ASPPA
WORKING FOR AMERICA'S RETIREMENT

RPF-1 Study Guide: Retirement Plan Fundamentals Part 1

2007 Edition

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Preface

The objective of the Retirement Plan Fundamentals Course is to give an individual beginning a career as a retirement plan professional a general background in qualified retirement plans as a "first step" toward meeting the challenges of the profession. It also is to provide those individuals who work for insurance companies, brokerage firms, or financial consulting firms a level of knowledge that will help them increase their ability to assist plan sponsors. The course is divided into two parts: each part is designed to build upon the groundwork established by its predecessor while not duplicating content or presupposing knowledge or experience level. **This manual contains Part 1 only.** Part 2 is available separately or within a set of manuals containing the entire course. The material covered in each part is described below.

Part 1 - Retirement Plan Fundamentals 1 (RPF-1)

- Introduction to Retirement Plan Fundamentals
- Who Sets up the Plan and Keeps it Running Smoothly
- Defined Contribution Plans
- Defined Benefit Plans
- First Steps to a New Plan
- Basic Plan Document Language
- Plan Qualification
- Enrolling Employees
- Disclosure and Communication
- Withdrawals While Actively Employed
- Participant Loans
- Distributions Tax Rules
- Updating Plans and Error Corrections
- Record Retention

Part 2 – Retirement Plan Fundamentals 2 (RPF-2)

- Retirement Plan Administration
- Allocations and Maximum Limitations on Benefits
- Annual Testing
- Living in an Electronic World: Daily Valuation
- Differences Between Balance Forward & Daily
- Fiduciary Considerations
- Appropriate Investments for Daily Valuation Plans
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- Mutual Fund Trading Practices
- Processing Transactions

- Ethics in Dealing With Trading Errors and Corrections
- Conversion Decisions & Issues
- Conversion Types & Methods
- Audits of Employee Benefit Plans
- Mergers and Terminations

Throughout the course, preference has been placed on using descriptive titles rather than numeric references to the sections of various laws that govern retirement plans. However, to facilitate cross-referencing of this and other reference texts, a table of Internal Revenue Code (Code or IRC) §401 through §417 with brief descriptions has been provided in Appendix D. In addition, in an effort to enhance understanding, both the descriptive title and the Code Section number may be provided within the textual discussions.

Should it be necessary to make any corrections to the study manuals or exams or should any clarification of the material in the study manuals or exams be required, this information will be posted on the ASPPA website at http://www.asppa.org/edu/study-guide-references.htm. It is the candidate's responsibility to regularly check the ASPPA website in order to obtain this information.

Each part (RPF-1 and RPF-2) of the Retirement Plan Fundamentals Course has a separate exam covering the material in that part. The exams are graded separately and may be taken at different times.

Additional information, including online registration for the RPF exams, is available on the ASPPA website at http://www.asppa.org/education/ed_rpf_info.htm. Once you register, you will receive access to the online exam via the ASPPA website. There are no paper exams for RPF-1 or RPF-2. All exams must be completed online. The instructions that appear at the beginning of the exams should be read carefully to understand the rules that must be followed when completing the exams. A grade of 90% (68 out of 75 questions correctly answered) is required to pass each exam.

Time Period Covered by This Material: This course manual and exams will not cover any new legislation passed after August 1, 2006.

Sample Forms and Procedures: The Retirement Plan Fundamentals Course contains sample forms and procedures. These are not meant to be used by a firm without review by the firm and its attorney. The forms and procedures are samples to show some of the items that may be included and are meant to be used as a training tool. The forms and procedures should not limit what is acceptable or might be used in practice.

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ASPPA welcomes comments about the course and requests completion of the User Input Form provided. For additional questions, please write to the ASPPA Education Services department at 4245 North Fairfax Drive, Suite 750, Arlington, VA 22203-1606. Candidates may also contact ASPPA by calling the Education Services department at (703) 516-9300, faxing an information request to (703) 516-9308, or sending a message to the ASPPA office via e-mail at educasppa@asppa.org.

User Input Form

Retirement Plan Fundamentals Course – Part 1
2007 Edition

Please complete this form with any suggestions which could be incorporated into future course updates. Make a note of any areas found unclear or where additional information might have been helpful. Any comments or observations are appreciated.

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Chapter 1:
Introduction to Retirement Plan Fundamentals

§1.01 Learning Objectives

- Discuss the concept of employee benefit plans including the primary differences between a welfare benefit plan and a pension benefit plan.
- Explain the key differences between defined contribution and defined benefit plans.

§1.02 Introduction

There are many types of benefits provided by employers for their employees in addition to wages, and indeed benefits represent an increasingly larger proportion of the total employee-related cost of doing business. In some cases, the employer pays the full cost of these benefits, such as paid vacation days, and they are considered fully funded by the employer. Often, however, the employee and the employer share in the expense of providing and obtaining employee benefits.

Employee benefit plans fall into two broad categories:

1. Welfare benefit plans that provide a variety of benefits ranging from vacation pay to health and life insurance; and

2. Pension benefit plans that provide retirement income.

This chapter is an introduction to employee benefit plans, with a special focus on pension benefit plans. It includes discussions of:

- The legislative role of the Employee Retirement Income Security Act of 1974 (ERISA);
- Welfare benefit plans;
- Defined contribution plans, a type of pension benefit plan;
- Defined benefit plans, an alternate type of pension benefit plan; and
- A look at the topics covered in the Retirement Plan Fundamentals course.

§1.03 Employee Benefit Plans

To promote the physical, financial and mental well-being of employees and their families, employers routinely offer benefits such as health and life insurance, vacation time, disability income and retirement plans. Certain benefits are designed to protect employees from suffering serious financial hardship due to unforeseeable catastrophic events, while others serve to provide stability and productivity in the workforce by enhancing employee morale and enabling competitive recruitment practices. Because employees have come to expect benefits in addition to their salaries, employee benefit plans often are provided instead of additional cash payments as an integral part of a total compensation package.

[A] Role of ERISA

Many tax laws and regulations that dictate employee rights and employer obligations underlie an employer's decision to offer employee benefit packages.

The **Employee Retirement Income Security Act of 1974 (ERISA)** was signed into law on September 2, 1974. It established an elaborate system of regulations covering virtually every employee benefit plan and literally wrote the framework upon which subsequent employee benefit legislation has been built. Often, references to ERISA encompass not just the legislation enacted in 1974, but the body of legislation that followed and currently governs employee benefit plans.

ERISA applies to all employee welfare benefit plans and employee pension benefit plans, except:

- Government plans, which are partially exempt from ERISA provisions;
- Church plans, which are partially exempt from ERISA provisions unless they elect to comply with ERISA;
- Plans maintained solely to comply with workers' compensation laws, unemployment compensation or disability insurance laws;
- Plans maintained outside the U.S. primarily for nonresident aliens; and

- Unfunded excess benefit plans, which are plans with no underlying assets that are designed to provide benefits which exceed those typically allowed in a qualified retirement plan.

[B] Welfare Benefit Plans

ERISA defines an employee **welfare benefit plan** as any plan, fund or program established or maintained by an employer or employee organization that provides any of the following types of benefits:

- Medical, surgical or hospital care;
- Benefits in case of sickness, accident, disability or death;
- Unemployment benefits;
- Vacation benefits;
- Apprenticeship or other training programs;
- Day care centers;
- Scholarship funds;
- Prepaid legal services; or
- Any benefit described in Section 302(c) of the Labor Management Relations Act of 1947 (Taft-Hartley Act). This includes holiday and severance pay or similar benefits. It excludes retirement and survivor pensions or insurance to provide such pensions.

Not surprisingly, the body of legislation covering benefit plans has expanded extensively beyond the original 1974 ERISA.

This course will focus on pension benefit plans, particularly those plans meeting the qualification requirements for special tax considerations under the Internal Revenue Code. Such plans are commonly referred to as **qualified plans**.

[C] Pension Benefit Plans

ERISA defines an employee **pension benefit plan** as any plan, fund or program established or maintained by an employer or employee organization that:

- Provides retirement income to employees; or
- Results in a deferral of taxable income until distribution.

ERISA's definition of an employee pension benefit plan applies to such arrangements despite the method of:

- Calculating the contributions made to the plan;
- Calculating the benefits under the plan; or
- Distributing benefits from the plan.

A plan that provides any of the following types of benefits falls under the definition of an employee pension benefit plan:

- Retirement benefits for age and/or service;
- Disability retirement benefits;
- Retirement benefits provided through accumulating savings under individual account plans such as profit sharing plans; or
- Deferral of income for periods extending to or beyond the end of employment.

§1.04 Pension Benefit Plans

[A] In General

As life spans increase and the Baby Boomer generation marches ever more quickly toward retirement, debates escalate over the ongoing viability of Social Security and Medicare. The continuing evolution of traditional family support structures coupled with the fact that the savings habits of Americans have deteriorated alarmingly in recent years raise serious doubts about our ability to enjoy our retirement years in financial security. It is now more important than ever that an individual assume an active role in preparing financially for retirement, and the wide variety of employer-sponsored retirement plans existing today offer themselves as a valuable savings tool for that individual.

To minimize the potential for their misuse, employer-sponsored retirement plans are subject to a complex and dynamic set of rules and regulations. For a plan to be a qualified retirement savings plan, that is, for participants and plan sponsors to be entitled to favorable tax treatment in conjunction with their use and operation of the plan, it must follow these rules. While nonqualified plans exist, by definition they do not comply with the rules for qualified status, and they are more individually tailored toward their particular plan sponsors. Since they are far less common than qualified plans, they are generally beyond the scope of this course.

Within the context of the ever-changing qualified plan rules and regulations, today's retirement plan professionals must meet several challenges: they need to understand thoroughly the complexities and interplay between qualification requirements and plan administration, keep up-to-date with the sometimes chaotic legislative environment, effectively explain the evolving rules and their consequences to plan sponsors and participants and professionally and efficiently implement changes where necessary.

Retirement income planning begins with the basic premise that all employees desire economic security throughout their lifetime. As part of the planning for that economic security, most employees anticipate a reduction in earnings upon retirement and intend to offset this reduction with personal savings that supplement employer-sponsored pension benefit plans and governmental programs such as Social Security.

Traditionally, these three elements (personal savings, employer-sponsored pension benefit plans and Social Security) combine to become the **three-legged stool** supporting retirees. However, each leg of the stool often is not perceived as equal in strength. The confidence level in the Social Security leg of the stool, particularly for average workers under age 45, is low. Many also worry that within the current economic environment they will be unable to accumulate adequate personal savings before reaching retirement age. With two of three legs on shaky ground, today the three-legged stool model is being strengthened by the addition of a fourth leg — continued employment. Presently, many of us choose or are required to continue working past retirement age in order to remain active, to increase income or both.

Consequently, employees may increasingly look to their employer's plan to provide supplemental retirement income, making an employer-sponsored pension benefit plan a powerfully influential element of retirement income planning.

There are two broad categories of employer-sponsored pension benefit plans: defined contribution plans and defined benefit plans. Throughout this course, we will refer to both types of plans generically as retirement plans.

[B] Defined Contribution Plans

A **defined contribution plan** is sometimes known as an individual account plan because a separate account is maintained for each individual participant. These types of plans define the contribution amount to be deposited into the participant's account. For example, a plan may provide that every eligible participant will receive an allocation, or share of the total plan contribution, equal to 5 percent of his or her compensation. Or, the plan may define a participant's contribution as a specific dollar amount, such as $1,000.

Example 1-1. Defined Contribution Amount. Mary works as a graphic artist for XYZ Corporation and earns $45,000 during the year. Using the percentage contribution formula above, Mary will receive an allocation of contribution for the year in the amount of $2,250 ($45,000 x 5%). This amount will be deposited into her individual account under the plan.

The participant bears the investment risk in a defined contribution plan because there is no requisite or promised amount paid to the participant at retirement. The participant's total benefit from the plan will be the accumulated value (total contributions plus total earnings) of the participant's account at retirement or termination of employment. Although the participant's contribution amounts will be invested under the plan with the intent of accumulating value, investment results are not guaranteed and do not affect the employer's cost. Rather, the employer's defined contributions are the extent of the employer's commitment to the participant's retirement income. In this manner, the participant will reap the rewards of positive investment earnings but also bear the brunt of any investment losses.

Generally, employees readily understand a defined contribution plan as it is easy to see how much has been added to their accounts for the year. Each participant regularly receives a statement of his or her individual account that displays the participant's share of contributions and plan earnings or losses for the reporting period.

Example 1-2. Sample Employee Statement. A sample employee statement might look like:

XYZ Corporation Profit Sharing Plan
Statement of Account for the Plan Year Ended December 31, 2006

Participant: Mary

Beginning Account Balance as of January 1, 2006	$10,000
Employer Contribution	2,250
Investment Gains/(Losses)	1,000
Ending Account Balance as of December 31, 2006	$13,250

Younger employees may find the defined contribution plan more attractive than their older counterparts. This is primarily because defined contribution plans generally favor younger employees as contributions for these employees accumulate and earn compound interest over a longer period of time under these plans. Consider the situation in which an employer allocates $500 per year to each employee's account. An employee who begins working for the company at age 25 will accumulate a much larger account by retirement than an employee who begins working for the company at age 50.

Example 1-3. Accumulation Based on Age. Mary was age 25 when she began working as a graphic artist with XYZ Corporation. Based on a $500 a year allocation to her account (ignoring investment gains/(losses)), at retirement age 65 she would have an account balance of $20,000 ($500 x 40 years). However, if Mary had been age 50 when she began working, her account balance at retirement age 65 would only be $7,500 ($500 x 15 years). If we consider the effect of compounding investment earnings, the disparity in comparative account values may be even greater.

[C] Defined Benefit Plans

In comparison to a defined contribution plan that generally dictates a certain contribution amount each year; a **defined benefit plan** promises to pay a specified benefit at a future retirement age. Rather than defining the contribution to be allocated into a participant's individual account, these plans define the amount of retirement benefit to be paid. The actual level of benefit is calculated using a formula stated in the plan document. The benefit is usually payable at a specified future time, such as attainment of age 65. Some plans also provide benefits upon the disability or death of the participant before retirement.

Defined benefit plans usually express the benefit to be paid as an **annuity**, a series of generally equal payments made at specified intervals, for example monthly or annually. Typically, payments commence at the uniform or normal retirement age chosen by the plan, often attainment of age 65, with payments ending upon the death of the participant. This is known as a life annuity because payments extend over the lifetime of the retired participant. There are other types of annuities which may be employed by a defined benefit plan, for example annuities which extend over the joint lifetimes of a participant and his or her spouse or beneficiary.

Unlike a defined contribution plan, defined benefit plans do not maintain a separate account for each participant since the assets of the plan as a whole are the pooled source of funds from which the retirement benefits are paid. In a defined benefit plan, the employer assumes the investment risk by agreeing to pay the specified benefit at the specified future date. Consequently, investment gains or losses incurred by the plan's assets do not affect the benefit payable to the participant but serve to decrease or increase employer costs.

One might view the promise of a specified retirement benefit payable at a future date as tied intrinsically to the financial viability of the sponsoring employer and the strength of the plan's invested assets. To alleviate some of the participant's risk of seeing that promised benefit evaporate when an employer endures a bankruptcy or similar period of business instability, ERISA ensures that participants in most defined benefit plans are guaranteed at least a portion of their benefits from the plan. This guarantee is provided through insurance under a program administered by a government agency called the **Pension Benefit Guaranty Corporation (PBGC)**. Employers covered by the PBGC pay insurance premiums each year to the PBGC based on the number of plan participants and a comparison of plan assets versus plan benefit liabilities. In return, the PBGC will step in to pay participant benefits should the need arise. It should be noted that there are limits on benefits covered under the PBGC's termination insurance program (further discussed in RPF-2, Chapter 16).

A decision to use a defined benefit plan as the preferred retirement program depends upon the goals and objectives of the plan sponsor. Part of this determination involves an examination of the workforce, since the ultimate cost of funding a defined benefit program will depend upon the employee demographics. In general, if the employee population is older, the annual funding requirement that the employer must make to the defined benefit plan is higher for the same benefits than if the employee group is younger. This is because an employer has less time to take advantage of the accumulation of plan earnings to support the funding of retirement benefits for older employees. From the employee's point of view, those closer to retirement age and with less time to seek relative financial stability usually prefer the guaranteed retirement income aspect of the defined benefit plan rather than the potential value fluctuations inherent in a defined contribution plan. Where employer costs weighed against employee considerations support the aims of its desired retirement benefit program, an employer could decide in favor of a defined benefit plan or even a defined benefit plan in unison with a defined contribution plan.

§1.05 Course Overview

As the industry has evolved so must our course on Retirement Plan Fundamentals. Following is a brief overview of the topics covered in the RPF-1 Course:

Chapter 2	The types of entities that sponsor retirement plans and the roles of various parties involved in the operation of the plan;
Chapter 3	The different types of defined contribution plans including profit sharing plans, 401(k) plans, SIMPLE plans, money purchase plans, stock plans, target benefit plans and IRA accounts;
Chapter 4	Defined benefit plans;
Chapter 5	Plan design, document and installation issues that are generic to all types of retirement plans;
Chapter 6	Plan document features including eligibility and vesting that are generic to all types of retirement plans; and
Chapter 7	Plan qualification issues that affect all types of retirement plans.

Upon completion of Chapter 7 the course turns its focus toward administration of a plan and those activities that occur throughout the year. It covers general administration issues that occur in most retirement plans such as:

Chapter 8	Enrollment of participants into a retirement plan and the normal forms used for the process;
Chapter 9	The reports that must be provided annually to various governmental agencies and to the participants. This includes Form 5500, the summary annual report and other disclosures;
Chapter 10	Those events that will allow a participant to receive a withdrawal of benefits while still employed. This discussion covers in-service withdrawals, hardships and qualified domestic relations orders;
Chapter 11	Participant loan programs;

Chapter 12 Distributions due to a distributable event such as termination of employment, retirement, death or disability. These are reviewed and the tax ramifications addressed;

Chapter 13 Events that may cause the plan to be amended such as law changes or the employer's situation changes that affect the plan. The process of amending a plan is discussed. Changes also may cause an error in administration. The error correction programs through the IRS and DOL are also covered;

Chapter 14 Being able to find records and knowing what records must be kept for how long is an important issue that is dealt with in this chapter; and

Chapter 15 The ASPPA Code of Professional Conduct.

