. Proc. 2006-27, § 1.03.

[392] *See* Rev. Proc. 2006-27, § 1.03.

Generally, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all taxable years (whether or not the tax year is closed). If a correction is made for a closed taxable year, the tax liability associated with that year will not be redetermined. In the case of a qualified plan with an operational failure, correction is determined by taking into account the terms of the plan at the time the failure occurred.[393] The specific requirements and procedures for each program are set forth in the revenue procedure.[394]

[393] *See* Rev. Proc. 2006-27, § 6.02.

[394] *See* Rev. Proc. 2006-27, § § 8 and 9 (SCP for insignificant/significant operational failures); § § 10 and 11 (VCP procedures and application process); § 12 (VCP fees);and § § 13 and 14 (Audit CAP requirements and sanction).

Appendices A and B of the revenue procedure set forth various methods and examples for correcting failures. Appendix C of the revenue procedure contains a checklist for ensuring the accuracy and completeness of a VCP submission.

For a further discussion of EPCRS, see 375 T.M., *EPCRS —Plan Correction and Disqualification*.

17. Remedial Amendment Periods

A qualified plan may be amended to correct a disqualifying provision on a retroactive basis during a limited period following the end of the plan year in which it would otherwise have become effective.[395] The end of this remedial amendment period for an individually designed plan maintained by a single employer with respect to a plan year generally is measured by the due date of the employer's federal income tax return for the taxable year in which the plan year begins, including extensions.[396]

[395] § 401(b); Regs. § 1.401(b)-1. *See, e.g.*, T.D. 9319, 72 Fed. Reg. 16878, 16893-94 (4/5/07) (amendments required by § 415 regulations).

[396] Regs. § 1.401(b)-1(c)(2)(i).

For tax-exempt employers that do not have a duty to file federal income tax returns but are required to file annual information returns under § 6033, the remedial period ends on the due date (including extensions) of the employer's annual information return.[397] For employers that are not required to file federal income tax returns or information returns under § 6033, but are required to file annual return reports on their plans under § 6058 (Form 5500), the remedial amendment period ends on the due date (including extensions) of the annual return report filed with respect to the plan.[398]

[397] Rev. Rul. 79-227, 1979-2 C.B. 185, § 3.01.

[398] Rev. Rul. 79-227, § 3.02.

If a tax-exempt trust forming part of a single qualified plan maintains a separate qualified plan for the benefit of employees of the trust, the remedial amendment period with respect to the plan maintained for the benefit of employees of the trust ends on the due date of the annual return report for the plan year of the plan of which the trust is a part, rather than the due date of the annual return report for the plan year of the plan maintained by the trust for its employees.[399]

[399] Rev. Rul. 79-227, § 3.03.

If a tax-exempt organization has no duty to file an annual information return or annual return report with respect to a plan, the remedial amendment period ends on the last day of the seventh month after the end of the plan year.[400]

[400] Notice 89-8, 1989-1 C.B. 628.

The IRS may extend the remedial amendment period and, in certain cases, such as for amending plans to comply with legislative and regulatory developments.

Plan amendments made pursuant to the Pension Protection Act of 2006, P.L. 109-280, or regulations issued thereunder, may be retroactively effective and will not violate the anti-cutback rule in § 411(d)(6), if, in addition to meeting the applicable requirements, the amendment is made on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 for governmental plans).[401]

[401] P.L. 109-280, § 1107. *See, e.g.*, T.D. 9319, 72 Fed. Reg. at 16893-94 (amendments required by § 415 regulations).

For example, in Rev. Proc. 2000-27,[402] the IRS extended the remedial amendment period under § 401(b) for amending plans for GUST [403] legislative provisions, as well as the remedial amendment period with respect to the 1986 Tax Reform Act (TRA '86)[404] for governmental and nonelecting church plans. Generally, all plan provisions that either caused a plan to fail to satisfy the qualification requirements of the Code because of changes to those requirements made by GUST or that were integral to a qualification requirement changed by GUST were disqualifying provisions under Regs. § 1.401(b)-1(b).

[402] 2000-26 I.R.B. 1272, *modified and superseded by* Rev. Proc. 2005-66, 2005-37 I.R.B. 509.

[403] GUST collectively refers to the following legislation: (1) the Uruguay Round Agreements Act (GATT), P.L. 103-465; (2) the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), P.L. 103-353; (3) the Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188; (4) the Taxpayer Relief Act of 1997 (TRA '97), P.L. 105-34; and (5)the Internal Revenue Service Restructuring and Reform Act of 1998(RRA '98), P.L. 105-206.

[404] P.L. 99-514.