The second part of the RPF series, RPF-2, will then cover a few remaining administration issues such as contribution limit, annual testing and census verification then changes focus to cover plans that allow participants to control the investment decisions of their account balance. These are primarily 401(k) plans. As 401(k) plans have influenced the industry so dramatically, they have also influenced this course. The course then delves into discussions of:

- The transition from balance forward administration to daily valuation and the effect participant-directed 401(k) plans have had on the roles of the recordkeeper and the administrator, how plans are marketed and how administration firms process their work;
- The differences between balance forward administration and daily valuation;
- Fiduciary liability and how a fiduciary can minimize the investment liability by allowing participants to direct the investment of their account balances;
- The investments used in daily valuation plans which includes a discussion of what is a mutual fund and the various types as well as a review of the important issues that must be considered when employer stock is offered as an investment in a 401(k) plan;
- Fees charged by various investments looking at mutual funds, guaranteed investment contracts as well as annuity products. Investment fees are the largest fee incurred by a retirement plan and must be understood by fiduciaries in the role of protecting the assets;
- Discussions revolve around activities that are performed in daily valuation, mutual fund trading practices, processing daily transactions, correcting trading errors and audits of service firms;
- The issues that should be considered by a plan sponsor when changing administration firms and moving from a balance forward recordkeeping approach to daily valuation; and
- Processing issues that are created when changing from balance forward recordkeeping to daily valuation and the investment issues that are presented if assets are liquidated to make the change.

§1.06 Key Terms

Annuity (or Life Annuity): A series of periodic payments, usually level in amount or adjusted according to some index (e.g., cost-of-living), that continues for the lifetime of the recipient.

Defined Benefit Plan: A plan designed to provide participants with a definite benefit at retirement. Contributions under the plan are determined by reference to the benefits provided.

Defined Contribution Plan: A plan that provides an individual account for each participant and in which benefits are based solely upon the amount contributed to the account (plus or minus any income, expenses, gain and losses allocated to the account).

Employee Benefit Plan: Any plan providing employee benefits generally falling into two broad categories, welfare benefit plans that provide a variety of benefits ranging from vacation pay to health and life insurance or pension benefit plans that provide retirement income.

Employee Retirement Income Security Act of 1974 (ERISA): The basic labor law covering qualified plans, it incorporates both the pertinent Internal Revenue Code provisions by reference and labor law provisions.

Pension Benefit Guaranty Corporation (PBGC): A nonprofit corporation, functioning under the jurisdiction of the Department of Labor, responsible for insuring benefits to participants of certain defined benefit plans.

Pension Benefit Plan: Any plan, fund or program established or maintained by an employer or employee organization that provides retirement income to employees or results in a deferral of taxable income until distribution.

Qualified Plan: A plan that meets the requirements of IRC §401(a) and, therefore, provides special tax considerations to the plan sponsor, the trust and plan participants.

Three-Legged Stool: Traditionally used as a way to describe the three elements of retirement savings (personal savings, employer-sponsored pension benefit plans and Social Security). More recently employees must consider a fourth leg, continued employment.

Welfare Benefit Plan: Any plan, fund or program established or maintained by an employer or employee organization that provides medical, surgical or hospital care, benefits in case of sickness, accident, disability or death, unemployment benefits, vacation benefits, apprenticeship or other training programs, day care centers, scholarship funds, prepaid legal services or any benefit described in

Section 302(c) of the Labor Management Relations Act of 1947 (Taft-Hartley Act).

§1.07 Review of Key Concepts

- Employee benefit plans fall into two broad categories: pension benefit plans that provide retirement income; and welfare benefit plans, providing such benefits as vacation pay and health insurance.

- ERISA established an elaborate system of regulations covering virtually every employee benefit plan. Since ERISA, the body of legislation covering qualified plans has expanded extensively.

- The two broad categories of employer-sponsored pension benefit plans are defined contribution plans and defined benefit plans.

- A defined contribution plan defines the amount of contribution to be deposited into a participant's individual account.

- A defined benefit plan defines the amount of a specified benefit to be paid at a future retirement age stated in the plan document.

§1.08 Review Questions

[A] True or False

______ 1. A defined contribution plan is sometimes known as an individual account plan because a separate account is maintained for each individual participant.

______ 2. Government pension benefit plans are required to comply with all provisions of ERISA.

[B] Multiple Choice

3. All of the following types of plans are covered by ERISA, **EXCEPT**:

   A. A plan that provides retirement benefits based on age and/or service
   B. A plan that provides disability retirement benefits
   C. A plan that provides for deferral of income past the end of employment
   D. A plan that provides medical benefits
   E. A plan that provides benefits solely for unemployment compensation

4. All of the following are characteristics of defined benefit plans, **EXCEPT**:

   A. A specified benefit is promised to be paid at retirement.
   B. The employer assumes the investment risk.
   C. The benefits are usually expressed as a dollar amount to be paid as an annuity.
   D. Younger employees require higher contributions than older employees given the same benefit level.
   E. The PBGC may guarantee a portion of the benefit.

5. All of the following are types of welfare benefit plans, **EXCEPT**:

   A. A plan that provides scholarship funds
   B. A plan that provides vacation benefits
   C. A plan that provides retirement benefits
   D. A plan that provides prepaid legal services
   E. A plan that provides hospital care

6. All of the following are characteristics of pension benefit plans, **EXCEPT:**

   A. Provides retirement income to employees
   B. Provides for unemployment benefits
   C. Provides for disability retirement benefits
   D. Provides for retirement savings through individual accounts
   E. Provides for deferral of income

7. All of the following are characteristics of defined contribution plans, **EXCEPT:**

   A. A separate account is maintained for each participant.
   B. The participant bears the investment risk.
   C. The participant’s retirement benefit equals the participant’s actual account balance.
   D. Investment results are not guaranteed.
   E. Older employees benefit more than younger employees.

§1.09 Answers

1. **True.** A defined contribution plan provides an individual account for each participant. §1.04 [B]

2. **False.** Government plans are exempt from certain provisions of ERISA. §1.03 [A]

3. The correct answer is **E.** §1.03 [A]

   A. Incorrect. The statement is true because a plan that provides retirement benefits based on age and/or service is a type of plan covered by ERISA.
   B. Incorrect. This statement is true because a plan that provides disability retirement benefits is a type of plan covered by ERISA.
   C. Incorrect. This statement is true because a plan that provides for deferral of income past the end of employment is a type of plan covered by ERISA.
   D. Incorrect. This statement is true because a plan that provides medical benefits is a type of plan covered by ERISA.
   E. Correct. This statement is false because plans that provide solely for unemployment compensation are not covered by ERISA.

4. The correct answer is **D.** §1.04 [C]

   A. Incorrect. The statement is true because defined benefit plans promise a specified benefit to be paid at retirement.
   B. Incorrect. This statement is true because the employer assumes the investment risk in a defined benefit plan.
   C. Incorrect. This statement is true because benefits are usually expressed as a dollar amount, paid as an annuity, in a defined benefit plan.
   D. Correct. This statement is false because defined benefit plans do not require higher contributions to younger employees given the same benefit level. They generally require higher contributions to older employees.
   E. Incorrect. This statement is true because the PBGC guarantees a portion of the benefit in some defined benefit plans.

5. The correct answer is **C.** §1.03 [B]

   A. Incorrect. The statement is true because a plan that provides scholarship funds is considered a welfare benefit plan.
   B. Incorrect. This statement is true because a plan that provides vacation benefits is considered a welfare benefit plan.
   C. Correct. This statement is false because a plan that provides retirement benefits is not a welfare benefit plan.
   D. Incorrect. This statement is true because a plan that provides prepaid legal services is considered a welfare benefit plan.
   E. Incorrect. This statement is true because a plan that provides hospital care is considered a welfare benefit plan.

6. The correct answer is **B.** §1.03 [C]

   A. Incorrect. The statement is true because a plan that provides retirement income to employees is considered a pension benefit plan.
   B. Correct. This statement is false because a plan that provides unemployment benefits is not considered a pension benefit plan.
   C. Incorrect. This statement is true because a plan that provides for disability retirement benefits is considered a pension benefit plan.
   D. Incorrect. This statement is true because a plan that provides for retirement savings through individual accounts is considered a pension benefit plan.
   E. Incorrect. This statement is true because plans that provide for deferral of income are considered pension benefit plans.

7. The correct answer is **E.** §1.04 [B]

   A. Incorrect. The statement is true because a separate account is maintained for each participant in a defined contribution plan.
   B. Incorrect. This statement is true because the participant bears the investment risk in a defined contribution plan.
   C. Incorrect. This statement is true because in a defined contribution plan the participant’s retirement benefit equals the participant’s actual account balance.
   D. Incorrect. This statement is true because investment results are not guaranteed in a defined contribution plan.
   E. Correct. This statement is false because defined contribution plans do not necessarily benefit older employees more than younger employees.

Chapter 2:
Who Sets Up the Plan and Keeps it Running Smoothly

§2.01 Learning Objectives

- Differentiate between the different types of business entities that may sponsor a retirement plan with respect to plan operation and administration.
- Identify a 5% owner and the family members attributed ownership under IRC §318.
- Explain the concept of common control and how it affects a qualified plan.

- Explain who the plan fiduciaries are with respect to a qualified plan and their duties.
- Identify the general duties and responsibilities of the plan administrator.
- Identify the parties involved in the operation of a qualified plan and discuss their traditional roles (accountants, actuaries, attorneys, consultants and investment advisors).
- Describe what a prohibited transaction is.
- Identify the parties-in-interest as they apply to prohibited transactions.

§2.02 Introduction

The type of business entity that sponsors a qualified plan can have a significant impact on the manner in which contributions are deducted or allocated, and also may place restrictions on rights, features or benefits available to certain participants under the plan. In addition, the degree of common ownership among a group of businesses might cause them to be considered a single employer for a number of plan purposes, adding layers of complexity to what would at first appear a routine administrative task or design consideration. "Know the employer" then, is a maxim best spoken often and with depth of conviction by successful retirement plan professionals.

This chapter begins by undertaking a study of the different types of businesses for tax purposes, and how each type influences the structure and administration of its qualified plan. These types include sole proprietorships, partnerships, C and S corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs).

Subsequently, the chapter describes the challenges and responsibilities of individuals involved in the operation of qualified plans, regardless of sponsor business type. The positions these individuals hold include fiduciary, plan administrator, trustee, accountant, actuary, attorney, consultant and investment advisor.

Finally, we include an overview of parties-in-interest and prohibited transactions as related to retirement plans.

§2.03 Employer/Plan Sponsor

[A] Plan Sponsors

The **plan sponsor** is the entity that establishes the plan. Corporations, partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs), tax-exempt organizations, state and local governments, trade unions, and sole proprietors may all sponsor retirement plans. Each entity type, however, will not be sponsoring mirror-image retirement plans. Rather, the plans will be reflective of their sponsor's particular business type and must show compliance with any specific qualified plan rules that apply to that business entity type.

Note that the terms employer and plan sponsor are frequently used interchangeably, but are separate concepts.

[B] Entity Change

It is essential for retirement plan professionals to request and keep on hand current information from the plan sponsor which identifies its tax status, owners, partners, officers, and relationships to other business entities and their retirement plans. Modification of the entity's structure for tax purposes, regardless of the entity type, can demonstrably affect administrative work and could potentially require that the plan document be amended. Additionally, changes in ownership and officers may influence the application of testing procedures, such as those for compliance tests, or cause multiple plans to be combined and tested as one plan because they are sponsored by entities linked through common ownership.

§2.04 Taxpayer Status of Employer/Plan Sponsor

The Internal Revenue Code establishes the tax classifications of organizations as taxpayers and sets out the standards for meeting these classifications. There are four main categories of employers for tax purposes:

1. Sole Proprietorships;
2. Partnerships;
3. C Corporations; and
4. S Corporations.

[A] Sole Proprietors

Sole proprietors are individuals who own 100% of their unincorporated businesses and are commonly referred to as self-employed persons. (A distinction should be made here. While all sole proprietors are self-employed, not all self-employed individuals are sole proprietors.) As someone "in business for him or herself," a sole proprietor is fully responsible for the liabilities of the business. The income or loss generated by a sole proprietorship is reported on the owner's personal income tax return, as determined on a separate schedule: Form 1040 Schedule C (Profit or Loss From Business – Sole Proprietorship), Schedule C-EZ (Net Profit from Business – Sole Proprietorship) or Schedule F (Profit or Loss From Farming). This Schedule C income is usually the basis for calculating required and/or deductible plan contributions for the self-employed person.

[B] Partnerships

A **partnership** is not taxable as a separate entity: the partners are taxed as individual taxpayers to the extent of their share of the partnership's taxable income, whether or not it has been paid to them. The treatment of liability for the debts of the partnership, including required contributions to the qualified plans, also resemble that of the sole proprietorship, for liability is passed through the partnership to the individual partners.

Earned income is the term used to define the compensation of a self-employed partner. The partner's earned income is net earnings from self-employment adjusted for certain modifications. The starting point for determining net earnings from self-employment of a partner is the Schedule K-1, line 14. Adjustments made for certain business deductions the individual partners claim on their Forms 1040, as well as one-half of the self-employment tax (computed on Schedule SE of Form 1040) are taken into consideration. Of course, non-partner employees of the partnership will be issued W-2s.

[C] Corporations

A **corporation** is a legal entity formed by business associates to conduct a professional venture and divide profits among investors. It is created under state law via filing of a charter or articles of incorporation within a state or states, and consequently becomes subject to the laws of those states as well as federal law. After drawing up bylaws to govern its operation, issuing stock, and appointing a board of directors to manage its affairs, the corporation then begins to "do business," and in many ways functions as if it were an individual taxpayer, existing separately and apart from owners. The corporation files its own tax return and pays taxes on its income. It can buy and sell property, and it can sue and be sued. The rights and liabilities of a corporation generally remain distinct from those of its underlying owners, and as such formation of a corporate entity provides a measure of protection or limited liability for investors. In most cases, none of the owners will be under obligation for the debts of a corporation, and the corporation's creditors may not attack the personal assets of the investors.

Corporations may be formed as “C” or “S” corporations under federal law: the alphabetic nomenclature refers to the applicable subchapter of the Internal Revenue Code to which the entity is subject. The “S” reference indicates that the creators of the corporation have elected that the corporation be taxed as if it were a partnership, but treated as a corporation for other purposes. Given that corporations and partnerships determine taxable income in different ways, this is a very important distinction for qualified plan purposes.

<u>1. C Corporations</u>

C corporations are what most people think of when they hear the term: corporation. They are subject to the largest tax bite, since corporate earnings are actually taxed twice. First, the corporation must pay corporate income tax on its net income. Thereafter, net income, if distributed to owners, is paid in the form of a dividend. Commonly, this dividend represents taxable income to the owner, thus creating the double payment of taxes: first at the corporate level and again at the level of the owner. Conversely, if the corporation has sustained a loss during its fiscal period, the corporation carries the loss forward to be applied against future earnings. The individual owners cannot claim the loss.

<u>2. How C corporation status affects qualified retirement plans</u>

Tax-deductible contributions to qualified plans will of course impact the corporation’s income and expense statements for the year, but the presence of a qualified plan can also influence the deductibility of dividends paid by the C corporation. For example, under certain circumstances a C corporation is allowed to deduct the dividends paid on employer shares held within an Employee Stock Ownership Plan (ESOP).

Compensation for an owner/employee is determined based on wages paid by the company which are generally reported on IRS Form W-2 (W-2). Income that is received by owners of the company represents a return on their investment rather than eligible compensation for plan purposes.

<u>3. S Corporations</u>

By electing “S” status for income tax purposes, **S corporations**, sometimes referred to as Subchapter S corporations, avoid the double-taxation of company earnings associated with their C corporation brethren. The S corporation itself usually does not pay any income tax. Both the income and the losses of the corporation pass through to the individual owners who must claim the income or losses on their personal income tax returns, whether or not the income has been distributed to them. These differences in taxation may be a primary consideration when a company chooses S status. It allows income taxes to be paid on company earnings just once: all at the individual level and at individual tax rates.

4. How the S corporation status affects qualified retirement plans

It is important to remember that S corporations are treated as corporations under the Internal Revenue Code for all purposes except how the income of the corporation is taxed. In other areas, the dissimilarities to partnerships are obvious. Owners of S corporations who are actively at work normally have both W-2 earnings and income reported on Form 1120-S Schedule K-1 (Shareholder's Share of Income, Credits, Deductions, etc.). Only the W-2 earnings from employment with the S corporations may be used for qualified plan purposes. Although income reported on Schedule K-1 flows through to the individual's personal income tax return as it does for partnership members, it does not qualify as plan eligible compensation.

[D] Limited Liability Companies (LLCs) or Limited Liability Partnerships (LLPs)

Limited Liability Companies (LLCs) and **Limited Liability Partnerships (LLPs)** are created under state laws which govern their formation. Not all businesses can operate as LLCs or LLPs. For example, companies in the banking and insurance industries are prohibited from electing LLC status, and some states forbid professionals such as physicians and architects from forming LLCs. The attraction of LLCs and LLPs is advertised in their name. They offer limited liability to their members as a separate and distinct legal entity, as a corporation does, but they are generally taxed as partnerships under state and federal law. Indeed, LLCs and LLPs use the same reporting forms to their owners as partnerships: the Schedule K-1. Should a state allow LLCs and LLPs to elect to be taxed as a corporation, as some states do, the form in which they elect to be taxed will determine the status to be used for qualified plan purposes.

The owners of an LLC are known as members. There is no limit to the number of owners in an LLC. Contrast this with an S corporation that may have no more than 100 shareholders.

§2.05 Ownership Issues

[A] 5% Owner

The Internal Revenue Code defines a **5% owner** as a person who owns more than 5 percent of the outstanding stock of the company. While this may appear straightforward on the surface, an individual who does not actually own stock may be treated as a 5% owner through attribution of ownership.

Attribution of ownership is the concept of treating an individual as owning an interest that he or she does not actually own. Attribution of ownership may be the result of a family relationship or a business relationship. Under IRC §318 an individual is attributed ownership in the stock owned by a spouse, children, grandchildren and parents. Since application of nondiscrimination testing and qualified plan rules revolve around the identities of 5% owners as determined under IRC §318, awareness of not just the actual owners of the employer but also their family ties to other employees is essential.

Please be aware the IRC §318 contains rules for attributing ownership both to and from organizations. Also a different set of attribution rules are used (IRC §1563) to determine businesses that may be considered under common control. These attribution rules are beyond the scope of this course.

§2.06 Common Control

In certain instances, common ownership of businesses can cause multiple businesses to be considered a single employer for purposes of applying qualified plan rules This common ownership is sometimes referred to as **common control**, and can either be in the form of a **controlled group** or an **affiliated service group (ASG)**. (These advanced topics are addressed at length in more advanced ASPPA courses.)

All employees of two or more trades or businesses under common control are treated as employed by a single employer for a host of plan qualification rules, among them minimum coverage standards, nondiscrimination testing, and maximum benefit limitations.

Understandably, then, common control situations can be one of the more difficult areas to monitor effectively. Clients tend to be unaware of the significant impact of the controlled group and affiliated service group rules, therefore most retirement plan professionals arm themselves with adequate information by annually requesting completion of detailed questionnaires disclosing all pertinent relationships. Only with current client information can there be any measure of assurance that the plan is being operated and administered according to the Internal Revenue Code and ERISA.

§2.07 Plan Fiduciaries

[A] Definition

Of the many individuals involved in the operation of a qualified plan, some are identified as fiduciaries while others may act under the direction of the fiduciaries.

According to ERISA, a **fiduciary** is any person who:

- Exercises any discretionary authority or control over the plan's management or the disposition of its assets;
- Renders investment advice with respect to plan funds or property for a fee or other compensation or has any authority or responsibility to render such advice; or
- Has any discretionary authority or responsibility in the administration of the plan.

It is important to note that these are functional definitions. A person or entity that performs these functions is a fiduciary, regardless of what his title is.

Every qualified plan must have at least one **named fiduciary** who has ultimate responsibility for operating the plan. The employer sponsoring the plan may be the named fiduciary; however, in many instances, officers of the corporation, as a committee, will act as the named fiduciary.

All plan fiduciaries are charged with acting for the exclusive benefit of the plan participants and beneficiaries, and for the exclusive purpose of providing benefits to those plan participants and beneficiaries.

[B] Ministerial Functions

Generally speaking, those who perform purely ministerial functions within the guidelines established by named fiduciaries are **not** plan fiduciaries. DOL regulations include the following as examples of ministerial functions:

- Applying rules to determine eligibility for plan participation or benefits;
- Calculating service and compensation for benefit purposes;
- Maintaining participants' service and employment records;
- Calculating retirement or termination benefits;
- Explaining the plan to new participants and advising participants of their rights and options under the plan;
- Collecting contributions and applying them as specified in the plan;
- Preparing reports covering participants' benefits;
- Processing claims; and
- Making recommendations to others for decisions with respect to plan administration.

The distinction between performing ministerial functions or working at the direction of a fiduciary and being a fiduciary cannot be overemphasized. Title I of ERISA sets forth strict standards of conduct for fiduciaries and avenues for enforcement against breaches of fiduciary duty. Under ERISA, fiduciaries are held personally liable for any direct misconduct on their own part, and may be held liable for actions taken by another fiduciary under co-fiduciary liability precepts.

[C] Named Fiduciaries

By nature of the duties that they perform, certain individuals or entities achieve named fiduciary status under the plan.

1. The plan sponsor, the entity that establishes the plan, is a fiduciary of the plan.

2. The **plan administrator** is specifically designated in the plan document and is responsible for managing the day-to-day activities of the plan. He or she is responsible for the following:

   - Hiring other service providers such as attorneys, accountants, and consultants (whose positions and duties are discussed later in this chapter);
   - Determining eligibility for plan participation, ownership or vesting, and earning benefits;
   - Advising participants or beneficiaries of their rights and distribution options;
   - Ruling on claims for benefits;
   - Directing the distribution of benefits;
   - Preparing reports for participants and to meet governmental requirements; and
   - Maintaining service, benefit, and benefit ownership records as well as other participant information.

   Note: Although many of these functions were listed as ministerial functions for others, the ultimate responsibility for their performance lies with the plan administrator.

3. The trustee is specifically named in the plan or trust documents, and its duties and responsibilities described therein. In general, the **trustee** holds legal title to the plan's assets and is responsible for the safeguarding and investment of those funds.

   When the plan names an individual employed by the plan sponsor as the trustee, such as a corporate officer, the plan is considered self-trusteed. Other plan sponsors prefer to retain a corporate trustee, usually a bank or other financial institution. The corporate trustee is known as an institutional trustee.

4. A plan may have a custodian. The **custodian** has possession of plan assets, but lacks any discretionary authority over the assets, the

administration or management of the plan. The custodian has no duty to recommend, select or approve investments and usually is not considered a fiduciary.

[D] Plan Administrator versus Pension Administrator

The terms plan administrator and pension administrator are often confused. The plan administrator is the designated person (or persons or entity) that has fiduciary responsibility under the plan. A pension administrator is generally **not** a fiduciary.

Pension administrators are hired, usually by the plan administrator, to provide purely ministerial services to the plan. Pension administrators work with all types of retirement plans, not just defined benefit and money purchase plans. To avoid confusion this course will use the term **retirement plan administrator** instead of pension administrator.

§2.08 Potential Fiduciaries and Others Associated with Plan Operations

Retirement plan administrators will collaborate with a number of other professionals who perform various services for their joint clients. Depending on the nature of their involvement with the plan, these fellow professionals may or may not be plan fiduciaries.

[A] Accountants

A plan administrator may employ an accountant to provide audited or unaudited financial statements and payroll information. As such, accountants may assist in the confirmation of the plan sponsor's taxpayer status, identification of owners and officers of the business, and serve as an additional source of knowledge regarding affiliated companies under common control.

At times, the accountant may be responsible for preparation of the plan's tax filing, the Form 5500. Additionally, plans with more than 100 participants generally must attach an independent accountant's opinion to the Form 5500, a service which might be provided by the plan's regular accountant if so qualified.

[B] Actuaries

Some retirement plan administration firms employ or retain enrolled actuaries to perform the required calculations and certify the various reports associated with defined benefit plans. Professionals in the area of statistics and probability, enrolled actuaries or pension actuaries have been specifically trained to apply those principles toward pension retirement plans. For example, actuaries determine the minimum, maximum, and required contributions for a defined benefit plan and certify those calculations by signing the Schedule B Actuarial Certification of the plan's Form 5500 filing.

Additionally, where a defined benefit plan is covered under the termination insurance program of the PBGC, an actuary will sign and certify the premium calculations. When an outside actuary is retained, it is possible the retirement plan administration firm may prepare all calculations for the actuary's review and approval.

[C] Attorneys

Depending on the nature of the engagement with the client, the responsibilities of the client's attorney may extend from providing an interpretation of the Internal Revenue Code or ERISA and advice regarding application of plan provisions for compliance with those statutes, through creating the legal plan documents, summary plan descriptions, and other employee disclosures and election forms. Attorneys also may be involved in preparing the forms required when requesting an IRS review of the plan for qualification purposes and be designated as the plan sponsor's representative.

Additionally, the client's attorney is typically consulted during plan level changes such as a plan termination or plan merger, or sponsor level changes such as a change in ownership or tax structure.

[D] Consultants

Any number of consultants are available to assist the plan administrator with the operation of the plan. Retirement plan professionals, insurance agents, financial advisors, brokers, and communication consultants all provide services for fees or commissions.

Predominantly, consultants offer services previously identified as ministerial functions. In practice, the consultant may be considered a fiduciary depending on the authority given to him or her by the plan administrator or may become a fiduciary as a result of the actions taken. An example would be a retirement plan administration firm that provides such a broad range of administrative services to the plan that the participants believe the firm is the plan administrator. Retirement plan administration firms must be wary of unintentionally extending their contracted services into the realm of discretionary authority over the plan and its operation unless they want to be considered plan fiduciaries.

[E] Investment Advisors

The size of the plan, the financial sophistication of the plan sponsor, the nature of the plan's assets, and the complexities of the plan's investment policy, will often dictate the number of investment advisors (financial consultants, brokers, investment managers or insurance agents) a plan administrator may engage. The investment advisors may direct, handle, and oversee the plan's assets or provide investment advice for plan participants.

[F] Parties-in-Interest

The term parties-in-interest has specific application within the context of plan qualification and operational compliance with the Internal Revenue Code and ERISA. (The Internal Revenue Code refers to such parties as disqualified persons.) One of the fundamental requirements for any plan to be considered qualified for tax purposes is that it be established and maintained by the employer for the exclusive benefit of its employees or their beneficiaries.

Thus certain dealings between the plan and parties-in-interest are expressly prohibited. These are described as **prohibited transactions**, and include, for example, the plan sponsor selling property to or purchasing property from the plan. Where specific transactions have been allowed by the DOL, such as loans to participants from their accounts, the transactions are noted as performed under a prohibited transaction exemption (PTE).

Prohibited transactions result in notification requirements to the IRS and payment of an excise tax or taxes. Should the employer fail to notify the IRS and correct the transaction in a timely manner, the plan may be subject to the most severe penalty: disqualification under the Internal Revenue Code and ERISA. For this reason, understanding which persons are parties-in-interest is vital. (Prohibited transactions are topics covered further in more advanced ASPPA courses.)

The following are considered **parties-in-interest** to the plan:

- Any plan fiduciary;
- A person providing services to the plan;
- An employer that has employees covered by the plan;
- An owner, direct or indirect, of 50% or more of the employer;
- Members of the family of any person listed above;
- An employee organization, such as a union, any of whose members are covered by the plan;
- A corporation, partnership, estate or trust that is 50% or more owned by a person listed above;
- Officers, directors, 10% or more owners and employees of the employer or employee organization;

- A 10% or more partner or joint venture with one of the people listed in some, but not all, of the categories above;
- Counsel to a plan; and
- An employee of the plan.

§2.09 Key Terms

5% Owner: Any person who owns, directly or indirectly, more than 5 percent of the stock of the employer. If the employer is not a corporation, the ownership test is applied to the person's capital or profit interest in the employer.

Affiliated Service Group: Two or more related service or management organizations, whether or not incorporated. Employees of the members of an affiliated service group are treated as employed by a single employer for plan qualification purposes.

Attribution: The concept of treating an individual as owning an interest that he or she does not actually own. Attribution of ownership may be the result of a family relationship or a business relationship.

C Corporation: An entity formed by business associates to conduct a business venture and divide profits among investors. It files a charter or articles of incorporation in a state, draws up bylaws, issues stock, and has its affairs managed by a board of directors.

Common Control: All employees of corporations that are members of a controlled group of corporations are treated as employed by a single employer for purposes of plan qualification. A comparable requirement applies to partnerships, sole proprietorships and other businesses under common control.

Controlled Group: The three types of controlled groups are (1) the parent-subsidiary controlled group, (2) the brother-sister controlled group, and (3) the combined group. All employees of the corporations that are members of a controlled group of corporations are treated as employed by a single employer for plan qualification purposes.

Corporation: An entity formed by business associates to conduct a professional venture and divide profits among investors. It files a charter or articles of incorporation within a state or states, and consequently becomes subject to the laws of those states as well as federal law.

Custodian: The organization (usually a bank or trust company) that holds in safekeeping the securities and other assets of a plan.

Fiduciary: Any person (individual or corporation) who exercises discretionary authority or control over the management or disposition of plan assets, renders investment advice for a fee or has discretionary authority or responsibility for the plan administration.

Limited Liability Company (LLC): Created under state laws governing their formation. These entities offer limited liability to their members but are generally taxed as partnerships and not corporations.

Limited Liability Partnership (LLP): Created under state laws governing their formation. These entities offer limited liability to the partners.

Named Fiduciary: A fiduciary that is named in the plan instrument or identified through a procedure set forth in the plan. One of the distinguishing features of the named fiduciary is that he or she has the authority to designate others to carry out fiduciary responsibilities (e.g., invest the plan funds).

Partnership: Partners are taxed as individual taxpayers as a partnership is not taxable as a separate entity. The treatment of liability for the debts of the partnership, including required contributions to the qualified plans, is passed through the partnership to the individual partners

Party-in-Interest: An ERISA term used to identify individuals when applying the prohibited transaction rules.

Pension Administrator: See Retirement Plan Administrator.

Prohibited Transactions: Specified transactions that may not be entered into (directly or indirectly) by a party-in-interest with the plan. Those include, for example, sales or exchanges, leases, and loans between the parties. The DOL has exempted specific transactions from the prohibited transaction restriction.

Plan Administrator: A person, group or entity specifically designated in the plan document as responsible for managing the day-to-day activities of the plan.

Plan Sponsor: The entity that establishes the plan. Note that the terms employer and plan sponsor are frequently used interchangeably, but are separate concepts.

Retirement Plan Administrator: A person, group or entity hired, usually by the plan administrator, to provide purely ministerial services to the plan.

S Corporation: A corporation whose shareholders have elected not to be taxed as a regular (or "C") corporation, but like a partnership. Profits and losses pass through directly to the shareholders rather than being taxed at the corporate level.

Sole Proprietor: An individual who owns 100% of an unincorporated business. Also referred to as self-employed persons.

Trustees: The parties named in the plan or trust documents that are authorized to hold the assets of the plan for the benefit of the participants. The trustees may function merely in the capacity of a custodian of the assets or also may be given authority over the investment of the assets. Their function is determined by the trust instrument or, if no separate trust agreement is executed, under the trust provisions of the plan.

§2.10 Review of Key Concepts

- The plan sponsor is the entity that establishes a plan.
- All sole proprietors are self-employed but not all self-employed individuals are sole proprietors.
- Partnerships generally pass through earnings or losses to the partners. The partners then report the income on their individual tax returns.
- An S corporation generally passes through earnings or losses to its owners, thus avoiding the double taxation of C corporations.
- The Internal Revenue Code defines a 5% owner as a person who owns more than 5 percent of the outstanding stock of the company.
- In general, an individual is attributed ownership in the stock owned by certain family members.
- A controlled group may exist if an individual has common ownership in more than one business.
- A plan fiduciary:
    1. Exercises discretionary authority over the management of the plan or the disposition of plan assets;
    2. Receives compensation for rendering investment advice; or
    3. Has discretionary authority or responsibility in plan administration.

- Those who perform purely ministerial functions for a plan are **not** fiduciaries.

- Certain individuals associated with the plan may be considered parties-in-interest with respect to the plan, and therefore may not engage in certain types of prohibited transactions, which would violate ERISA's exclusive benefit rule.

§2.11 Review Questions

[A] True or False

______ 1. An enrolled actuary determines the minimum and maximum contribution for an ESOP.

______ 2. Common control is sometimes referred to as common ownership and can take the form of a controlled group or an affiliated service group.

______ 3. An individual who owns more than 5 percent of a business is considered a 5% owner.

______4. If two businesses are under common control, the businesses are considered a single employer for purposes of applying the qualified plan rules.

______ 5. A prohibited transaction is a transaction between the plan and a party-in-interest.

______ 6. A partnership is taxable as a separate entity.

______ 7. A person performing ministerial functions is generally considered a fiduciary.

[B] Multiple Choice

8. All of the following entities may sponsor a retirement plan, EXCEPT:

   A. A trust
   B. A local government
   C. A corporation
   D. A sole proprietor
   E. A limited liability partnership

9. All of the following are considered 5% owners under IRC §318, EXCEPT:

   A. A person who owns 10% of the business
   B. The spouse of a person who owns 50% of the business
   C. The parent of a person who owns 1% of the business
   D. The child of a sole proprietor
   E. The partner who owns 50% of the business

10. All of the following are automatically parties-in-interest, EXCEPT:

    A. A named beneficiary for a plan participant
    B. A spouse of the 100% owner of the plan sponsor
    C. Counsel to the plan
    D. An officer of the employer organization
    E. A person providing services to the plan

11. All of the following are duties of the plan administrator, EXCEPT:

    A. Hire plan service providers such as the attorney
    B. Rule on benefit claims
    C. Determine eligibility rules
    D. Draft the articles of incorporation
    E. Direct distribution of benefits

12. All of the following are considered fiduciaries, EXCEPT:

    A. A paid investment advisor who renders advice regarding plan funds
    B. A trustee who has discretionary authority to sell assets
    C. A spouse of a participant
    D. A plan administrator who is named in the plan document
    E. A plan sponsor

13. All of the following statements regarding plan service providers are TRUE, EXCEPT:

    A. The enrolled actuary may determine the minimum and maximum contribution for a defined benefit plan.
    B. The investment advisor may provide investment advice to plan participants.
    C. The attorney may interpret the retirement plan provisions of the Internal Revenue Code.
    D. The accountant may prepare audited financial statements.
    E. The retirement plan professional may adopt the plan.

14. All of the following statements regarding plan compensation for business owners are TRUE, EXCEPT:

    A. Dividends paid to the owner of a C Corporation are included as eligible compensation.
    B. W-2 earnings received by the owner of an S Corporation are included as eligible compensation.
    C. Schedule C income is the basis for determining compensation for a sole proprietor.
    D. Schedule K-1 income is the basis for determining compensation for a partner in a limited liability partnership.
    E. W-2 earnings received by the owner of a C Corporation are included as eligible compensation.

§2.12 Answers

1. **False**. An enrolled actuary determines the minimum and maximum contribution for a defined benefit plan. §2.08 [B]

2. **True**. Common control is sometimes called common ownership and can take the form of a controlled group or an affiliated service group. §2.06

3. **True**. A 5% owner is defined as an individual who owns more than 5 percent of a business. §2.05 [A]

4. **True**. Two businesses under common control are considered a single employer for plan purposes. §2.06

5. **True**. A prohibited transaction is a transaction between the plan and a party-in-interest. §2.08 [E]

6. **False**. A partnership is not taxable as a separate entity. The partners are taxed as individual taxpayers. §2.04 [B]

7. **False**. Generally those who perform purely ministerial functions are not plan fiduciaries. §2.07 [B]

8. The correct answer is **A.** §2.03 [A]

   A. Correct. This statement is false because a trust is not an entity that may sponsor a retirement plan.
   B. Incorrect. This statement is true a local government may sponsor a retirement plan.
   C. Incorrect. This statement is true because a corporation may sponsor a retirement plan.
   D. Incorrect. This statement is true because a sole proprietor may sponsor a retirement plan.
   E. Incorrect. This statement is true because a limited liability partnership may sponsor a retirement plan.

9. The correct answer is **C**. §2.05 [A]

   A. Incorrect. This statement is true because a person who owns 10% of the business is considered a 5% owner.
   B. Incorrect. This statement is true because the spouse of a person who owns 50% of the business is considered a 5% owner.
   C. Correct. This statement is false because the parent of a person who owns 1% of the business is not considered a 5% owner.
   D. Incorrect. This statement is true because the child of a sole proprietor is considered a 5% owner.
   E. Incorrect. This statement is true because the partner who owns 50% of the business is considered a 5% owner.

10. The correct answer is **A**. §2.08 [F]

   A. Correct. This statement is false because a named beneficiary for a plan participant is not necessarily a party-in-interest.
   B. Incorrect. This statement is true because a spouse of the 100% owner of the plan sponsor is a party-in-interest.
   C. Incorrect. This statement is true because counsel to the plan is a party-in-interest.
   D. Incorrect. This statement is true because an officer of the employer organization is a party-in-interest.
   E. Incorrect. This statement is true because a person providing services to the plan is a party-in-interest.

11. The correct answer is **D**. §2.07 [D]

   A. Incorrect. This statement is true because hiring plan service providers such as the attorney is a duty of the plan administrator.
   B. Incorrect. This statement is true because ruling on benefit claims is a duty of the plan administrator.
   C. Incorrect. This statement is true because determining eligibility rules is a duty of the plan administrator.
   D. Correct. This statement is false because drafting the articles of incorporation is not a duty of the plan administrator.
   E. Incorrect. This statement is true because directing distribution of benefits is a duty of the plan administrator.