The GUST remedial amendment period generally ended on the later of February 28, 2002, or the end of a plan's 2001 plan year, except that certain plans that were eligible for an extended GUST remedial amendment period under Rev. Proc. 2000-20[405] had until September 30, 2003.[406] The GUST remedial amendment period for pre-approved plans was extended to January 31, 2004, only if certain conditions were satisfied.[407]

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[405] 2000-1 I.R.B. 553, *superseded by* Rev. Proc. 2005-16, 2005-10 I.R.B. 674.

[406] Rev. Proc. 2002-55, 2001-49 I.R.B. 552, and Rev. Proc. 2002-73, 2002-49 I.R.B. 932, respectively.

[407] Rev. Proc. 2003-72, 2003-38 I.R.B. 578. Rev. Proc. 2003-72 also extended the time by which defined contribution plans had to be amended to comply with final and temporary regulations under § 401(a)(9), relating to required minimum distributions, until the later of the end of the first plan year beginning on or after Jan. 1, 2003, or the end of the GUST remedial amendment period. The GUST program for defined contribution pre-approved plans closed June 15, 2005. Announcement 2005-36, 2005-10 I.R.B. 674. The IRS will announce at a later date the closing of the GUST program for defined benefit pre-approved plans and for individually designed plans. *Id.*

In Notice 2001-42,[408] the IRS initially announced that the remedial amendment period under § 401(b) for a disqualifying provision enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[409] would not end before the last day of the first plan year beginning on or after January 1, 2005.[410]

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[408] 2001-30 I.R.B. 70, *modified by* Rev. Proc. 2005-66.

[409] P.L. 107-16.

[410] *See* Notice 2001-57, 2001-38 I.R.B. 279, *modifying* Notice 2001-42, which provides sample EGTRRA plan amendments that plans may adopt as a good faith EGTRRA plan amendment.

This period was extended by Rev. Proc. 2005-66,[411] which implemented a system of cyclical remedial amendment periods for individually designed plans, pre-approved plans and volume submitter plans. Under the program, individually designed plans have a five-year cycle for plan amendments and pre-approved and volume submitter plans have a six-year cycle. The EGTRRA remedial amendment period is extended to the end of the initial five- and six-year remedial cycles for qualified plans.[412] The extension only applies to plans that satisfy the conditions for eligibility for the EGTRRA remedial amendment period set forth in Notice 2001-42, which requires the adoption of timely good faith EGTRRA plan amendments or other plan qualification requirements.[413]

[411] 2005-37 I.R.B. 509, *modifying and superseding* Rev. Proc. 2000-27, and *modifying* Notice 2001-42, Rev. Proc. 2005-16, and Announcement 2005-36, *and modified and superseded by* Rev. Proc. 2007-44, 2007-28 I.R.B. __, generally effective June 13, 2007.

[412] Rev. Proc. 2005-66, Part II, § 7, *superseded by* Rev. Proc. 2007-44, Part II, § 7. This extension also applies to retroactive remedial amendments regarding the required minimum distributions rules under Regs. § 1.401(a)(9)-1 (T.D. 9130, 69 Fed. Reg. 33288 (6/15/04); *see* Rev. Proc. 2003-10, 2003-2 I.R.B. 259, *modifying* Rev. Proc. 2002-29, 2002-2 C.B. 1176)); the mortality table in Rev. Rul. 2001-62, 2001-2 C.B. 632; deemed § 125 for existing plans, after Dec. 31, 2001. Defined benefit plans have by the end of the initial five- or six-year remedial amendment cycle set forth in Rev. Proc. 2005-66 to adopt plan amendments for the required minimum distribution rules set forth in Regs. § 1.401(a)(9)-0 through-9 (T.D. 8987, 67 Fed. Reg. 18987 (4/17/02), and T.D. 9130, 69 Fed. Reg. 33288 (6/15/04)). Notice 2005-95, 2005-51 I.R.B. 1172, clarifying Rev. Proc. 2005-66.

[413] Rev. Proc. 2005-66, Part I, § 2.07, *superseded by* Rev. Proc. 2007-44, Part I, § 2.07. Note that this relief does not apply to changes made to § 411(d)(6)(B), (D) and (E) by EGTRRA, § 645. Notice 2001-42, § III. Prior to Rev. Procs. 2005-66 and 2005-16, determination, opinion and advisory letters were not considered for EGTRRA changes, and could not be relied upon with respect to EGTRRA changes. However, an employer's reliance on a favorable determination, opinion or advisory letter did not adversely affect the timely adoption of good faith EGTRRA plan amendments. Also, individually designed plans submitted for GUST determination letters could incorporate EGTRRA changes, but the GUST determination letter did not extend to plan amendments for EGTRRA changes. *See* Notice 2001-42.