12. The correct answer is **C**. §2.07 [A]

    A. Incorrect. This statement is true because a paid investment advisor who renders advice regarding plan funds is a fiduciary.
    B. Incorrect. This statement is true because a trustee who has discretionary authority to sell assets is a fiduciary.
    C. Correct. This statement is false because a spouse of a participant is not necessarily a fiduciary.
    D. Incorrect. This statement is true because a plan administrator who is named in the plan document is a fiduciary.
    E. Incorrect. This statement is true because a plan sponsor is a fiduciary.

13. The correct answer is **E**. §2.08

    A. Incorrect. This statement is true because the enrolled actuary may determine the minimum and maximum contribution for a defined benefit plan.
    B. Incorrect. This statement is true because the investment advisor may provide investment advice to plan participants.
    C. Incorrect. This statement is true because the attorney may interpret the retirement plan provisions of the Internal Revenue Code.
    D. Incorrect. This statement is true because the accountant may prepare audited financial statements.
    E. Correct. This statement is false because the plan sponsor not the retirement plan professional adopts the plan.

14. The correct answer is **A**. § 2.04

    A. Correct. This statement is false because dividends paid to the owner of a C Corporation are not included as eligible compensation.
    B. Incorrect. This statement is true because W-2 earnings received by the owner of an S Corporation are included as eligible compensation.
    C. Incorrect. This statement is true because Schedule C income is the basis for determining compensation for a sole proprietor.
    D. Incorrect. This statement is true because Schedule K-1 income is the basis for determining compensation for a partner in a limited liability partnership.
    E. Incorrect. This statement is true because W-2 earnings received by the owner of a C Corporation are included as eligible compensation.

Chapter 3:
Defined Contribution Plans

§3.01 Learning Objectives

- List the general characteristics of each type of defined contribution plan.
- Define elective deferrals, designated Roth contributions and catch-up contributions.

§3.02 Introduction

There are many types of defined contribution plans. These plans maintain a separate account for each individual participant. Each of these plans defines the contribution amount to be deposited into the participant's account. The participant bears the investment risk because there is no promised benefit to be paid at retirement like in a defined benefit plan.

This chapter will describe some of the features of the following types of defined contribution plans, including:

- Profit Sharing and 401(k) Plans;
- SIMPLE Plans;
- Money Purchase and Thrift Plans;
- Stock Bonus and Employee Stock Ownership Plans;
- Target Benefit Plans; and
- Other types of tax-advantaged arrangements.

The tax-advantaged arrangements which are broadly described in this section are not an exhaustive list. They are merely provided as examples of some of the available types of tax-advantaged arrangements and to enhance an understanding of the spectrum of retirement program options open to consideration by employers.

§3.03 Profit Sharing Plans

[A] Profit Sharing Plans

Through a **profit sharing plan**, employees can be rewarded with a share in the employer's revenue, which was generated in part due to their efforts. The employer may exercise discretion over the amount contributed to the plan each year and need not base the contribution on actual profits. Accordingly, the plan does not have to state explicitly what amount will be contributed each year, but it must contain a specific formula for allocating any contribution made to participants.

Example 3-1. Profit Sharing Allocation. An employer contributes $40,000 to its profit sharing plan for the current year. The allocation formula states that a participant will share in the contribution in proportion to his or her compensation. If the sum of compensation for all plan participants eligible to share in the profit sharing contribution is $500,000 and a participant's individual compensation is $50,000, he or she will be allocated 10% ($50,000/$500,000) of the employer contribution, or $4,000.

Thus, an employer often selects a profit sharing plan for its employees because it can determine each year how much to contribute to the plan based on its financial condition. The employer may decide not to make a contribution for a particular year should the business climate be less than fruitful with little or no profits, or when the income is needed for other business expenses.

Although the employer has no fixed annual contribution commitment under a profit sharing plan, profit sharing contributions must be substantial and recurring in order to prevent the plan from being considered a terminated plan.

Although the employer can choose the amount of the profit sharing contribution each year, the maximum amount the employer can deduct on its tax return is 25% of the total eligible compensation of all participants.

[B] 401(k) Plans

In order to encourage employees to actively save for their retirement and to bolster utilization of and appreciation for employer plans, today numerous employers are sponsoring the very popular Internal Revenue Code §401(k) salary deferral plan. Having the perhaps dubious distinction of being more commonly and widely known by its Internal Revenue Code Section number than its descriptive name, this type of profit sharing plan with a qualified **cash or deferred salary arrangement (CODA)** is referred to by the public and practitioner alike as a **401(k) plan**.

<u>1. Elective Deferrals</u>

The CODA or 401(k) feature of a profit sharing plan permits employees to elect to defer part or in rare cases all of their compensation into the 401(k) plan on a pre-tax basis instead of receiving these sums as taxable income. These contributions are alternately known as employee elective salary deferrals, elective contributions, employee salary deferrals, elective deferrals, or simply salary deferrals. In general, we will refer to these contributions throughout this course as **elective deferrals**.

Since they are contributed to the plan on a pre-tax basis, these elective deferrals reduce the current taxable income of the employee for federal, and in most cases, state income tax purposes. Notably, an elective deferral does not reduce compensation for Social Security taxes (FICA) or Federal Unemployment Taxes (FUTA).

Each employee is subject under IRC §402(g) to an individual limit regarding the total amount he or she can contribute as elective deferrals to all 401(k) plans in which he or she participates during a calendar year.

For example, if an individual worked for two different employers during the calendar year and contributed into each employer's 401(k) plan, the limit would apply to the individual's combined elective deferrals into both employers' plans for that calendar year. As such, the limit is not specific to the plan but rather is specific to the individual. This maximum elective deferral amount is sometimes called the 402(g) dollar limit**.**

In accordance with the Internal Revenue Code, the maximum elective deferral limit is adjusted annually for cost-of-living increases under a procedure called indexing, or it may be set at a new level as part of a legislative change. For 2007, $15,500 is the maximum elective deferral amount that an individual can contribute into all 401(k) plans under which he or she is eligible to participate during the 2007 calendar year. Future limits will increase as dictated by inflation (indexed) in $500 increments.

Please refer to Appendix A for a summary of the various plan limits, including limits on elective deferrals in 401(k) plans.

<u>2. Catch-Up Contributions</u>

In recognition of changing social times and the increasing importance of the employer-sponsored retirement plan leg of the three-legged stool, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added a Section to the Internal Revenue Code which allows a qualified plan to permit **catch-up contributions** as additional contributions by certain older plan participants. In order to make a catch-up contribution for a calendar year, a participant must be at least age 50 by the end of that calendar year.

Catch-up contributions are elective deferrals that exceed an applicable deferral limit. Therefore, an elective deferral is classified as a catch-up contribution when the participant who is catch-up eligible has reached a limit in the law or in the plan.

One event that would cause an elective deferral to be classified as a catch-up contribution would be having deferred the maximum amount allowed by the Internal Revenue Code, such as the maximum elective deferral limit discussed above. Another event would be reaching a limit imposed by the plan itself, such as a plan provision which prohibits a participant from deferring more than 10% of his or her compensation.

Having been limited in this manner and prevented from deferring as much as a participant might wish to defer into the 401(k) plan, if the plan so allows, an eligible participant could catch-up to where he or she wished to be financially by making an additional, allowable contribution up to the catch-up contribution limit.

Example 3-2. IRC §402(g) Limit. Jason, age 51, defers the $15,500 maximum elective deferral for 2007 into his employer's plan. Having earned $45,000 for the year, he decides to contribute another $5,000 into the plan as the maximum allowable catch-up contribution. In total, $20,500 will be credited to his individual account under the 401(k) plan for the year.

Example 3-3. Plan Limit. Susan, age 52, earned $50,000. The plan has a 10% limit on the percent of compensation that can be deferred. Thus, Susan can contribute a $5,000 maximum elective deferral and a catch-up contribution of another $5,000 for 2007.

Please refer to Appendix A for a summary of the various plan limits, including catch-up contribution limits in 401(k) plans.

3. Designated Roth Contributions

Starting January 1, 2006 a 401(k) plan may accept designated Roth contributions. This is another option employees can use to save for their retirement. **Designated Roth contributions** are considered elective deferrals except that they are made on an after-tax basis to a 401(k) or 403(b) plan.

The earnings generated by the designated Roth contributions are tax free when distributed if the distribution is made

- after the participant is age 59½, and
- five years after the first designated Roth contribution was contributed to the 401(k) plan.

A participant in a plan that has been amended to allow designated Roth contributions will have the opportunity to designate whether elective deferrals are designated Roth contributions, pre-tax elective deferrals, or a combination (e.g. a portion of the elective deferral is after-tax and a portion is pre-tax.).

The designated Roth contributions are subject to the same limit as pre-tax elective deferrals. The designated Roth contribution plus the pre-tax elective deferrals together cannot exceed $15,500 for 2007. In addition, participants who are catch-up eligible may make an additional $5,000 catch-up contribution as a designated Roth contribution, a pre-tax elective deferral, or a combination.

A separate account will be set up in the 401(k) plan to track the designated Roth contributions from the pre-tax elective deferrals and from any after-tax employee contributions that are not designated Roth contributions.

4. Matching Contributions

In conjunction with elective deferrals and to encourage participants to defer at higher levels into the 401(k) plan, the employer may choose to make **matching contributions** that match all or part of the employee's pre-tax elective deferrals and designated Roth contributions.

For example, an employer may contribute 50% (or match $.50 for each $1.00 deferred) up to the first 6% of compensation the employee defers to the 401(k) plan. In this example, the employer knows its maximum cost for matching contributions to the 401(k) plan is 3% of the compensation of eligible participants (50% of 6% of compensation) and can make the appropriate budget provisions for paying the employer match into the plan.

Example 3-4. Matching Contribution. George earns $25,000 and defers $2,500 into his company retirement plan for 2007. Using the above formula, George will receive an employer matching contribution of $750 (the lesser of $2,500 x 50% or $25,000 x 6% x 50%).

<u>5. Nonelective Contributions</u>

Since the CODA or 401(k) arrangement is actually a feature of a profit sharing plan, the employer also may elect to make a discretionary contribution under the profit sharing provisions of the plan. All employer contributions to 401(k) plans, other than elective deferrals and matching contributions, are known as **nonelective contributions**.

Employer nonelective contributions are subject to nondiscrimination testing rules under the Internal Revenue Code to demonstrate that they do not provide disproportionately greater benefits to the highly compensated employees, a group which typically includes owners and highly paid employees of the employer.

Elective deferrals, designated Roth contributions, employer matching contributions, and any after-tax employee contributions to the plan, if allowed, must also comply with special nondiscrimination rules.

§3.04 SIMPLE Plans

Savings Incentive Match Plans for Employees (SIMPLEs) were created by the Small Business Job Protection Act of 1996 (SBJPA) and could be adopted for the plan years beginning on or after January 1, 1997. Designed to address the needs of small businesses and intended to simplify qualified plan administration for their sponsors, a SIMPLE must be the only plan sponsored by the employer, and only employers with 100 or fewer employees may utilize SIMPLEs.

All SIMPLE plans are exempt from nondiscrimination testing provided the employer makes the required contributions. As a caution created by their similar names, SIMPLE plans should not be confused with Simplified Employee Pensions (SEP). (SEPs are discussed later in this chapter along with other Tax-Advantaged Arrangements.)

There are two types of SIMPLEs: SIMPLE IRAs and SIMPLE 401(k) plans. Please refer to Appendix A for a summary of the various plan limits, including those limits applicable to SIMPLE plans. Also refer to Appendix B for a comparison of SIMPLE IRAs to SIMPLE 401(k) plans.

[A] SIMPLE IRAs

Most of us are familiar with the concept of an **Individual Retirement Account (IRA)**: a personal savings account established by an individual for the purpose of accumulating retirement tax favored income. A **SIMPLE IRA** is a particular type of IRA that may be maintained only in conjunction with an employer-sponsored arrangement.

Under SIMPLE IRAs:

- Any employee who receives $5,000 in compensation during any two of the preceding years and is expected to earn at least $5,000 during the current year must be eligible to enter the plan (this does not apply to collectively-bargained employees).
- Pre-tax employee contributions (elective deferrals) are allowed. After-tax employee contributions are not allowed. Catch-up contributions may be permitted.
- The employer must make either a matching contribution of 100% of each employee's contribution (up to 3% of compensation) or an employer nonelective contribution of 2% of compensation to all eligible employees. While the matching contribution only goes to those eligible employees who contribute, the nonelective contribution must go to all eligible employees regardless of whether they chose to make elective deferrals.
- The employer deposits each employee's elective deferral and employer contribution amounts into the employee's IRA.
- All contributions must be 100% vested; that is, they must be fully owned by the participant at the time of their contribution into the plan.
- Participants may make withdrawals at any time; however, there are tax consequences depending on when the withdrawal is made.
- Loans to plan participants from their accounts are not allowed.
- The plan year for a SIMPLE IRA must be the calendar year.
- SIMPLE IRAs require minimal recordkeeping.
- The plan is not required to file Form 5500, an annual return/report, with the Department of Labor (DOL).
- The maximum limitations on benefits, also called the annual additions limit, do not apply.

[B] SIMPLE 401(k) Plans

A **SIMPLE 401(k)** is a type of 401(k) plan that permits only certain types of contributions and that does not require nondiscrimination testing, including top-heavy testing.

Under SIMPLE 401(k) plans:

- Classes of employees can be excluded from participating in a SIMPLE 401(k), provided that the minimum coverage rules are satisfied.
- Pre-tax employee contributions (elective deferrals) are allowed. After-tax employee contributions are not allowed. Catch-up contributions may be permitted.
- The employer must make either a matching contribution of 100% of the first 3% of compensation deferred or an employer nonelective contribution of 2% of compensation to all eligible employees. While the matching contribution only goes to those eligible employees who contribute, the nonelective contribution must go to all eligible employees. The employer deposits employee and employer contributions in the same manner as regular 401(k) plans.
- All contributions must be 100% vested; that is, they must be fully owned by the participant at the time of their contribution to the plan.
- Withdrawals are subject to the same withdrawal rules as traditional 401(k) plans.
- Loans to participants from their accounts are allowed.
- The plan is required to file Form 5500, an annual return/report, with the Department of Labor (DOL).
- The maximum limitations on benefits, also called the annual additions limit, apply.

§3.05 Money Purchase Plans

[A] Money Purchase Plans

From the participant's perspective, a **money purchase plan** looks very similar to a profit sharing plan in that both are individual account plans. The differences, however, are substantial. While an employer may decide each year what level of profit sharing contribution it wishes to make, if any, a money purchase plan obligates the employer to contribute a specific amount or percentage of the participants' compensation to the plan each year. The specific contribution formula is written into the plan document, and the contribution is required to be made under the IRC §412 known as the **minimum funding requirement**.

Failure by the employer to meet the contribution or funding requirement will result in a 10% excise tax on the minimum funding deficiency payable by the employer. This amount is in addition to the required money purchase contribution.

Therefore, in designing a money purchase plan contribution formula, employers must be confident that they will be able to contribute the required amount on an on-going basis and should set the contribution level accordingly. For minimum funding purposes the contribution is generally due 8½ months after the close of the plan year. This deadline may be different than the contribution due date for deductibility purposes.

In most money purchase plans, the method for allocating the contribution to a participant's account is the same as the contribution formula. But, they do not have to be the same. For example, the contribution formula might be 5% of the total eligible compensation of all plan participants. Once the dollar amount of the contribution for the year has been determined, it could be allocated to the participants based on their age and service years, or in such a manner as to consider the Social Security taxes an employer pays on behalf of a participant.

Therefore, the plan document should be scrutinized to determine whether the contribution formula and the allocation formula are the same.

Example 3-5. Money Purchase Allocation. Sam earns $30,000 from ABC Company, sponsor of a money purchase plan that contains a contribution formula of 10% of eligible compensation. The plan's allocation formula is the same as the contribution formula. Sam's required allocation for the year would be $30,000 x 10% = $3,000.

The employer contribution formula generally will not exceed 25% of compensation, as that is the maximum deduction limit for the employer.

At this point, one might ask why employers should choose a money purchase plan which would lock them into making a required and fixed level of contribution yearly, when profit sharing plans also have a 25% maximum deduction limit and offer flexibility in determining the amount of contribution to be made each year.

A first supportive argument would be offered by current and potential employees, who would be made much happier if granted a fixed, regular money purchase contribution allocation into their accounts each year rather than experiencing the uncertainties surrounding a discretionary profit sharing contribution. However, a profit sharing plan could also be designed with a fixed contribution requirement.

Setting workforce considerations aside, part of the answer to the money purchase versus profit sharing debate is historical in nature. Prior to

EGTRRA, profit sharing plans were subject to a maximum deduction limit of 15% of eligible compensation. Therefore, before 2002, if an employer wished to contribute and deduct more than 15% of compensation and did not desire a defined benefit plan, that employer typically chose a money purchase plan design or a money purchase plan with a low, affordable fixed contribution amount in tandem with a profit sharing plan that would provide additional contribution flexibility up to the overall 25% of compensation maximum deduction limit.

Post-EGTRRA, now that the profit sharing plan alone can achieve the 25% maximum deduction limit, the usefulness of money purchase plans has diminished, and accordingly many of them have since been terminated or merged into their companion profit sharing plans to generate an additional savings on plan administration for one plan rather than two.

[B] Thrift Plans

Under the Internal Revenue Code, a **thrift plan** (or thrift savings plan) may be a money purchase or profit sharing plan. To participate in a thrift plan and receive a money purchase or profit sharing contribution allocation, an employee is required to make **after-tax employee contributions**. These are sometimes referred to as mandatory contributions. Since these are contributions made from the employee's net income after taxes, there is no reduction in the current taxable income of the participant, as compared to the effect of elective deferrals under a 401(k) plan.

As with all employee elective deferrals or after-tax employee contributions, the employee's thrift plan contributions are considered fully owned by the employee at the time of their contribution to the plan; that is, they are always 100% vested.

The employer's money purchase or profit sharing contributions are used to match the participating employee's mandatory contributions. The plan document generally explains to what extent the employer has agreed to match employee contributions; an example formula would be a $.50 match for each $1.00 of the participating employee's required contribution. Employers also may be allowed by the plan to make contributions in addition to the employer match amounts.

Despite the incentive of receiving an allocation of the employer contribution, not all employees will be able to or will choose to participate in the thrift plan by contributing on an after-tax basis. Consequently, the funding cost to the plan sponsor of a thrift plan is usually less than that of a traditional profit sharing or money purchase plan. Unfortunately, there is no lessening of nondiscrimination costs given that after-tax employee contributions and employer matching contributions in thrift plans are subject to the same special nondiscrimination test as 401(k) plans containing the same types of contributions.

In light of these similar nondiscrimination testing requirements, the same general limit on deductibility of employer contributions, and the stated preference of most employees for the current tax savings generated by contributing on a pre-tax rather than an after-tax basis, it is understandable that thrift plans have become far less common since the introduction of the 401(k) plan.

§3.06 Stock Bonus Plans

[A] Stock Bonus Plans

A **stock bonus plan** is a profit sharing plan that generally distributes shares of company stock as benefits to terminated or retired participants. As a profit sharing plan type, stock bonus plans are allowed to have discretionary contribution formulas, and employers have the option of contributing in the form of cash or company stock. When cash contributions are made to the plan, they are normally then used to purchase company stock under the plan. If cash distributions are allowed by the plan, and the company stock is not a public stock that may be traded on the open market, participants have the right to sell their shares back to the company for cash.

[B] Employee Stock Ownership Plans (ESOPs)

An **employee stock ownership plan (ESOP)** may be either a stock bonus plan, with a discretionary contribution formula, or a combination stock bonus and money purchase plan, wherein the required minimum funding amount is intended to be contributed in the form of or used to purchase company stock.

A portion of a plan, such as an employer stock investment within the 401(k) feature of a profit sharing plan, also may be designated as an ESOP. To qualify as an ESOP, a plan or portion of a plan must be designed to be invested primarily in the stock of the employer (primarily is generally interpreted to mean a more than 50% investment).

An essential difference between a traditional stock bonus plan and a stock bonus plan which has been established as an ESOP lies in the ESOP's ability to borrow money to purchase company stock. The purchased shares represent the collateral on the ESOP loan. Thereafter, the employer's cash contributions to the ESOP are used as loan repayments, and as these payments are made those shares released from their status as loan collateral are allocated to the individual accounts of the ESOP participants.

Other ESOP incentives lie in tax advantages such as the potential deductibility of dividends paid on shares contributed to the ESOP and the inherent value of employees steadily becoming shareholders of their employer. An ESOP may be used as a method to transfer ownership of a company to its employees, to create a market for privately-held employer stock, and to generate cash flow for the employer to finance its growth.

As one might imagine, there are several unique rules that further set the ESOP apart from profit sharing plans. Examples of these are rules governing share voting rights, participant distributions, diversification of company stock investments for older participants, and tax deductibility surrounding contributions and interest payments on ESOP loans.

It also should be noted that investment of plan assets in company stock does not automatically create a stock bonus plan or ESOP, and other types of plans may invest in employer stock. For example, defined benefit and target benefit plans may have up to 10% of assets invested in employer stock. A key distinction here is that these plans are not intended to distribute benefits chiefly in the form of company stock, as is the case with stock bonus plans and ESOPs.

ESOPs are quite complex and therefore are discussed in more detail in advanced ASPPA courses.

§3.07 Target Benefit Plans

Target benefit plans are defined contribution plans that contain a benefit formula similar to that of a defined benefit plan and, consequently, are often considered to be a cross between a defined benefit plan and a defined contribution plan. As with all defined contribution plans, the employer does not promise or guarantee the amount to be paid at retirement under a target plan. The target, or assumed, benefit is used only for determining the amount of the employer contribution.

Each participant’s individual account in a target benefit plan is credited with allocated contributions and investment gains or losses. The benefit paid to the participant at retirement will only be the benefit that can be provided by the participant’s actual account balance at retirement. In this sense, the target benefit is aptly named; it serves only as the intended benefit, and reality as measured by the participant’s individual account will determine whether that targeted benefit is achieved, missed or surpassed.

The ages of the participants are key factors in determining the amount of the contribution allocated to each participant. By using the number of years remaining before a participant reaches retirement age under the plan as part of the contribution calculation, the allocations of contributions reflect the fact that older employees have less time to take advantage of compounding earnings. Because older employees receive larger contributions relative to their compensation as the result of the age-related allocation, the target plan appeals to the older segment of the workforce.

In contrast, the allocation of contributions in a money purchase plan is usually based solely on compensation. This means that money purchase allocations for employees with identical compensation are the same despite their differing ages.

In all other respects, the target benefit plan operates as a money purchase plan. The plan sponsor must meet the minimum funding requirements and, therefore, a contribution is required each year. Participants receive individual account statements that reflect the contribution and earnings activity for the reporting period; they are subject to the identical maximum benefit limitations; and the employer's maximum deduction limit is the same.

In summary, target benefit plans are often attractive because such plans allow an employer to avoid the complicated funding and benefit crediting rules of defined benefit plans while striving to provide a certain targeted level of retirement income to participants.

§3.08 Other Types of Tax-Advantaged Arrangements

Tax-Sheltered Annuities (TSA), Individual Retirement Accounts (IRA), Simplified Employee Pensions (SEP) and 457 plans are other forms of tax-advantaged arrangements. Their operation is similar to that of defined contribution plans.

[A] Tax-Sheltered Annuities (403(b) Plans)

Tax-Sheltered Annuities (TSAs) are distinguished by the nature of their eligible plan sponsors: only certain employers such as charitable foundations or educational organizations operated by a state may sponsor a TSA. Prior to the Small Business Job Protection Act of 1996 (SBJPA), which removed the prohibition against tax-exempt organizations establishing 401(k) plans, TSAs were often thought of as a not-for-profit organization's version of a 401(k) plan since TSAs may allow for elective deferrals and employer matching contributions.

The annuity portion of its name derives from the original, historical requirement that contributions had to be invested in annuity contracts, which generally were purchased from an insurance company. That is, in exchange for the current amount of contribution, the insurance company would pay future benefits to the participant in the form of an annuity. Today, other types of investments such as mutual funds held in custody for the benefit of the participants also are allowed.

Notably, the Section of the Internal Revenue Code which governs TSAs (IRC §403(b)) differs from the Section that defines a qualified plan, and thus while there are many parallel requirements between the two Sections, there are intrinsic differences as well.

[B] Individual Retirement Accounts (IRAs) and Simplified Employee Pensions (SEPs)

Individual Retirement Accounts (IRAs) and **Simplified Employee Pensions (SEPs)** are spoken of together because SEPs deposit their contributions into IRAs established for their participants. Since the retirement savings vehicle under SEPs is a participant's individual IRA (SEP-IRA), the participant owns and exercises control over the IRA.

The overall concept of a SEP might be simplified into the following construct: instead of creating individual accounts for participants within a separate and distinct employer plan, the employer substitutes use of individual IRAs that together comprise the body of the employer's retirement program. In this manner, the cost and complexities of maintaining and administering an employer-sponsored retirement plan are greatly diminished, for SEPs are easily established and the employer's deduction parallels that of any other profit sharing plan.

The simplified construct of the SEP arrangement results in avoidance of some of the more stringent requirements of qualified plans. For example, SEPs are not subject to annual return/report filings with the government and other reporting and disclosure statutes. However, the tradeoff for this administrative ease lies in the SEP's decreased flexibility in other areas. Consider that all SEPs contain the following provisions:

- SEP-IRAs must be provided for all employees who have attained age 21, receive compensation of at least $500 (as indexed for 2007), and have performed services for the employer during at least three of the previous five years (collectively-bargained employees may be excluded).
- A minimum hours worked requirement cannot be attached to the definition of performance of service.
- Employer contributions are discretionary, but must be fully vested, that is fully owned by the participant at the time of deposit into the SEP-IRA.
- Distribution and withdrawal rules for SEPs follow IRA rules rather than qualified plan rules.
- Loans to participants are not allowed.

A **Salary Reduction SEP (SARSEP)** is a SEP that allows for elective deferrals, but employers are barred from implementing a SARSEP after December 31, 1996. Those SARSEPs created prior to December 31, 1996 may continue to operate and accept elective deferrals. As an alternative to the disallowance of new SARSEPs, employers might consider adoption of a SIMPLE 401(k).

Similarly, SIMPLE IRA plans might be an alternative to establishing a SEP. Both SIMPLE IRAs and SEPs employ individual employee IRAs to hold contributions, but the two types of plans are distinguishable in several areas: primarily in the compensation levels and other requirements to be covered under the plans, mandatory versus discretionary employer contributions, and nondiscrimination testing. (SEP requirements resemble those of profit sharing plans while SIMPLE IRA requirements are akin to 401(k) plan rules.)

[C] 457 Plans

A **457 plan**, like a 401(k) plan, also takes its name from the Internal Revenue Code Section (IRC §457) that governs it, but unlike a 401(k) plan, a 457 plan is a nonqualified deferred compensation plan that only may be sponsored by a distinct group of employers.

Eligible sponsors of 457 plans are:

- A State;
- A political subdivision of a State;
- An agency or instrumentality of a State or political subdivision of a State; or
- A tax-exempt organization.

The regulations applicable to 457 plans often mirror those of qualified 401(k) plans since the amount of compensation deferred under 457 plans is usually determined at the election of the employee. However, the nonqualified status of 457 plans often translates into a myriad of different limits and applicable statutes. Thus, as examples, 457 plans do not need to comply with top-heavy rules and have alternate catch-up contribution allowances, maximum benefit, and compensation limits.

§3.09 Key Terms

401(k) Plan: Permits employees to elect to defer compensation into the plan on a pre-tax, or in the case of designated Roth contributions, post-tax basis. See CODA.

457 Plan: Nonqualified deferred compensation plan available to only certain employers.

After-tax Employee Contributions: Amounts that a participant voluntarily contributes to a plan in addition to the contributions made by the employer. After-tax employee contributions, unlike employer contributions, are not deductible on either the employee's or the employer's tax return. Alternately referred to as voluntary contributions, mandatory contributions, post-tax contributions or employee after-tax contributions.

Cash or Deferred Arrangement (CODA): A qualified profit sharing or stock bonus plan that gives a participant an option to take cash or to have the employer contribute the money to a qualified profit sharing plan as an employer contribution to the plan (i.e., an elective deferral). These arrangements are often referred to as 401(k) plans.

Catch-Up Contributions: Elective deferrals made to a cash or deferred arrangement in excess of an applicable limit. Participants expected to attain age 50 in the calendar year are catch-up eligible.

Designated Roth contributions: Elective deferrals made to Roth 401(k) accounts under a 401(k) plan. Also referred to as Roth 401(k) contributions or Roth 401(k) after-tax elective deferrals.

Elective Deferral: A contribution to a cash or deferred arrangement made pursuant to an employee's election to have such contribution made in lieu of receiving cash. Alternately referred to as elective contributions, salary deferrals or salary reduction contributions.

Employee Stock Ownership Plan (ESOP): A profit sharing, stock bonus, or money purchase plan, designed to be invested primarily in employer company stock. Unlike other plans, an ESOP may borrow from the employer or use the employer's credit to acquire company stock.

IRA: A personal savings account established by an individual for the purpose of accumulating retirement tax favored income.

Matching Contributions: Employer contributions made to a plan based on a participant's elective deferrals.

Minimum Funding Requirement: The minimum amount an employer must contribute to fund adequately a defined benefit, money purchase, or target benefit plan.

Money Purchase Plan: A defined contribution plan under which the employer is subject to minimum funding requirements. Contributions are usually based on each participant's compensation. Retirement benefits under the plan are based on the amount in the participant's individual account at retirement.

Nonelective Contributions: Employer contributions made to a plan other than elective deferrals or matching contributions. Often made in the form of a discretionary profit sharing contribution.

Profit Sharing Plan: A defined contribution plan under which the employer makes discretionary contributions (usually out of profits). A participant's retirement benefits are based on the amount in his or her individual account at retirement.

Salary Reduction SEP (SAR-SEP): A SEP that allows for elective deferrals. Not available unless implemented by December 31, 1996.

SIMPLEs: Savings Incentive Match Plans for Employees. See SIMPLE IRA and SIMPLE 401(k).

SIMPLE 401(k): A type of 401(k) plan that permits only certain types of contributions and does not require nondiscrimination testing.

SIMPLE IRA: A type of IRA maintained in conjunction with an employer-sponsored arrangement.

Simplified Employee Pension (SEP): An employer-sponsored retirement plan that uses individual IRAs as the funding vehicles. Subject to lesser administrative requirements than plans qualified under IRC §401(a).

Stock Bonus Plan: A defined contribution plan that is similar to a profit sharing plan except that benefit payments generally must be made available in the form of employer company stock.

Target Benefit Plan: A variation of a defined benefit plan and a money purchase plan. Similar to a defined benefit plan, the annual contribution is determined by the amount needed each year to accumulate a fund sufficient to pay a targeted retirement benefit to each participant at retirement. Similar to a money purchase plan, contributions and earnings are allocated to separate accounts maintained for each participant and benefits to be paid at retirement are not guaranteed.

Tax-Sheltered Annuities (TSAs): Governed by IRC §403(b). Although similar to 401(k) plans in many respects they are only available to certain types of employers.

Thrift Plan: A defined contribution plan that requires after-tax employee contributions. Employer contributions are often made on a matching basis.

§3.10 Review of Key Concepts

- A profit sharing plan provides great flexibility to an employer because it has no fixed annual contribution commitment. However, employer profit sharing contributions must be substantial and recurring in order to prevent the plan from being considered a terminated plan.

- A CODA or 401(k) arrangement within a profit sharing plan permits employees to elect to defer compensation into the plan on a pre-tax basis instead of receiving these sums as taxable income, reducing the current taxable income of the employee. Beginning in 2006 employees may be able to defer designated Roth contributions into the plan on an after-tax basis as well.

- Elective deferrals are made pursuant to an employee's election in lieu of receiving cash compensation.

- Designated Roth contributions are elective deferrals made on an after-tax basis.

- Catch-up contributions are elective deferrals made in excess of an applicable deferral limit by a catch-up eligible participant.

- There are two types of SIMPLE Plans, SIMPLE IRA and SIMPLE 401(k)s.

- Both money purchase plans and target benefit plans are subject to the minimum funding requirements, where the employer is committed to funding the plans according to a specific formula in the plan document each year.

- A thrift plan is a money purchase plan or a profit sharing plan that requires an employee to make after-tax employee contributions in order to receive an allocation of employer contributions.

- Employee stock ownership plans (ESOPs) and stock bonus plans both invest in employer stock. ESOPs have the distinction of being able to borrow money to purchase company stock, allocating the stock to participants as the shares that were once used as collateral are released by repayments of the loan.

- Other types of tax-advantaged arrangements exist. Some can only be sponsored by certain employers, such as TSAs or 457 plans for charitable foundations or state governments. Others, such as SEPs, are chosen by employers to reduce the administrative burden and expense of more popular types of plans.

§3.11 Review Questions

[A] True or False

______ 1. Participant loans are permitted from a SIMPLE IRA plan.

______ 2. A stock bonus plan generally distributes benefits in the form of company stock.

[B] Multiple Choice

3. All of the following statements regarding types of defined contribution plans are **TRUE, EXCEPT**:

   A. A money purchase plan is subject to minimum funding requirements.
   B. Thrift plans require after-tax employee contributions.
   C. A profit sharing plan must provide for a formula to determine the contribution amount.
   D. Older employees receive larger contributions relative to compensation than younger employees in a target benefit plan.
   E. 401(k) plans allow employees to defer compensation on a pre-tax basis.

4. All of the following statements regarding elective deferrals are **TRUE, EXCEPT:**

   A. Elective deferrals reduce the current taxable income of the individual for federal income tax purposes.
   B. Elective deferrals reduce compensation for Social Security taxes.
   C. Catch-up contributions are elective deferrals made in excess of an applicable deferral limit.
   D. The IRC §402(g) dollar limit is adjusted annually for inflation.
   E. Elective deferrals may be subject to nondiscrimination testing.

5. All of the following statements regarding catch-up contributions are **TRUE, EXCEPT:**

   A. A catch-up contribution is an additional contribution allowed to certain older plan participants.
   B. An elective deferral is classified as a catch-up contribution when the participant has reached a limit in the law or the plan.
   C. Individuals must attain age 50 by the date they make a catch-up contribution.
   D. Catch-up contribution limits are adjusted annually for inflation.
   E. A catch-up contribution to a 401(k) plan is treated the same as a pre-tax elective deferral for tax purposes.

6. All of the following statements regarding 401(k) plans are **TRUE, EXCEPT**:

   A. Designated Roth contributions are considered elective deferrals.
   B. A catch-up eligible participant may defer $20,500 in calendar year 2007.
   C. An employer may make matching and/or nonelective contributions to a 401(k) plan.
   D. An employee can defer the maximum IRC §402(g) dollar limit in plans of two different employers in the same calendar year.
   E. An employee born December 15, 1956 may be able to make catch-up contributions beginning January 1, 2006.

§3.12 Answers

1. **False.** Participant loans are permitted from SIMPLE 401(k)s but not from SIMPLE IRAs. §3.04

2. **True.** Stock bonus plans are profit sharing plans distinguishable by the fact that benefits are distributed in the form of employer stock. §3.06 [A]

3. The correct answer is **C.** §3.03 [A]

   A. Incorrect. This statement is true because a money purchase plan is subject to minimum funding requirements.
   B. Incorrect. This statement is true because thrift plans require after-tax employee contributions.
   C. Correct. This statement is false because a profit sharing plan must provide for a formula to allocate a contribution but need not provide a formula for determining the amount of the contribution.
   D. Incorrect. This statement is true because older employees receive larger contributions relative to compensation than younger employees in a target benefit plan.
   E. Incorrect. This statement is true because 401(k) plans allow employees to defer compensation on a pre-tax basis.

4. The correct answer is **B.** §3.03 [B]

   A. Incorrect. This statement is true because elective deferrals reduce the current taxable income of the individual for federal income tax purposes.
   B. Correct. This statement is false because elective deferrals do not reduce compensation for Social Security taxes.
   C. Incorrect. This statement is true because catch-up contributions are elective deferrals made in excess of an applicable deferral limit.
   D. Incorrect. This statement is true because the IRC §402(g) dollar limit is adjusted annually for inflation.
   E. Incorrect. This statement is true because elective deferrals may be subject to nondiscrimination testing.

5. The correct answer is **C.** §3.03 [B]

   A. Incorrect. This statement is true because a catch-up contribution is an additional contribution allowed to certain older plan participants.
   B. Incorrect. This statement is true because an elective deferral is classified as a catch-up contribution when the participant has reached a limit in the law or the plan.
   C. Correct. This statement is false because individuals expected to attain age 50 in a calendar year are catch-up eligible for that year.
   D. Incorrect. This statement is true because catch-up contribution limits are adjusted annually for inflation.
   E. Incorrect. This statement is true because a catch-up contribution is treated the same as a pre-tax elective deferral for tax purposes.