For individually designed plans, the end of the EGTRRA remedial amendment period ranges from January 31, 2007, to January 31, 2011, depending on what initial remedial amendment cycle is assigned to the plan.[414] The end of the EGTRRA remedial amendment period for pre-approved defined contribution plans is January 31, 2011, and January 31, 2013, for pre-approved defined benefit plans.[415] 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.[416]

[414] Rev. Proc. 2005-66, Part III, § 12.01, *superseded by* Rev. Proc. 2007-44, Part III, § 12.01. The initial determination letter cycle for individually designed plans opened Feb. 1, 2006, and takes into account EGTRRA requirements. Rev. Proc. 2005-66, Part I, § 1.02.

[415] Rev. Proc. 2005-66, Part IV, § 18.01, *superseded by* Rev. Proc. 2007-44, Part IV, § 18.01. The initial determination letter cycle for defined contribution pre-approved plans began Feb. 17, 2005, which takes into account EGTRRA requirements. Rev. Proc. 2005-16, § 1.02. The first cycle for pre-approved defined benefit plans is expected to begin Feb. 1, 2007. Rev. Proc. 2005-66. The submission deadline for the EGTRRA remedial amendment period was extended from Oct. 31, 2005, to Jan. 31, 2006, for plan sponsors and practitioners of mass submitter and national sponsor plans. Rev. Proc. 2005-66, Part IV, § 18.02(1), *modifying* Announcement 2005-36.

[416] Rev. Proc. 2005-66, Part IV, § 18.03, *superseded by* Rev. Proc. 2007-44, Part IV, § 18.03. Form 6406, *Short Form Application for Determination for Minor Amendment of Employee Benefit Plan*, cannot be used for the EGTRRA remedial amendment cycle determination letter. Individually designed plans must be restated when they are submitted; a working copy of the plan in a restated form is sufficient. Rev. Proc. 2005-66, Part III, § 15.03 and .04, *superseded by* Rev. Proc. 2007-44, Part III, § 12.03 and .04 (specifying that, effective July 9, 2007, the IRS will not accept Form 6406 to apply for a determination letter, adding that copies of timely executed interim and discretionary amendments must be separately submitted with the application, and adding that a plan submitted in proposed form must be adopted no later than 91 days after determination letter's date).

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Rev. Proc. 2007-44[416.1] updated and superseded Rev. Proc. 2005-66, generally effective June 13, 2007. The guidance expands and clarifies the exceptions to the general rule for determining a plan's five-year cycle. A centralized organization that handles the administration and operation of plans that have substantially the same terms and are maintained by separate tax-exempt organizations that are not controlled groups or affiliated service groups may elect to have the cycle determined based on the employer identification number of that organization.[416.2] The initial remedial amendment cycle for a new plan is the applicable cycle that includes the date on which the plan's initial remedial amendment period ends under Regs. § 1.401(b)-1.[416.3] In addition, special deadlines apply for the adoption of interim and discretionary amendments for tax-exempt and governmental employers.[416.4]

[416.1] 2007-28 I.R.B. __.

[416.2] Rev. Proc. 2007-44, Part III, § 10.07.

[416.3] *Id.*, Part II, § 5.03.

[416.4] *Id.*, Part II, § 5.06. Section 5.05 of the guidance provides general amendment adoption deadlines, however, section 5.07 provides that other statutory provisions or guidance may set forth earlier or later deadlines, such as the delayed amendment deadline under P.L. 109-280, § 1107.

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18. Special Rules for Plans of Churches, Societies, Orders, VEBAs, Etc.

a. General Description

Qualified plans maintained by certain types of tax-exempt organizations are exempt from part or all of the requirements of ERISA and the tax laws.[417]

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[417] In addition, a plan that is established and maintained by a labor organization described in § 501(c)(5) and which does not at any time after Sept. 2, 1974, provide for employer contributions, is exempt from the coverage provisions of ERISA, but not from the corresponding provisions of the tax laws. ERISA § 201(a)(4). *See* Morganbesser v. U.S., 984 F.2d 560 (2d Cir. 1993) (multiemployer pension plan qualified as a § 501(c)(5) labor organization even though contributions were made by employers and plan failed to qualify under ERISA). However, the IRS nonacquiesced in *Morganbesser* in AOD 1995-016, 1995-52 I.R.B. 4, and noted that it would continue to litigate the *Morganbesser* issues in all cases except those appealable to the Second Circuit. The IRS also revoked GCM 35862 (6/20/74) (union pension plan may qualify under § 501(c)(5)), relied on heavily by the Second Circuit in *Morganbesser*, but which, according to the IRS, was an incorrect statement of law. *See* GCM 39889 (12/8/95). Finally, the IRS amended the regulatory definition of an exempt labor organization and affirmed its position that union funds and retirement plans, even if created for union members, do not qualify under § 501(c)(5). *See* Regs. § 1.501(c)(5)-1(b)(2). But note that the revised regulatory definition of labor organization includes dues financed pension funds as tax-exempt labor organizations. Since taking these steps, the IRS has been more successful in challenging the treatment of multiemployer pension funds as labor organizations. *See* Stichting Pensioenfonds Voor De Gezonheid v. U.S., 129 F.3d 195 (D.C. Cir. 1997); Tupper v. U.S., 134 F.3d 444, 21 EBC 2509 (1st Cir. 1998) (pension trust established pursuant to collective bargaining agreement and controlled jointly by union and employers did not qualify for exemption as labor organization under § 501(c)(5)).

These exemptions are available to church plans that do not elect to be governed by ERISA[418] and plans exclusively funded by means of employee contributions which are maintained by organizations exempt from federal income tax under § 501(c)(8) and (9).[419]

[418] *See* § § 414(e), § 401(a) (flush language); § § 410(c)(1)(B), 411(e)(1)(B) and 412(h)(4), and ERISA § § 4(b)(2) and 4021(b)(3). For plan years beginning in 2008, § 412(h)(4) is repealed and replaced by § 412(e)(2)(D). P.L. 109-280, § 111(a), amending § 412.

[419] *See* § § 401(a) (flush language), 410(c)(1)(D), 411(e)(1)(D), 412(h)(6); ERISA § § 201(3)(A), 301(a)(4) and 4021(b)(4)(A). For plan years beginning in 2008, § 412(h)(6) is repealed and replaced by § 412(e)(2)(F). P.L. 109-280, § 111(a), amending § 412.

(1) Nonelecting Church Plans

A church plan is a plan established and maintained for its employees (or their beneficiaries) by a church, or convention or association of churches, which is exempt from tax under § 501[420] or by an organization that is controlled by or associated with a church or convention or association of churches, if the controlled or associated organization's principal purpose is to fund or administer the plan or program and the plan is for employees of a church or convention or association of churches.[421] Whether an organization is a church depends on the facts and circumstances.[422] A religious purpose of itself is not sufficient. Bringing people together for worship must be more than an incidental part of the organization's activities. The IRS has adopted standards of varying importance for determining whether an organization is a church, including whether the organization has a distinct legal existence, a recognized creed and form of worship, a definite and distinct ecclesiastical government, a formal code of doctrine or discipline, a distinct religious history, an independent membership, an organization of specially trained and ordained ministers to serve its congregations, a literature, established places of worship, regular congregations, religious services, religious schools and seminaries.[423]

[420] § 414(e)(1).

[421] § 414(e)(3)(A); *see*, Chronister v. Baptist Health, 442 F.3d 648, 37 EBC 1303 (8th Cir. 2006).

[422] Lutheran Social Services of Minn. v. U.S., 758 F.2d 1283 (8th Cir. 1985); De La Salle Institute v. U.S., 195 F. Supp. 891, 903 (N.D. Cal. 1961); Foundation of Human Understanding v. Comr., 88 T.C. 1341, 1356-61 (1987).

[423] Exempt Organization Examination Guidelines, IRM 4.76.7.2.4 (6-1-04).

Generally, a convention or association of churches is a national, regional, state or local group of churches, usually but not necessarily of the same denomination, that engages in cooperative religious activities.[424] A religious order or organization is treated as a church if it is an integral part of a church and is engaged in carrying out church functions, including ministration of sacerdotal functions and conduct of worship pursuant to the tenets and practices of the particular religious body.[425]

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[424] Rev. Rul. 74-224, 1974-1 C.B. 61 (association of churches may consist of representatives of different denominations); PLR 8309092 (group of churches principally carrying on social welfare activities is not association of churches); PLR 8624126.

[425] Regs. § 1.511-2(a)(3)(ii).

An organization is controlled by a church if a majority of its officers or directors are appointed by the church's governing board or by officials of the church.[426] An organization, including a religious order, is associated with a church or convention or association of churches if it shares common religious bonds and convictions with the church.[427] The plan itself may cover employees of a tax-exempt organization controlled by or associated with a church or convention or association of churches, even though there are independent grounds for the employer's tax-exempt status under § 501(c)(3).[428] Employees generally include ministers, regardless of the source of their compensation,[429] employees of a tax-exempt organization controlled by or associated with a church,[430] and employees who have separated from service whose benefits remain undistributed or on whose behalf contributions are made for a period of up to five years after separation.[431]

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[426] § 414(e)(3)(A); Regs. § 1.414(e)-1(d)(2).

[427] § 414(e)(3)(D); Regs. § 1.414(e)-1(d)(2); GCM 39007.

[428] § 414(e)(3)(B), (C) and (D).

[429] § 414(e)(3)(B)(i).

[430] § 414(e)(3)(B)(ii).

[431] § 414(e)(3)(B)(iii).