6. The correct answer is **D.** §3.03 [B]

   A. Incorrect. This statement is true because designated Roth contributions are considered elective deferrals.
   B. Incorrect. This statement is true because a catch-up eligible participant may defer $20,000 in calendar year 2006.
   C. Incorrect. This statement is true because an employer may make matching and/or nonelective contributions to a 401(k) plan.
   D. Correct. This statement is false because an employee can only defer the maximum IRC §402(g) dollar limit in one calendar year regardless of the number of plans.
   E. Incorrect. This statement is true because an employee born December 15, 1956 may be able to make catch-up contributions beginning January 1, 2006.

Chapter 4:
Defined Benefit Plans

§4.01 Learning Objectives

- Describe in general terms how contributions to defined benefit plans are determined.
- Explain how a participant's retirement benefit is calculated in a defined benefit plan.
- Discuss the forms of benefit payment in a defined benefit plan.
- Define the term accrued benefit and calculate a participant's accrued benefit.

- Understand what factors are used and how they are applied in determining actuarially equivalent plan benefits.
- Explain how the maximum benefit limits are applied to defined benefit plans.

§4.02 Introduction

The special characteristics of defined benefit plans require an understanding of benefit-related concepts that are not applicable to most defined contribution plans. Defined benefit plans do not provide benefits each year in the form of a current deposit into one's individual account. Instead, the contribution each year is determined by calculating the amount of one's future benefit, taking into consideration employment and salary histories to date, and funding the plan as needed in order to meet the projected future benefit. A portion of the benefit is earned each year by performing service during the plan year.

This chapter includes discussion and illustrations of some of these special characteristics of defined benefit plans, with particular emphasis on:

- Accrued benefits;
- Actuarial equivalence;
- Average compensation; and
- Normal form of benefits.

While most of the topics in this chapter relate only to defined benefit plans, note that certain topics also are applicable to target benefit plans. That type of defined contribution plan first projects or "targets" a future retirement benefit and then translates that benefit into a current contribution allocation. These topics might include the definition of average compensation as well as the computation of the retirement benefit.

§4.03 Defined Benefit Plans

A **defined benefit plan** promises to pay a specified benefit at future retirement to eligible participants, in contrast to a defined contribution plan that pays a specified contribution to its participants at a present time. The actual amount of the participant's benefit in a defined benefit plan is described by a formula stated in the plan document, and the employer as plan sponsor assumes the investment risk by agreeing to pay the calculated benefit to the participant upon attainment of the retirement age under the plan. Therefore, if plan assets earn less than expected, the employer will make a larger contribution to ensure that the plan has sufficient monies to pay the promised benefits. Should the plan's investments earn more than anticipated, the employer's costs will decrease.

Since the plan costs and ability to pay benefits are tied to the financial viability of the sponsoring employer and the strength of the plan's invested assets, ERISA provides through the PBGC that participants in most defined benefit plans are guaranteed at least a portion of their benefits from the plan in the event of employer bankruptcy or other insolvency.

A cash balance plan is a type of defined benefit plan that contains hypothetical account balances communicated to participants. There has been much recent legislative activity regarding cash balance plans and age-discrimination issues, and due to the complexity of these issues, these plans are not considered in this course but are covered in more advanced ASPPA courses.

[A] Employer/Employee Contributions

Under a typical defined benefit plan, contribution and assets are entirely employer-derived: employees are neither allowed nor required to contribute. While defined benefit plans may accept after-tax employee contributions, the presence of these contributions would require the plan to maintain individual, separate accounts in the manner of defined contribution plans, provide for full and immediate vesting on those accounts, and perform necessary nondiscrimination testing. For these obvious reasons, separate accounts within a defined benefit plan would require a type of financial accounting and administrative process that argues strongly against such a plan design, and therefore after-tax employee contributions under defined benefit plans are uncommon.

In contrast, although somewhat rarely found in the private sector, mandatory employee contributions in defined benefit plans can occur in the public sector, such as within state-sponsored governmental plans. When present, mandatory employee contributions are not separately accounted for; rather, a portion of the retirement benefit under the plan is considered to be funded by these mandatory employee contributions. As a consequence, distinctions are then made between the employer-derived retirement benefit and the employee-derived retirement benefit under the plan. Again, this type of defined benefit design often proves more complex to administer and to communicate to employees, and unless the plan sponsor desires to emphasize an employee's participation in the funding of his or her retirement benefit, mandatory employee contributions typically would be avoided.

Consequently, discussions of defined benefit assets center almost exclusively on employer contributions to the plan. A very simplified explanation of how employer contributions are determined would begin with a calculation of the amount of retirement benefits under the plan as decreed by the plan's benefit formula, e.g., 25% of the compensation to be paid in monthly installments for the lifetime of the participant beginning at retirement age 65. Next, determine how many installments will be paid using an assumption of how long the participant will live beyond age 65. Then figure out what lump sum amount would be necessary at the time payments begin in order to fund the anticipated benefit.

This is done by considering the participant's current age and determining how many years until the participant reaches retirement age 65, utilizing an interest assumption while payments are being made. The time between the present and attainment of age 65 represents the period over which the employer must deposit money into the plan in preparation for payment of retirement benefits.

Acknowledging that the plan's current assets should continue to earn interest to use toward benefit payments, calculate the difference between the current assets increased with interest until retirement age and the lump sum amount needed at that retirement age. That difference represents the unfunded benefit. If that unfunded benefit is amortized into installment payments made by the plan sponsor over the course of the intervening years between the present and retirement age 65, the amount of the installment payment would represent the amount of the present employer contribution. If one considers that the unfunded benefit will be greater if the plan's current assets do not perform as expected, the necessity for larger employer contributions in lean investment return years illustrates the fact that the employer bears all investment risk under defined benefit plans.

Defined benefit plans with older participants will tend to have higher contribution requirements than plans with younger participants. This becomes evident by applying the relationship between contributions and benefits. Older participants will have fewer years of plan funding and investment earnings than younger participants. Since the amount of benefits is determined by the plan provisions, larger funding contributions for older participants are required to accumulate the amount of money needed to provide their benefits when compared to funding for younger participants with the same benefit amount. Thus, as an example, should the plan sponsor undertake a hiring of proportionally older applicants rather than recent college graduates, the plan sponsor should expect to see a corresponding increase in benefit costs with respect to the defined benefit plan.

Example 4-1. Contribution Comparison. Sid and Carl are both entitled to a retirement benefit of $750 per month beginning at age 65. Sid is currently 55, and Carl is 40. Although both participants' benefit is the same, and under the terms of the plan the same amount of money would need to be available when benefit payments commence, the employer has 15 more years to accumulate the necessary funds to pay for Carl's benefit than for Sid's (25 years of funding versus 10 years). The annual cost attributable to Sid's benefit, therefore, is higher than that attributable to Carl's.

[B] Funding

Once each plan year, a defined benefit plan's actuary performs a series of calculations to determine the plan sponsor's annual contribution amount under a process typically called the plan's **actuarial valuation**. The actuarial valuation will employ a particular set of assumptions in order to allocate the cost of the plan over a reasonable time period, typically the working lifetime of the participants.

The specific calculation used to allocate the cost is determined by the **funding method** being applied. There are many funding methods available that are sanctioned by ERISA for actuarial use, and an important part of the profession of the plan's actuary is to choose a funding method for the plan that is best suited to the plan's benefit formula, investments, the demographics of the participant population and the employer's financial structure and corporate needs. For example, some funding methods immediately incorporate any investment gain or loss into the calculation of the annual contribution, while others spread the recognition of gains or losses over a period of years. Some funding methods calculate plan costs by determining each participant's individual cost and then adding them together, while others calculate costs by considering the plan population in total at the aggregate level.

Given the variety and complexity of actuarial assumptions and funding methods, it will be no surprise that actuaries must earn professional credentials to demonstrate expertise in the statistical analyses required by pension valuations before they can offer their services to defined benefit plans. Defined benefit plans must hire an actuary as a service provider, and each year the actuary must complete and sign various governmental filings on behalf of the plan. An example of these actuarial reports is the Schedule B for the plan's Form 5500 filing.

§4.04 Benefit Formulas

[A] Overview

The amount of a participant's retirement benefit is defined in the plan and is determined using the plan's **benefit formula**. There are many ways a plan can define a participant's benefit. Some plans base benefits on the participant's compensation, others use service years and still others take both compensation and service into consideration.

Thus, benefit formulas can be categorized in a number of ways. For example:

- **Pay-related** and **non-pay-related** depend on whether participants with different salaries receive different benefits.
- **Service-related** and **non-service-related** formulas are based on whether the length of a participant's service is a factor in determining the amount of the future benefit.

The pay-related category can be further subdivided depending on the period during which compensation is determined or averaged. For example, the compensation used may be the last year before retirement, averaged over the final few years of a participant's career or averaged over an entire career.

The employer selects the formula at the time the plan is designed and incorporates it into the plan document. As with all plan designs, the employer decides upon that formula which best reflects its retirement program goals, taking into consideration the employee population and its financial position. Employers who wish to provide larger benefits for higher paid employees choose pay-related formulas. Those who wish to give larger benefits to long service employees choose service-related formulas. Usually, the chosen benefit formula will then express retirement benefits in terms of monthly payments commencing at retirement age.

[B] Pay-Related Formulas

One of the simplest pay-related formulas is one that sets the participant's benefit as a flat percentage of compensation. As an example, the plan might provide that the monthly retirement benefit to be provided for each participant who retires on a normal retirement date shall be equal to 50% of such participant's average monthly compensation.

In pay-related formulas, the definition of compensation is an integral component of the benefit formula, and therefore various pay-related formulas can be distinguished from one another depending on the period over which the compensation is determined. Two commonly found compensation definitions are: final average and career average.

<u>1. Final Average Compensation</u>

Formulas using **final average compensation** calculate the retirement benefit using an average of compensation earned by the participant over a specified period. Traditionally, this period includes compensation earned immediately before retirement, presumably the highest levels of compensation achieved by the participant, but the period alternately could reflect the highest period of compensation during the participant's career.

For example, a plan may base benefits on compensation averaged over the highest five consecutive years during the participant's employment. Often the definition limits the years for which compensation may be counted, such as in the 10 years immediately preceding retirement, thus rendering the final average compensation to be the average of the five highest consecutive years of compensation in the final ten years of compensation history.

<u>2. Career Average Compensation</u>

In contrast, a plan sponsor may feel it is appropriate to base a participant's benefit on compensation the participant earned during his or her entire career, rather than over a few years of employment. Formulas using **career average compensation,** therefore, consider the participant's compensation over the working lifetime with the employer in determining the retirement benefit, averaging the participant's compensation across all years of employment.

[C] Integrated Formulas

An **integrated benefit formula** is allowed to take into consideration the contributions that employers make on behalf of their employees to Social Security. Because part of the Social Security taxes paid each year on wages up to the stated, yearly Social Security Taxable Wage Base ($97,500 for 2007) are used to provide retirement benefits, in effect an employer is contributing actively toward its employees' retirement via the Social Security program. As such, by integrating the plan sponsor's retirement plan with Social Security, the plan sponsor can capture credit for these contributions made outside of the defined benefit plan.

Integration with Social Security can be accomplished using either an excess (also known as step-rate) approach or an offset approach. The excess methodology is similar to the approach to integration used in defined contribution plans. In contrast, the offset approach is unique to defined benefit plans.

<u>1. Excess (Step-Rate) Formula</u>

With an **excess or step-rate formula**, a base benefit is calculated for all participants. An additional (or excess) benefit for participants whose compensation exceeds the integration level is then provided. In most cases, the integration level is covered compensation which is an average of the Social Security Taxable Wage Bases over a 35-year period.

The excess benefit is allowed to exceed the base benefit by a specified percentage, which is generally the lesser of the base benefit percentage or .75%. For example, an integrated benefit formula might be .85% of average annual compensation plus .75% of average annual compensation in excess of covered compensation for each year of service up to 35 years.

Although a participant whose compensation is less than the integration level will receive a lower benefit as a percentage of average annual compensation than a participant whose compensation exceeds the integration level, this disparity in benefit amount is permitted because of the presence of Social Security. Consequently, this process of integration is alternately called using permitted disparity.

2. Offset Formula

In an **offset formula**, an amount that is presumed to represent a portion of the participant's anticipated Social Security benefit is used to reduce the plan's stated benefit. In other words, first a gross benefit is calculated, and then it is reduced or offset by an allowable amount under qualified plan rules. This offset is subject to a maximum offset allowance to keep the disparity between benefits provided to participants with differing compensation levels to the permitted amount.

3. A word of caution

It is important to note that the discussions of integration contained in this course are intended to be introductory. There are many complex issues surrounding integration levels, covered compensation, excess benefit percentages, retirement age definitions, the number of years taken into account within the benefit formula, and other factors which determine what a defined benefit plan may use as an integrated benefit formula under qualified plan rules. Thus, a more comprehensive study of the subject is undertaken in advanced ASPPA courses.

[D] Service-Related Formulas

Some plans incorporate a service feature that reduces the benefit if the participant's years of service with the employer at retirement age are less than a stated period. For instance, the benefit might be reduced proportionately if the participant has less than 25 years of service with the employer at normal retirement. In essence, the sponsor is saying that to receive full benefits an employee must work his or her entire career with the plan sponsor.

Example 4-2. Service-Related Formula. Reggie terminates employment with his employer after 10 years of service. Under the benefit formula of Reggie's defined benefit plan, the retirement benefit is 50% of the average 5 highest consecutive years of compensation, reduced proportionally for years of service less than 25. Reggie's average compensation is calculated as $80,000. Reggie will receive a monthly benefit of $1,333.33, determined as follows:

$80,000 x .50 x 10/25 = $16,000 annually or $1,333.33 per month

Service-related formulas are also called **fixed benefit** or **flat benefit** formulas. Commonly found in multiemployer or union-negotiated plans, these formulas provide a stated dollar amount of benefit and do not consider a participant's compensation. Examples are a monthly benefit of $200, or a monthly benefit of $15 times the years of service.

Another service-related formula is called a unit benefit formula, sometimes referred to as **unit credit.** It considers the employee's length of service as a determinant of the amount of retirement benefit payable. A unit credit formula is a type of fixed benefit formula. The calculation of the retirement benefit is an application of the number of years of service multiplied by either a flat dollar amount or a flat percentage of pay. Examples are a monthly benefit of 1% times monthly compensation times years of service, or a monthly benefit of $10 times years of service.

§4.05 Form and Starting Date of Benefit Payment

In tandem with the benefit formula, which sets the amount of the retirement benefit, the form and starting date of the benefit payment serve to delineate the value of that benefit by determining how the benefit will be paid and for what length of time payments will continue.

As an illustration, a plan that pays a certain monthly amount after retirement for the retiree's lifetime and guarantees payments for a set period to the retiree or the retiree's beneficiary will be more valuable than a plan that pays that same monthly amount with no guaranteed period of payment. Similarly, a lifetime benefit that begins at a younger age is generally more valuable than one that does not begin until the participant is much older since more payments are expected to be made.

To assist in the determination of the value of retirement benefits, an understanding of the following terms is necessary.

[A] Normal Retirement Date

Normal retirement date for both defined contribution and defined benefit plans is that date under the plan at which the participant is entitled to retire. The specific date will be explained in the plan document. It may or may not be the same date that a participant attains normal retirement age, which typically is age 65 or age 65 and 5 years of participation. (The later of age 65 or 5 years of participation is the maximum normal retirement age under the Internal Revenue Code.) An example of a common definition for normal retirement date is the first day of the month coincident with or next following the attainment of age 65.

[B] Normal Form

In defined benefit plans, the plan's benefit formula states the participant's benefit in terms of a specific standard or normal form. That is, the normal retirement benefit is a monthly income starting at normal retirement age payable in the normal form of benefit. Traditional normal forms are life annuity (alternately called single life, straight life or life only), life annuity with ten years certain, and joint and survivor annuity.

For example, a sample benefit formula is 25% of the highest three-year average compensation paid monthly starting at age 65 in the form of a joint and 50% survivor annuity for married participants and in the form of a single life annuity for unmarried participants.

Many plans include the definition of the normal form of benefit within the normal retirement benefit definition. Of note: the normal form of benefit may not necessarily be the form of benefit under which a participant is paid his or her benefit. Plans can provide for optional forms of benefit from which a participant can select the payment form desired. Remember that the normal form of benefit is employed in the determination of the value of the retirement benefit in addition to its function as the default form of payment absent a participant's properly executed election.

<u>1. Life Annuity</u>

A life annuity provides for payments during the participant's lifetime, typically beginning at retirement and ceasing upon the participant's death. These life annuities are sometimes called single life annuities since they extend over a single lifetime: that of the participant. Compare this to the joint and survivor annuity described below.

<u>2. Life Annuity with Ten Years Certain</u>

A life annuity with ten years certain provides a monthly benefit to the participant for life with a guarantee of payments for ten years. If the participant dies before the end of ten years, his or her benefit will continue to be paid to a designated beneficiary for the remainder of the ten-year period.

<u>3. Joint and Survivor Annuity</u>

Joint and survivor annuities provide a series of monthly payments over joint lives, rather than a single life. Typically, the participant is the primary annuitant, and a spouse is the secondary or survivor annuitant. Under a joint and survivor annuity, payments will be made to the primary annuitant for that person's lifetime. Upon the death of the primary annuitant, payments will be made to the secondary annuitant for the remainder of that person's lifetime. If the secondary annuitant predeceases the primary annuitant, payments cease upon the death of the primary annuitant. The monthly payment to the survivor is generally 50%, 75% or 100% of the monthly payment the primary annuitant was receiving prior to death, since these annuity forms are usually designed to satisfy the definition of a qualified joint and survivor annuity.

§4.06 Accrued Benefits

Defined benefit plans are designed to supply benefits upon retirement, and within the ongoing administration of these types of plans, it will be necessary to determine how much of their normal retirement benefits participants have earned to date. Part of the process of valuing the funded status of the plan involves a comparison of the plan's assets and the liability associated with the benefits earned under the plan at the time of the valuation. Additionally, for benefit statement disclosure purposes, a participant is informed of these earned or accrued benefits and is therefore able to assess progress toward full retirement benefits and understand what he or she can expect to be paid if employment is terminated.

Accrued benefits should be distinguished from the concept of vested benefits, although the notion of ownership or earned benefit is associated with each. Consider that under the Internal Revenue Code and ERISA, a participant must be fully vested, i.e. have a completely nonforfeitable interest, in his or her benefit under the plan no later than after seven years of vesting service. Consider as well that an inherent intention of a defined benefit plan is the provision of benefits upon retirement as a reward or incentive for continued service with the employer.

If the concept of gradually accruing one's promised retirement benefit did not exist, there would arguably be little reason to labor for any employer beyond seven years. Consequently, a participant progressively accrues a portion of his or her retirement benefit upon completion of each year of accrual service while the vested interest applied to that accrued benefit also increases. After a certain point in time, the participant will be 100% vested in the accrued benefit, which continues to increase as service continues and retirement approaches. Of course, plans could provide for 100% immediate vesting, in which instance vesting remains constant at 100% while the underlying accrued benefit increases.