After 1996, a self-employed minister may participate in a church plan,[432] or establish his or her own retirement income account. A self-employed minister is treated as his or her own employer and as if the employer were a tax-exempt organization under § 501(c)(3). The earned income of the self-employed minister is treated as his or her compensation. In addition, a minister employed by an organization other than a church may participate in a church plan. If a minister is employed by an employer that is not eligible to maintain a church plan, the minister is not taken into account by that employer in applying nondiscrimination rules.[433]

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[432] § 414(e), as amended by SBJPA § 1462.

[433] *Id.*

A plan cannot be a church plan unless substantially all participants are church employees. Therefore, a plan that covers employees of a church and employees of a taxable entity owned by a church could be a church plan, but care should be taken in covering such nonchurch employees.[434]

[434] § 414(e)(2); *see* PLR 199919040 (church plan status is not forfeited as result of inclusion of employees of taxable affiliate contributing 2.86% of total number of plan participants); *see also*, PLRs 9810034, 9441040, 9204034 and 8734045 for further guidance to the extent to which nonchurch employees may be included.

Also, a plan established and maintained primarily for the benefit of employees of an unrelated trade or business maintained by a church cannot be a church plan.[435] Generally, an unrelated trade or business is an activity carried on for the production of income from the sale of goods or performance of services that is not substantially related(aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption.[436] A church employee is employed in connection with an unrelated trade or business if a majority of his or her duties and responsibilities are directly or indirectly related to the conduct of one or more unrelated trades or businesses.[437]

[435] § 414(e)(2)(A).

[436] § 513(a); see 870 T.M., *Tax-Exempt Organizations: Reporting, Disclosure and Other Procedural Aspects*.

[437] Regs. § 1.414(e)-1(b)(3).

To satisfy the standards with respect to a plan established after September 2, 1974, employees of any unrelated trades or businesses eligible to participate in the plan must constitute less than 50% of the total number of employees eligible to participate when it is established.[438] To satisfy the standards with respect to a plan in existence on September 2, 1974, employees of unrelated trades or businesses must have constituted less than 50% of all persons participating at any time during either of its first two plan years ending after September 2, 1974.[439] In addition, if contributions or benefits are based upon compensation, employees of unrelated trades or businesses must have received less than 50% of the total compensation paid by the employer to participants during that plan year.[440]

[438] Regs. § 1.414(e)-1(b)(2)(i)(A).

[439] Regs. § 1.414(e)-1(b)(2)(i)(B) and (ii)(A).

[440] Regs. § 1.414(e)-1(b)(2)(ii)(B).

Whether or not a plan was in existence on September 2, 1974, to remain a church plan on an ongoing basis, employees of unrelated trades or businesses must continue to constitute less than 50% of eligible employees and receive less than 50% of total compensation paid by the employer to participants in four out of five of a plan's most recent plan years.[441]

[441] Regs. § 1.414(e)-1(b)(2)(ii).

In applying any of the foregoing standards, individuals who do not participate because they do not make mandatory contributions are taken into account as eligible to participate.[442]

[442] Regs. § 1.414(e)-1(b)(2)(iv).

If a plan has been in existence for less than five years, it may remain a church plan until the second year in which it fails to meet the requirements for church plans.[443] Disqualification generally occurs with respect to the second plan year for which the plan fails to satisfy one or more of the requirements,[444] but a plan may remain a church plan under special facts and circumstances taking into account the margin of failure and whether there was a reasonable error in characterization of unrelated trades or businesses or the identities of their employees.[445]

[443] Regs. § 1.414(e)-1(b)(2)(ii).

[444] *Id.*

[445] Regs. § 1.414(e)-1(b)(2)(iii).

A plan may correct its failure to satisfy the standard within a period not less than 270 days after mailing by the IRS of notice of the failure, a period set by a court of competent jurisdiction after final determination of the failure, but in any event, not less than 270 days after the determination becomes final, or an additional correction period determined by the IRS to be reasonable or necessary to correct the failure.[446] Failure to satisfy the standard without timely remedial action prevents a plan from attaining church plan status for all future years.[447]

[446] § 414(e)(4).

[447] Regs. § 1.414(e)-1(a).

Two or more entities may maintain a single plan that satisfies the standards for church plans with respect to each employer and its employees independently.[448] If the portion of the plan maintained for the benefit of one employer under such a plan fails to meet the standards, the entire plan ceases to be a church plan unless the affected employer withdraws from the plan by the end of the plan year in which the employer receives final notice of the failure from the IRS.[449]

[448] Regs. § 1.414(e)-1(c).

[449] *Id.*

The plan administrator of what would otherwise be an exempt church plan may irrevocably elect that the plan be governed by ERISA, including the tax provisions, and all subsequent legislation.[450] In that case, ERISA and all amendments to ERISA and the Code since enactment of ERISA apply to the plan for the year as to which the election first becomes effective and all subsequent plan years.[451]

[450] Code § 410(d); ERISA § 4(b)(2). In PLR 200350020, the IRS ruled that the merger of an electing church plan into a nonelecting church plan would adversely affect the status of the nonelecting merged plan because the merger would effectively revoke the electing plan's § 410(d) election. Although both plans had provisions that would protect accrued benefits in the case of a merger, the prohibition against revoking the § 410(d) election applied to the electing plan as a whole, not just to the benefits accrued. Thus, any transaction that served to directly or indirectly revoke the § 410(d) election would violate the irrevocability requirement.

[451] The election must be made by the plan administrator by a statement attached to the plan's annual return report for the initial year or by statement attached to a request for favorable letter of determination. If the election is made by attachment to a request for favorable determination, the election may be conditioned on issuance of a favorable determination letter. Regs. § 1.410(d)-1(c).

Considerable confusion exists as to whether a welfare plan may use the Code § 410(d) election procedure to opt into ERISA coverage. In DOL Advisory Opinion 95-07A, the Department of Labor took the position that the Code § 410(d) election procedure was not available to welfare plans. However, the law is unsettled. In Catholic Charities of Maine, Inc. v. City of Portland,[452] a city ordinance required Catholic Charities to extend its health and welfare benefits to the domestic partners of its employees. Catholic Charities refused and claimed the ordinance was preempted by ERISA and also filed an irrevocable election under Code § 410(d) so that its health plans would not be treated as church plans for purposes of ERISA. The district court ruled that the Code § 410(d) election applies to church welfare plans and allowed Catholic Charities to make the election. Further, the court determined that the city ordinance had an impermissible connection with Catholic Charities' health and welfare plans and was preempted when the election was made.

[452] 304 F. Supp.2d 77, 32 EBC 1021 (D. Me. 2004).

For a further discussion of church plans, see 372 T.M., *Church and Governmental Plans.*

(2) Plans Maintained by § 501(c)(8)and (9) Organizations

The exemptions apply to plans established and maintained by a society, order or association described in § 501(c)(8) or (9) only if no part of the contributions to or under the plan are made by employers of participants in the plan. Organizations exempt from tax under § 501(c)(8) include fraternal benefit societies, orders and associations operating under the lodge system or for the exclusive benefit of their members and providing for the payment of life, sick, accident or other benefits to their members or their dependents.[453] Organizations exempt from tax under § 501(c)(9) include voluntary employees' beneficiary associations.[454]

[453] See 870 T.M., *Tax-Exempt Organizations: Reporting, Disclosure and Other Procedural Aspects*.

[454] See 395 T.M., *VEBAs and Other Self-Insured Arrangements*.

b. Requirements from Which Exempt Plans Are Excused

Nonelecting church plans and eligible plans maintained by § 501(c)(8) and (9) organizations are excused from certain of the coverage, vesting, benefit accrual, and funding requirements of Parts 2 and 3 of Title I of ERISA and the corresponding provisions of the Code that apply to other tax-qualified plans. The requirements are: the minimum age and service requirements of Code § 410(a) and ERISA § 202; the minimum coverage requirements of Code § 410(b);the minimum vesting standards and benefit accrual standards of Code § 411 and ERISA § § 203 and 204; the minimum funding standards of Code § 412 and ERISA § § 302 through 308;[455] the joint and survivor annuity and preretirement survivor annuity requirements of Code § § 401(a)(11) and 417 and ERISA § 205; the restrictions on mergers, consolidations, and transfers of assets under Code § 401(a)(12) and ERISA § 208; the restrictions on assignments and other transfers under Code § 401(a)(13) and ERISA § 206(d), except that a domestic relations order which is enforceable against a church plan is treated as if it were a qualified domestic relations order for purposes of the Code;[456] the mandatory distribution rules of Code § 401(a)(14) and ERISA § 206(a); prohibition of benefit reduction on account of Social Security increases after termination of employment under Code § 401(a)(15) and ERISA § 206(b); prohibition of forfeiture of employer contributions upon withdrawal of employee contributions under Code § 401(a)(19) and ERISA § 206(c); the controlled group rules and predecessor employer rules of Code § 414(a), (b) and (c) and ERISA § 210; Title IV of ERISA regarding PBGC coverage[457] and the notice to the PBGC required by Code § 401(a)(20) in the event of qualified total distributions on account of plan termination; the duty to file Schedule SSA under Code § 6057; and the duty to file actuarial reports under Code § 6059.

[455] For plan years beginning in 2008, the funding rules in Code § 412 and ERISA § § 302 through 308 are repealed and replaced with new funding rules in Code § § 412, 430, 431, and ERISA § § 302 through 305. The Pension Protection Act of 2006, P.L. 109-280, § § 111(a), 112(a), 211(a), 101(a) and(b), 102(a), 201(a), respectively.

[456] Code § 414(p)(11). This permits taxation of the distribution as if it met the requirements for a QDRO.

[457] ERISA § 4021(b)(3) and (4).