[A] Accrued Benefit

In a defined contribution plan it is easy to determine the amount of benefit a participant has earned to date: it is the account balance. In a defined benefit plan, the participant's **accrued benefit**, that portion of the participant's normal retirement benefit earned as of a particular date, is computed using one of the allowable accrual methods under the Internal Revenue Code and ERISA. The chosen methodology must be set forth in the plan document so that the amount of benefit provided under the plan is definitely determinable, a plan qualification requirement. The accrued benefit still has all the characteristics of the normal retirement benefit: it is expressed as a monthly benefit payable at the participant's normal retirement age in the normal form defined in the plan.

[B] Fractional Accrual Method

A common accrual method for small plans is the fractional accrual method. Under this method a participant is deemed to earn or accrue a pro rata share of the retirement benefit each year from the date benefit accrual first begins until normal retirement age is attained. For example, if a participant begins accruing a benefit 25 years before normal retirement age, that participant will accrue 1/25 of the normal retirement benefit each year. This is sometimes referred to as the project and prorate method.

Fractional accrual can use either years of service or years of participation as the period over which benefits accrue. The plan document will specify which period is applicable and also explain any provisions regarding the number of service hours that need to be completed in order to obtain credit for a year of service or participation for accrual purposes.

[C] Alternate Accrual Method

There are alternate accrual methods other than fractional accrual which are available to defined benefit plans. As an example, under one of these alternate methods, the rate of accrual may increase from year to year within certain limitations, rather than remain steady at the even rate of the fractional accrual method. A full explanation of these alternate accrual methods is beyond the scope of this introductory course and will be undertaken in advanced ASPPA courses.

[D] Accrued Benefits in Top-Heavy Plans

Top-heavy defined benefit plans are subject to minimum benefit requirements that dictate minimum accruals for non-key employees for each year of participation when the plan is top-heavy. In such cases, the participant's accrual is the greater of the accrued benefit computed upon application of the accrual method under the plan or the minimum accrued benefit under top-heavy rules.

The top-heavy minimum benefit in a defined benefit plan must not be less than the employee's average compensation multiplied by the lesser of:

1. 2% times the number of years of service, or
2. 20%.

In this manner, for the first ten years of service for top-heavy purposes, the minimum accrued benefit will be 2% of average compensation times years of service. After ten years, the minimum top-heavy accrued benefit is 20% of average compensation.

For top-heavy purposes, in broad terms average compensation is defined as a participant's total compensation averaged over a testing period during which the employer paid the participant the highest compensation. The testing period cannot be greater than five consecutive years, and certain years such as those prior to the inception of the top-heavy rules for qualified plans may be disregarded.

Also in broad terms, years of service for top-heavy purposes generally include years during which the participant performs 1000 hours of service and may disregard plan years beginning before 1984, when top-heavy rules were first created, plan years during which the plan is not top-heavy and years in which no key employee benefits under the plan.

Further study of the top-heavy rules for qualified plans can be found in advanced ASPPA courses.

[E] Accruing Benefits after Normal Retirement Age

It should be noted that participants working beyond normal retirement age are entitled to additional benefits under anti-age discrimination rules.

[F] Preservation of Accrued Benefits if Benefit Formula is Amended

In the event that plan's benefit formula is amended, qualified plan regulations necessitate the preservation of a participant's accrued benefit. That is, while a defined benefit plan may amend its benefit formula such that the normal retirement benefit is lowered, the plan cannot be amended to decrease the amount of benefit already accrued by participants.

Example 4-3. Projected Normal Retirement Benefit. Using the following data, project Terry's normal retirement benefit as of December 31, 2006.

Date of Birth: December 31, 1958 Date of Hire: December 1, 1983
Date of Participation: January 1, 1985 Normal Retirement: January 1, 2024

Compensation History (assume compensation for future years is the same as year 2006 compensation):

1983	$ 1,000	1991	$ 92,000	1999	$140,000
1984	$52,000	1992	$ 99,000	2000	$140,000
1985	$55,000	1993	$100,000	2001	$140,000
1986	$60,000	1994	$100,000	2002	$140,000
1987	$65,000	1995	$110,000	2003	$150,000
1988	$77,000	1996	$120,000	2004	$150,000
1989	$85,000	1997	$125,000	2005	$150,000
1990	$85,000	1998	$130,000	2006	$150,000

The first step is to compute Terry's average monthly compensation as of normal retirement date. The plan defines average monthly compensation as the average over the five highest consecutive years of service during employment, and assumes that future compensation will be the same as that for the year of calculation, $150,000 in 2006.

Therefore, at normal retirement date the highest 5 consecutive years are represented by any five-year period from 2003, the first year of compensation at $150,000, through 2023. Average monthly compensation for projecting Terry's normal retirement benefit will be $12,500.

2019	$150,000			
2020	$150,000			
2021	$150,000			
2022	$150,000			
2023	<u>$150,000</u>			
	$750,000	/ 5	=	$150,000 (annually)
		/ 60	=	$ 12,500 (monthly)

Next, the benefit formula is 50% of average monthly compensation. Applying this benefit formula, Terry's normal retirement nenefit is $6,250 per month.

$ 12,500 x 50% = **$ 6,250**

This is the monthly benefit Terry can expect to receive if employment continues until normal retirement age, and compensation is $150,000 in all future years. Since continued service and compensation are being projected, this benefit is sometimes called the projected benefit. If in 2007 Terry's compensation were to increase to $160,000, the normal retirement benefit would be $6,666.67 ($160,000 per year from 2019 through 2023 or $13,333.33 as average monthly compensation, then multiplied by 50%).

Example 4-4. Computation of Accrued Benefit. If Terry should cease employment after December 31, 2006, vesting would be applied to the accrued benefit, and Terry would be entitled to that vested accrued benefit upon reaching normal retirement.

The first step in calculating the Accrued Benefit as of December 31, 2006, therefore, is to compute Terry's average monthly compensation as of December 31, 2006. The plan defines average monthly compensation as the average over the five highest consecutive years of service during employment, which is now assumed to end on December 31, 2006.

As of the calculation date, the highest five consecutive years are those of the five-year period from 2002 through 2006, rendering an average monthly compensation of $12,333.33.

2002	$140,000		
2003	$150,000		
2004	$150,000		
2005	$150,000		
2006	$150,000		
	$740,000	/ 5	= $148,000 (annually)
		/ 60	= $ 12,333.33 (monthly)

Next, the benefit formula is 50% of average monthly compensation, and the plan uses the fractional accrual method based on years of participation. Terry became a participant on January 1, 1985, and therefore has completed 22 years of participation as of December 31, 2006. At normal retirement date in 2024, Terry will have 39 years of plan participation. Applying the plan provisions, Terry's accrued benefit as of December 31, 2006, is $3,478.63.

$12,333.33 x 50% x 22 / 39 = $ 3,478.63

§4.07 Actuarial Equivalence

Benefits provided by a defined benefit plan are stated in terms of the normal form of benefit: generally monthly payments beginning at normal retirement age and continuing for a specified period of time, often the lifetime of the participant.

However, the plan may give the participant the option of receiving benefits in a form other than the normal form, or the plan sponsor may wish to compute the current value of the benefits to compare it to the plan assets. For these reasons, the plan must have a way to convert benefits from one form to another and to compute the present value of benefits.

Benefits that are of equal value at a given point in time are called **actuarially equivalent benefits**. The plan must define a basis to convert benefits from the normal form to equivalent forms, and this basis for conversion includes mortality and interest assumptions that are sometimes referred to as **actuarial equivalence factors**.

[A] Determining Actuarially Equivalent Benefits

The procedure for determining actuarially equivalent benefits is fairly straightforward conceptually but initially may be difficult to grasp. In simplified terms, first the normal form of benefit is valued as of the determination date, and then that value is converted into an optional form of benefit using the actuarial equivalent factors stated in the plan.

As a simplified example, consider a retiring participant with a $1,000 per month normal retirement benefit payable in the normal form of a single life annuity. To determine the value of that benefit to the retiring participant at date of retirement, a mortality assumption such as the Unisex (UP-84) Mortality table estimates the length of the remaining lifespan of the retiree. This in turn provides the number of $1,000 monthly payments the plan will be presumed to have to pay. For this example, assume that the plan's mortality table decrees a remaining 20-year lifespan for the participant.

At the point of retirement, however, the plan would not need to have on hand $240,000 ($1,000 per month x 12 months x 20 years) to fund the participant's retirement payments. A lesser amount is required because those funds will continue to earn interest throughout the 20-year payment period. For this purpose, let's assume a 6% rate of return. Thus, in essence the present value at the participant's retirement date is that lump sum amount which will be assumed to earn 6% interest per annum while decreasing in $1,000 monthly increments until after 20 years the last $1,000 payment is made.

Assume for the moment that this lump sum is $140,000, and the retiring participant wishes to elect an optional form of payment: a joint and 100% survivor annuity. Under this optional form, the monthly payments remain the same but are paid out over the joint lifetimes of the retiring participant and beneficiary. If the plan's mortality table sets out a joint lifespan of 30 years given the present ages of the participant and beneficiary, the question then becomes what amount of payment can be made with $140,000 if payments need to last for 30 years and the funds are assumed to earn 6% interest per annum during the payment period? The answer is an $839 monthly payment, which is the joint and 100% survivor actuarially equivalent benefit under the plan to the normal form of benefit: the $1,000 monthly single life annuity.

Note that a benefit payable for a participant's life with payments guaranteed for a certain period of time, such as a life annuity with ten years certain, will have a greater present value than the same amount of benefit payable for a participant's life with no guaranteed period. It is also true that a joint and survivor annuity, since it is paid over the lives of two individuals, will have a greater present value than that same amount of payment under a life only benefit option. For this reason, when converting a less valuable form of benefit to an actuarially equivalent benefit under a more valuable form, the payment amount will be lower, as illustrated in the example above.

There are circumstances other than election of an optional form of payment upon retirement when actuarially equivalent benefits and present values are computed. As an illustration, a participant who terminates employment prior to normal retirement may be able to select a lump sum distribution immediately, rather than wait until normal retirement date to receive his or her vested accrued benefit. In this instance, the value of the vested accrued benefit is discounted to the present day using the pre-retirement interest assumption, or actuarial factor, and any other actuarial assumptions specified by the plan.

Continuing the example above, if the plan's pre-retirement interest factor was also 6%, and if the participant terminated employment 15 years prior to his normal retirement date, the $140,000 value of the normal retirement benefit would be discounted at 6% for 15 years. The result would be a present value lump sum amount of approximately $58,400, representing that sum of money which if invested for 15 years at an annual interest rate of 6% per annum would yield $140,000.

The plan's provisions regarding actuarial equivalence always should be carefully examined. It is possible to have different factors of actuarial equivalence for each of the following conversions:

- Optional forms of benefit payment;
- Top-heavy present value;
- Lump sum present value; and
- Early retirement.

Note that the above discussion surrounding actuarial equivalence, the computation of present values, and the example in particular is meant for introductory purposes only. There are various other factors, such as PBGC requirements, that influence the calculation of present values. As a complex and advanced subject, actuarial equivalence and present value calculations are further explored in more advanced ASPPA courses.

§4.08 Maximum Benefit Limitations

The Internal Revenue Code §415 contains a maximum benefit limitation for defined benefit plans, just as it does for defined contribution plans. Sometimes called 415 limits after the Internal Revenue Code section that contains them, these 415 limits set a ceiling on the amount of annual retirement benefits that may be provided to a defined benefit plan participant. The defined benefit limits are stated in terms of the maximum annual benefit paid as a single life annuity at age 65. Thus, if the plan's normal form of benefit is not expressed as a single life annuity paid at age 65, the actuarial equivalent of the plan benefits is tested against the IRC §415 limit. Note that if the defined benefit plan accepts employee contributions, as reviewed earlier in this chapter, only the employer-derived benefit is subject to the IRC §415 limitation. Compliance with this limitation is mandatory for qualified status, and therefore accrued and projected plan benefits as determined by the plan formula must be limited to the maximum allowed.

The IRC §415 limit for defined benefit plans has two components: a compensation limit and a dollar limit. The lesser amount under either component functions as a participant's IRC §415 limit.

1. Compensation Limit – This is set to 100% of average compensation during the three consecutive years that the participant had the highest compensation (high three-year average annual compensation).

2. Dollar Limit – For limitation years ending in 2002, EGTRRA set the dollar limit at $160,000. (The limitation year is the 12-month period as defined by the plan document that dictates how the maximum benefit limit is calculated and over what annual period it will be measured. The limitation year does not have to be the plan year.)

   Thereafter, this limit will be increased in $5,000 increments if the cost of living adjustments warrant an increase. Any increase in the dollar limit is effective January 1, and the dollar limit applicable for a given limitation year is the dollar limit that is in existence at the end of the limitation year. In 2006 the limit is $175,000 and $180,000 in 2007. Please refer to Appendix A for a summary of the IRC §415 dollar limits.

[A] Reducing the Compensation Limit for Service

The compensation limit must be reduced if a participant will have less than ten years of service at normal retirement age. The reduction is 10% for each year of service less than ten.

Example 4-5. Compensation Limit Adjustment. The plan administrator has determined that Willie's annual benefit under the IRC §415 dollar limitation cannot exceed $105,000 based on his six years of participation ending on his date of retirement: December 31, 2006. Willie was hired on January 1, 2000, a year before his entry into the defined benefit plan on January 1, 2001. Thus, Willie has seven years of service upon reaching retirement.

For the last five years of service, Willie earned $170,000 in compensation from his employer. His high three-year average compensation for IRC §415 limit purposes is $170,000, which is reduced by 30% to reflect seven years of service rather than ten years. Willie's applicable IRC §415 compensation limit is $119,000 ($170,000 reduced by 30% = $170,000 x .70 = $119,000). Since Willie's dollar limitation is less than his compensation limitation, Willie's annual retirement benefit under the defined benefit plan cannot exceed $105,000, expressed as a single life annuity payable at age 65.

[B] Retirement Prior to Age 62 or After Age 65

The annual IRC §415 dollar limit applies when retirement benefit payments commence between age 62 and age 65. If benefits begin prior to age 62, the dollar limit is actuarially adjusted to a lower amount, while if benefits begin after age 65, the dollar limit is actuarially adjusted upward. The Internal Revenue Code specifies what actuarial assumptions are used to perform these adjustments to the dollar limit. Note, however, that the 100% of average compensation limit is not adjusted for differing retirement ages.

[C] Reducing the Dollar Limit for Participation

If an employee will be a participant in the defined benefit plan for less than ten years upon reaching normal retirement age under the plan, the IRC §415 dollar limit is reduced by 10% for each year of participation less than ten.

Example 4-6. Dollar Limit Reduction. Willie enters his employer's calendar year defined benefit plan on January 1, 2001 and reaches retirement age under the plan at December 31, 2006. At retirement, Willie has been a participant for 6 years. His dollar limit for IRC §415 purposes, therefore, must be reduced by 10% for each year of participation less than ten. Since the plan's limitation year is the same as the plan year and the calendar year, Willie's annual benefit from the defined benefit plan cannot exceed $105,000 ($175,000 reduced by 40% = $175,000 x .60 = $105,000).

[D] Form of Benefit Adjustments to Both Limits

As explained in this section, the IRC §415 limit for defined benefit plans assumes payment in the form of a single, or straight, life annuity payable at age 65. If a participant receives his or her benefit in a form other than a straight life annuity, such as a ten-year certain and life annuity, both the dollar limit and the compensation limit are adjusted utilizing the actuarial equivalence factors contained in the Internal Revenue Code.

In other words, the plan must measure the form of benefit chosen in an actuarially equivalent manner against the maximum benefit under IRC §415. Note that there is an exception for plans whose normal form of benefit payment is a qualified joint and survivor annuity. These QJSA benefits need not be actuarially adjusted before measurement against the stated IRC §415 limits.

§4.09 Key Terms

Accrued Benefit: A benefit that an employee has earned (or accrued) through participation in the plan. In a defined contribution plan, the participant's accrued benefit is the balance in his or her individual account at a given time. In a defined benefit plan, the accrued benefit is determined as specified by the plan.

Actuarial Valuation: A series of calculations performed by the plan's actuary to determine the plan sponsor's annual contribution amount in a defined benefit plan.

Actuarially Equivalent Benefits: Two different forms of benefit (such as life annuity and lump sum) that have equal value under a set of actuarial assumptions defined in the plan.

Actuarially Equivalence Factors: Mortality and interest assumptions used to convert benefits from the normal form of benefit to an equivalent form.

Benefit Formula: The way a participant's retirement benefit is defined in the plan. It is often based on compensation, years of service or both.

Career Average Compensation: Used in a benefit formula when the benefit is determined using an average of compensation earned by the participant during his or her entire career.

Defined Benefit Plan A plan designed to provide participants with a definite benefit at retirement (e.g., a monthly benefit of 50 percent of final average compensation upon reaching age 65). Contributions under the plan are determined by reference to the benefits provided.

Excess (Step-Rate) Formula: An integrated benefit formula whereby a base benefit is calculated for all participants with an additional benefit is provided for participants whose compensation exceeds the integration level.

Final Average Compensation: Used in a benefit formula when the benefit is determined using an average of compensation earned by the participant over a specified period, often the period immediately before retirement.

Fixed Benefit: See service-related benefit formula.

Flat Benefit: See service-related benefit formula.

Funding Method: The specific calculation used to allocate cost in a defined benefit plan.

Integrated Benefit Formula: A benefit formula that takes into consideration contributions made to Social Security.

Offset Formula: An integrated benefit formula whereby the retirement benefit is calculated and then reduced (or offset) by an amount anticipated to be funded by Social Security.

Pay-Related Benefit Formula: A benefit formula based on compensation.

Service-Related Benefit Formula: A benefit formula based on the length of a participant's service. Also called fixed benefit or flat benefit formulas.

Unit Credit A type of defined benefit pension plan that calculates benefits on the basis of units earned by the employee during employment, taking into consideration length of service as well as compensation.

§4.10 Review of Key Concepts

- A defined benefit plan promises to pay a specified benefit at future retirement to eligible participants, in contrast to a defined contribution plan where the benefit is not specified but results from accumulated contributions and earnings.

- If a defined benefit plan's assets earn less than expected, the employer will generally have to make a larger contribution to ensure that the plan has sufficient monies to pay the promised benefits. Should the plan's investments earn more than anticipated, the employer's costs will generally decrease.

- Actuaries use a set of calculations called funding methods to determine the proper annual contribution amounts necessary to accumulate sufficient monies to pay promised retirement benefits.

- The amount of a participant's retirement benefit is defined in the plan and is determined using the plan's benefit formula. There are many ways a plan can define a participant's benefit. Some plans base benefits on the participant's compensation, others use service years and still others take both compensation and service into consideration.