Nonelecting church plans also are generally exempt from Parts 1 and 4 of Title I of ERISA, which impose reporting and disclosure requirements and fiduciary duties;[458] from the duty of filing annual information returns under Code § 6058;[459] and from the prohibited transaction rules of Code § 4975.[460] They are beyond the jurisdiction of the federal courts and the preemption provisions of ERISA do not apply to them.[461]

[458] ERISA § 4(b)(2).

[459] Announcement 82-146, 1982-47 I.R.B. 53.

[460] Code § 4975(g)(3).

[461] ERISA § 4(b)(2).

Some church plans also are exempt from one of the minimum distribution rules imposed by Code § 401(a)(9). In general, plans sponsored by these organizations do not have to provide actuarial increases to active participants who delay commencement of distribution after age 70 $^1/_2$.[462] The church plans entitled to this exemption are plans maintained by churches and qualified church-controlled organizations described in Code § 3121(w)(3)(A) and (B). Code § 3121(w)(3)(A) and (B) only includes tax-exempt churches, associations or conventions of tax-exempt churches, elementary and secondary schools controlled, operated or principally supported by churches, and some, but not all, tax-exempt organizations controlled by affiliated churches, whether or not operated or principally supported by a church. A tax-exempt organization controlled, operated, or principally supported by a church is not a church or church-controlled organization within the meaning of Code § 3121(w)(3)(A) or (B) if it offers goods, services, or facilities for sale to the general public for more than a nominal charge and normally receives more than 25%of its support from government sources, receipts from admissions, sales, provision of services or facilities, and activities related to its tax-exempt purpose.[463]

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[462] Code § 401(a)(9)(C). Church plans also are exempt from the requirement that distributions for a 5% owner commence after age 70$^1/_2$ regardless of whether the employee has retired, an exception of limited scope given the usual organization of a church or church-related employer. For a more complete discussion of the minimum distribution rules, see II, A, 8, b, above.

[463] Code § 3121(w)(3)(B)(i) and (ii).

This includes church-controlled organizations such as hospitals and colleges.

c. Requirements from Which Exempt Plans Are Not Excused

Even though these plans are exempt from part or all of the requirements of ERISA and certain portions of the Code, they remain subject to other requirements imposed by the Code on tax-qualified employee pension benefit plans. Some of these requirements were in effect before enactment of ERISA in 1974; others were enacted after ERISA.

An exempt plan remains subject to Code § 401(a)(3) as in effect on September 1, 1974.[464] The standard must be satisfied on at least one day in each calendar quarter, under Code § 401(a)(6) as in effect on September 1, 1974. Code § 401(a)(3) as in effect on September 1, 1974, provided two alternative standards for eligibility to participate. A plan (or group of aggregated plans maintained by the same employer, as determined under law then in existence)[465] must either: (1) benefit 70% or more of all employees, or 80% or more of all employees eligible to benefit, if at least 70% are eligible, disregarding employees who have not satisfied the plan's service requirement (not exceeding five years) and employees whose customary employment is for not more than 20 hours per week or five months per calendar year; or (2) benefit a classification of employees set up by the employer and found by the

Secretary not to be discriminatory in favor of officers, shareholders, supervisors, or highly compensated employees. For purposes of the percentage tests, the exclusions relating to employees who are members of collective bargaining units, nonresident aliens, and airline pilots under Code § 410(b)(3) do not apply.[466] For purposes of determining whether a plan covered a nondiscriminatory classification of employees under Code § 401(a)(3), Code § 401(a)(5) as in effect on September 1, 1974, permitted a plan to exclude employees whose entire compensation was subject to FICA, or to only cover salaried or clerical employees.

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[464] Code § 410(c)(2).

[465] Aggregation of controlled group members under Code § 414(b) and (c) was not required until enactment of ERISA.

[466] An exempt plan has to take the burdens as well as the benefits of prior law.

An exempt plan also is subject to the vesting rules of Code § § 401(a)(4) and 401(a)(7) as in effect on September 1, 1974.[467] With respect to vesting, Code § 401(a)(4) as in effect on September 1, 1974, required a plan to provide that a participant be fully vested at normal retirement age.[468] No specific minimum vesting standards of the type provided for in Code § 411(a)(2) were required by statute or regulation, but operational discrimination in favor of officers, shareholders, supervisors, and highly compensated employees was prohibited.[469] This was determined case-by-case on the basis of a pattern of abuse (such as firing of employees shortly before their benefits vest), or actual or reasonably foreseeable accrual of benefits or forfeitures tending to discriminate in favor of the prohibited group.[470] Code § 401(a)(7) as in effect on September 1, 1974, required full vesting on plan termination or complete discontinuance of contributions. In the case of a defined benefit pension plan, the amount vested was limited to the extent then funded; in the case of a defined contribution plan, full vesting was required with respect to all amounts credited to employee's accounts.

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[467] Code § § 411(e)(2), 412(h) (flush language). For plan years beginning in 2008, see § 412(e)(2) (flush language), as amended by P.L. 109-280, § 111(a). Pre-ERISA Code § 401(a) is reproduced in the Worksheets of 372 T.M., *Church and Governmental Plans*.

[468] Rev. Rul. 66-11, 1966-1 C.B. 71.

[469] Regs. § 1.401-1(b)(3).

[470] *See* Conf. Rep. No. 1280, 93d Cong., 2d Sess. at 276, reprinted at 1974-3 C.B. at 437.

Exempt plans are not exempt from certain other generally applicable provisions of the Code relating to qualified plans. They are subject to the requirements of Code § 401(a)(1) and (2), relating to the exclusive purpose and exclusive benefit requirements; Code § 401(a)(4), requiring nondiscrimination in contributions or benefits;[471] Code § 401(a)(8), requiring that forfeitures not be applied to increased benefits under a defined benefit pension plan; Code § 401(l), relating to integration of benefits and contributions with Social Security; Code § 415, providing for limitations on annual additions and benefits; Code § 416, relating to top-heavy plans; Code § 401(a)(17), the limitation of compensation to $150,000, as adjusted for cost of living;[472] Code § 401(a)(25), requiring that actuarial assumptions applied to calculate any benefit be specified in the plan; and the minimum participation requirements of Code § §

401(a)(26), 401(k) and 401(m).

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[471] After 1996, church plans subject to pre-ERISA nondiscrimination rules are to apply the same definition of highly compensated employee as other pension plans, rather than the pre-ERISA rule relating to employees who are officers, shareholders, and persons whose principal duties consist of supervising the work of other employees. Code § 414(q), as amended by SBJPA § 1463.

[472] The Code § 401(a)(17) compensation limit was increased to $200,000, effective for years beginning after Dec. 31, 2001, and may be adjusted annually for inflation thereafter. Code § 401(a)(17), as amended by P.L. 107-16, § 611(c)(1). For the current and prior year dollar amounts, see the Worksheets to 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

Exempt plans also are subject to the permissive provisions of Code § 401, including Code § 401(a)(24), which permits investment in group trusts; Code § 401(b), relating to the remedial amendment period; Code § 401(f) and (g), permitting investment in custodial accounts and nontransferable annuity contracts and face amount certificates;and Code § 401(h), permitting a pension plan to provide medical benefits to retirees.

Even though nonelecting church plans are exempt from the reporting and disclosure requirements of Title 1 of ERISA, they are not exempt from the pre-ERISA requirement imposed by regulation under Code § 401(a) that the material provisions of the plan be made known to employees,[473] or the requirement to furnish a notice to recipients of distributions eligible for rollover treatment under Code § 402(f).

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[473] Regs. § 1.401-1(a)(2).

Although nonelecting church plans are exempt from Code § 4975, they are not exempt from Code § 503, under which a church plan that engages in a prohibited transaction can lose its tax-exempt status.[474] The exemption only is lost for taxable years after the taxable year in which the plan is notified that it has engaged in a prohibited transaction by the IRS, unless the plan engaged in the prohibited transaction with the purpose of diverting its corpus or income from its exempt purpose, and the transaction involved a substantial part of the corpus or income.[475] The trust may reapply for exemption with respect to taxable years beginning after the prohibited transaction occurs by applying for a favorable determination letter, together with a declaration that the plan will not again knowingly engage in a prohibited transaction.[476]

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[474] § 503(a)(1)(B).

[475] Code § 503(a)(2).

[476] Code § 503(c); Regs. § 1.503(c)-1.

The transactions prohibited by Code § 503 are not the same as those prohibited by Code § 4975. Because a tax-qualified plan receives only employer and employee contributions and no charitable contributions, the other party to a prohibited transaction with a plan only can be the employer, the trustee or other fiduciary or an employee who makes large after-tax employee contributions. The transactions prohibited by Code § 503 include loans from the plan without adequate security and a reasonable interest rate; payment of consideration by the plan in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered; making any part of the plan's services available on a preferential basis; engaging in any substantial purchase of securities or other property for more than adequate consideration;engaging in any substantial sale of securities or other property for less than adequate consideration; or any other transaction which results in a substantial diversion of the plan's income or corpus.[477] Special rules apply to certain securities issued by the employer.[478]

[477] Code § 503(b).

[478] Code § 503(e) and (f).

Nonelecting church plans that are exempt from Title 1 of ERISA are not subject to ERISA preemption provided for in ERISA § 514. Therefore, state law governs interpretation of the plan, the standard for judicial review, damages, the right to trial by jury, and enforceability of state court orders, including support orders and claims of judgment creditors, and the federal courts do not have subject-matter jurisdiction.