- The normal form of benefit specified in the plan is the manner in which the normal retirement benefit is to be paid under a defined benefit plan. Traditional normal forms of benefit are life annuity, life annuity with ten years certain and joint and survivor annuity. The plan may allow for optional forms of benefit and must define how they are to be calculated.

- A common accrual method for small plans is the fractional accrual method. Under this method a participant is deemed to earn or accrue a pro rata share of the retirement benefit each year from the date benefit accrual first begins until normal retirement age is attained.

- Benefits that are of equal value at a given point in time are called actuarially equivalent benefits. The plan must define a basis to convert benefits from the normal form to equivalent forms, and this basis for conversion includes mortality and interest assumptions.

- The IRC §415 limits set a ceiling on the amount of annual retirement benefits that may be provided to a defined benefit plan participant.

§4.11 Review Questions

[A] True or False

______ 1. The IRC §415 dollar limit is adjusted for less than ten years or service at normal retirement age.

______ 2. The IRC §415 maximum benefit limit is the lesser of the dollar limit or the compensation limit.

______ 3. Actuarial equivalence is a method used to determine the minimum and maximum contribution in a defined benefit plan.

______ 4. An actuarial valuation is performed annually to determine the contribution necessary to fund the benefits.

[B] Multiple Choice

5. All of the following influence the required employer contribution to a defined benefit plan, **EXCEPT**:

   A. Participants' job function
   B. Plan’s investment experience
   C. Funding method chosen by actuary
   D. Interest and life expectancy assumptions chosen by the actuary
   E. Benefit formula

6. All of the following can be used to determine a participant's benefit in a defined benefit plan, **EXCEPT**:

   A. Career average compensation
   B. Plan's benefit formula
   C. Interest and dividends
   D. Final average compensation
   E. Years of service

7. All of the following statements regarding actuarial equivalence in a defined benefit plan are **TRUE, EXCEPT**:

   A. It refers to benefit options that are of equal value at a given point in time.
   B. The basis for calculating actuarial equivalence includes interest and mortality assumptions.
   C. The actuarial equivalence factors for calculating early retirement benefits can be different from those for top-heavy present value calculations.
   D. The basis for calculating actuarial equivalence must be defined in the plan document.
   E. PBGC requirements have no impact on actuarial equivalence calculations of the present value of benefits.

8. All of the following are typical normal forms of benefit payment from a defined benefit plan, **EXCEPT**:

   A. Life only annuity
   B. Lump sum
   C. Joint and survivor annuity
   D. Life annuity with ten years certain
   E. Straight life annuity

9. Based on the following information, determine Participant A's monthly accrued benefit from the defined benefit plan.

   - Normal Retirement Age is 65.
   - Participant A's age at hire was 40.
   - Participant A's current age is 60.
   - Benefit accrual is based on years of service.
   - The plan document specifies the fractional accrual method is to be used.
   - Participant A's monthly Normal Retirement Benefit is $3,333.33.

   A. $2,500.00
   B. $2,666.66
   C. $2,750.00
   D. $3,000.00
   E. $3,333.33

§4.12 Answers

1. **False.** The IRC §415 dollar limit is adjusted for less than ten years of participation at normal retirement age. §4.08 [C]

2. **True.** The IRC §415 maximum benefit limit is the lesser of the dollar limit or the compensation limit. §4.08

3. **False.** Actuarial equivalence is when two different forms of benefit (such as life annuity and lump sum) have equal value under a set of actuarial assumptions defined in the plan. §4.07

4. **True.** An actuarial valuation is a series of calculations performed by the plan's actuary to determine the plan sponsor's annual contribution amount in a defined benefit plan. §4.03 [B]

5. The correct answer is **A.** §4.03

   A. Correct. This statement is false because a participants' job function does not influence the employer's contribution in a defined benefit plan.
   B. Incorrect. This statement is true because a plan's investment experience affects the contribution in a defined benefit plan.
   C. Incorrect. This statement is true because the funding method chosen by actuary affects the contribution in a defined benefit plan.
   D. Incorrect. This statement is true because interest and life expectancy assumptions chosen by the actuary affect the contribution in a defined benefit plan.
   E. Incorrect. This statement is true because the benefit formula affects the contribution in a defined benefit plan.

6. The correct answer is **C**. §4.04

   A. Incorrect. This statement is true because career average compensation may be used to determine a participant's benefit in a defined benefit plan.
   B. Incorrect. This statement is true because the plan's benefit formula is used to determine a participant's benefit in a defined benefit plan.
   C. Correct. This statement is false because interest and dividends are not used to determine a participant's benefit in a defined benefit plan.
   D. Incorrect. This statement is true because final average compensation may be used to determine a participant's benefit in a defined benefit plan.
   E. Incorrect. This statement is true because years of service may be used to determine a participant's benefit in a defined benefit plan.

7. The correct answer is **E.** §4.07

   A. Incorrect. This statement is true because actuarial equivalence refers to benefit options that are of equal value at a given point in time.
   B. Incorrect. This statement is true because the basis for calculating actuarial equivalence includes interest and mortality assumptions.
   C. Incorrect. This statement is true because the actuarial equivalence factors for calculating early retirement benefits can be different from those for top-heavy present value calculations.
   D. Incorrect. This statement is true because the basis for calculating actuarial equivalence must be defined in the plan document.
   E. Correct. This statement is false because PBGC requirements do impact actuarial equivalence calculations of the present value of benefits.

8. The correct answer is **B.** §4.05 [B]

   A. Incorrect. This statement is true because life only annuities are a typical form of benefit in a defined benefit plan.
   B. Correct. This statement is false because while they may be allowed, lump sum distributions are not the typical form of payment found in a defined benefit plan.
   C. Incorrect. This statement is true because joint and survivor annuities are a typical form of payment found in a defined benefit plan.
   D. Incorrect. This statement is true because life annuity with ten years certain is a typical form of payment found in a defined benefit plan.
   E. Incorrect. This statement is true because a straight life annuity is a typical form of payment found in a defined benefit plan.

9. The correct answer is **B.** The participant currently has earned 20 years of service out of a possible 25. The monthly accrued benefit is the participant's normal retirement benefit earned to date. This is $2,666.66 ($3,333.33 x 20/25). §4.06

Chapter 5:
First Steps to a New Plan

§5.01 Learning Objectives

- Identify factors that influence plan design.
- Calculate an employer's maximum deductible contribution to a defined contribution plan.
- Identify the types of contributions that may be categorized as employee contributions.
- Distinguish between the different types of plan documents (master plan, prototype, volume submitter, individually designed and trust document).
- Name and describe the key documents that must be prepared when implementing a new plan.

- Explain the fidelity bond requirement and who is bonded.
- Explain the reasons for requesting an IRS determination letter and outline the process.

§5.02 Introduction

The first crucial steps in the process of plan administration begin with designing the right plan to meet the plan sponsor's goals, creating the written plan, and setting the plan in motion or installing the plan. This process is critical to establishing and maintaining a qualified retirement plan for the benefit of the employer's participating employees as well as for the employer itself. Time spent here avoiding potential missteps will be well-spent. Once formalized on paper, what constitutes the plan document will not only fulfill one of the four fundamental requirements for qualification—that the plan be in written form—but it will also serve as the cornerstone reference for future plan operation and administration.

To address issues surrounding a plan's inception, this chapter provides an introduction to:

- The basics of plan design;
- Contribution and deduction issues;
- The types of plan documents available;
- The other documents that are essential for plan implementation;
- Fidelity bonding requirements; and
- The IRS determination letter program.

§5.03 Basics of Plan Design

Given the legal, financial, accounting, internal resource management and tax ramifications surrounding the institution of a qualified retirement plan program, an employer is well-advised to seek the counsel of its accountant, attorney and retirement plan professional for assistance in determining the type of qualified plan most appropriate to serve the best interests of the company and its employees. In addition, the input of any human resource specialist should be duly considered.

The valued input of accountants and attorneys being readily understood, the employer will gain retirement plan expertise by engaging a retirement plan professional whose initial role is to help the employer focus on the most beneficial plan design for its individual situation. Through explanations of the various types of plans via extensive data-gathering about the employer, a retirement plan professional guides a plan sponsor through the myriad factors influencing the selection of a qualified plan. Some of the more important of these would be:

- Employee demographics such as age, service years, salary levels, and size of population;
- Employees' retirement needs and their familiarity or comfort level with savings and investment practices;
- Consistency in the level of employer's profits;
- Prospects for continued profits to fund the retirement plan;
- Tax deductibility of contributions;
- Employer's need to be able to compete for qualified employees;
- Plan features designed to benefit specific employees as retention incentives;
- Plan features available to encourage participation under the plan, such as the ability to borrow from an individual account; and
- Ease of administration and impact on an employer's human resources staff.

Considering the characteristics of the employee population such as average age, years from retirement, salary levels and degree of familiarity with investment or financial planning principles can help determine the best retirement plan for a particular organization. For example, a grocery store chain with employees who are wary of actively managing assets within their individual accounts might consider offering investments directed by an appointed party such as a financial advisor, while a banking institution might find its employees prefer participant-directed investments from a multitude of available fund options. A bakery with a mature workforce might opt for a target benefit plan design to accelerate the accumulation of retirement assets but still provide for individual accounts, while a landscaper with a youthful workforce may choose to offer the ability for participants to borrow from their accounts as a participation incentive.

Employer-based considerations also have an intrinsic effect on choices concerning the right retirement plan. An employer's review of the profitability of the organization or desire to minimize the retirement-related responsibilities of its administrative staff might eliminate certain plan designs while promoting others. A plan sponsor wishing to maximize the tax deduction from year to year could implement a generous defined benefit plan formula, while low profits might call for a 401(k) profit sharing plan with only employee-driven savings. Alternately, establishing a retirement plan offering similar or higher benefits than those of one's competitors may constitute a winning advantage in hiring negotiations or landing a bid for contracted work. Ease and cost of administration to the employer may suggest a SIMPLE IRA plan or SEP.

Balancing these and other employee and employer-based considerations, therefore, results in an efficient and successful plan design. The next section discusses the tax deduction limits of the various types of plans which can play a role in determining the appropriate retirement plan for the employer.

§5.04 Contributions and Deductions

[A] Contributions

The contributions and allocations section of a defined contribution plan document will explain how the amount of required or discretionary contribution is determined. For example, while money purchase plans contain a required contribution formula, sponsors of profit sharing plans enjoy discretion in the amount of profit sharing contributions made each year, if any. Notably, sponsors of profit sharing plans may contribute amounts that exceed current or accumulated profits, and therefore the plan document should be carefully checked to understand how a sponsor will determine its profit sharing contribution. Any employer matching contribution formula for 401(k) plans also will be specified in the plan document.

[B] Deductibility of Employer Contributions

Employers normally expect their plan contributions to be deductible under the Internal Revenue Code, and there are many rules that affect the deductibility of employer contributions made to a retirement plan. Consequently, it is common practice for a retirement plan administration firm to provide contribution information to a plan sponsor so that the sponsor's tax advisors may confirm deductible amounts and contribution deadlines.

This information regarding contributions may include:

- The minimum required contribution amount;
- The maximum contribution amount; and
- Any deadlines for depositing plan contributions.

The maximum tax-deductible contribution for an employer sponsoring a profit sharing plan, money purchase plan or both a profit sharing and a money purchase plan is 25 percent of the total compensation of eligible participants. Compensation considered to determine the tax-deductible contribution is measured based on the plan sponsor's fiscal year rather than the plan year. In most cases, but not all, the plan year is set up to be the same as the plan sponsor's fiscal year. This avoids the need to perform calculations on compensation for two different twelve-month periods.

Notably, EGTRRA provided that elective deferrals under a 401(k) plan, which are technically employer contributions, are always deductible and are not considered in computing the 25 percent maximum. Also, in these calculations, each eligible individual's compensation is limited to the maximum annual amount of compensation that may be considered for plan purposes under the Internal Revenue Code ($220,000 in 2006).

Example 5-1. Sample Deduction Calculation for 2006.

- Participant A's compensation $250,000
- Participant B's compensation $225,000
- All other participants $500,000*
- Total elective deferrals $ 50,000

Total eligible compensation before the deduction limit is $975,000 ($250,000 + $225,000 + $500,000).

The amount of compensation in excess of the compensation limit is $35,000 (($250,000 – $220,000) + ($225,000 – $220,000)).

The net eligible compensation for deduction purposes is $940,000 ($975,000 - $35,000).

The maximum tax-deductible contribution is **$235,000** ($940,000 x 25%).

Note, this means that the employer can contribute and deduct a total of $235,000 to the plan, including employer matching and profit sharing contributions. The elective deferrals of $50,000 are separately deductible by the employer and not included in this limitation.

*None individually exceeds $220,000.

An actuary will determine the minimum and maximum required contributions for a defined benefit plan to meet funding standards under the Internal Revenue Code, which also determines the amount of the employer's tax deduction for that plan. Where employees participate in both a defined contribution and a defined benefit plan sponsored by their employer, generally the overall tax-deductible contribution is subject to an additional limit: the greater of 25 percent of the total compensation of eligible participants or the amount necessary for the defined benefit plan to meet funding standards.

As a general rule, contributions made after the close of the employer's taxable year but prior to the due date of the employer's tax return, including extensions, are deductible for the prior tax year as long as statutory limits on the amount of contributions are not exceeded. Where plan years and tax years do not coincide, there may be an extended period between when a contribution is allocated at plan year end, and when it is actually deposited into the plan's trust. Note that there are special rules for elective deferrals and matching contribution deductions when the plan year does not equal the employer's fiscal year.

[C] Excise Taxes

Every year, the plan sponsor of a money purchase plan, target benefit plan, or a defined benefit plan must contribute the amount required to satisfy the minimum funding requirements of IRC §412. Failure to meet the minimum funding requirements subjects the employer to a 10 percent excise tax on the amount of the deficiency. If the deficiency is not corrected, a 100 percent excise tax is due. In similar fashion, the Internal Revenue Code also imposes an excise tax when the plan sponsor contributes more than what is deductible: 10 percent of the nondeductible contribution as of the end of the employer's tax year. Excess contributions to a 401(k) plan additionally may incur a 10 percent penalty if not timely corrected. The consequences of contributing in excess of the deductible limits or less than the required minimum amounts may be substantial; therefore, any perceived contribution error should be carefully investigated.

[D] Employee Contributions

Various plan deposits may be categorized as employee contributions, including:

- After-tax employee contributions;
- Mandatory employee contributions;
- Qualified voluntary employee contributions (QVECs);
- Deemed IRAs; and
- Rollover contributions (including transfers from other qualified plans).

The administration of these types of contributions centers around proper crediting to the individual participant's account and identifying the contribution by its type so as to preserve the participant's pre-tax or after-tax basis in the contribution.

After-tax employee contributions are not as commonly found as they once were, due to the rising popularity of 401(k) plans which offer pre-tax elective deferrals and catch-up contributions. The plan document provisions should be consulted to determine if after-tax employee contributions will generate matching contributions by the employer and to identify any specific accounting or eligibility parameters regarding these employee contributions. They will also require nondiscrimination testing.

Mandatory employee contributions are treated as after-tax employee contributions and should consequently not be confused with elective deferrals. Remember that elective deferrals, including designated Roth contributions and catch-up contributions, are considered employer rather than employee contributions. While somewhat rare in the private sector, mandatory employee contributions are more common in the public sector, such as within state-sponsored governmental plans. Like after-tax employee contributions, mandatory employee contributions are subject to further nondiscrimination testing.

From 1982 through 1986, qualified plans could allow participants to make qualified voluntary elective contributions that were deductible by the participants as IRA contributions. Some plans still have QVEC accounts for those participants who took advantage of the provision during those intervening years.

EGTRRA reinstated this concept, and beginning in 2003, qualified plans may allow participants to make IRA contributions into a separate account under the plan called a deemed IRA. These deemed IRAs must be provided for in the plan document. Consequently, the presence of QVEC or deemed IRA accounts should be duly noted for any separate accounting, earnings allocation, withdrawal eligibility, and reporting purposes required.

Rollover contributions, including transfers from another qualified plan, represent the accumulation of pre-tax contributions and earnings where the tax-deferred status is being preserved under the receiving plan. If the plan document permits, eligible retirement plans may receive rollover contributions from any of the following:

- Another qualified plan;
- Certain types of IRAs;
- A TSA 403(b) plan; and
- A governmental 457 plan.

The plan document's contributions and allocations section should address any allowable employee contributions and provide clear guidance on how these should be held and administered under the plan.

§5.05 Types of Qualified Retirement Plan Documents

Once the preferred retirement plan vehicle has been identified, the process of establishing a plan turns toward choosing from several different types of qualified retirement plan documents. Some are uniform and relatively simple to use while others are more sophisticated and address complex plan design and qualification issues. As one might imagine, uniformity and simplicity may also translate into less document-related expense, but here as elsewhere the employer's retirement plan objectives are of paramount influence. Whatever the choice of format and written instrument, the legal plan document must accurately represent and support the plan design while achieving tax-qualified status.

To assist in the creation of accurate and allowable plan documents and minimize the potential for flawed language, the IRS has actively encouraged greater use of more uniform and less individualized plans by publishing recommended language and sponsoring several different plan document programs. The types of plan document programs are:

- Master and Prototype Plan;
- Volume Submitter Plan; and
- Individually Designed Plan.

[A] Master and Prototype Plans

The most widely used of these programs is the master and prototype program run by the IRS National Office, which pre-approves for qualified status the language contained in these documents. While there is an essential distinction between a master and a prototype document (discussed later), the extensive similarities lend themselves first to a joint discussion of both types.

A **master or prototype plan** is a two-part document: both parts, taken together as one legal instrument, form a sponsor's plan document. One part is the **basic plan document** that contains language addressing common provisions and definitions that will apply for *all* employers choosing to use or adopt the master or prototype.

To illustrate: the basic plan document typically explains who is defined as a highly compensated employee under the Internal Revenue Code and ERISA, what constitutes an hour of service with an employer, and which rules of conduct apply for all who handle and manage plan assets.

The other part, generally known as the **adoption agreement** or sometimes joinder agreement, is a "fill-in-the-blank" or "check-the-box-that-applies" document that the employer completes to its specifications, such as whether the plan will exclude employees who are less than age 21.

Both defined contribution and defined benefit plans are available in master or prototype format, and a basic plan document may have several affiliated adoption agreements differentiated by type of plan. For example, a defined contribution prototype plan may have profit sharing, money purchase, and 401(k) plan adoption agreements, all of which may be used with the same basic plan document.

Using the appropriate adoption agreement, the plan sponsor chooses from various plan provisions available in the master or prototype arrangement and supplies employer information such as plan sponsor name, address, and tax identification number. For example, when completing a profit sharing plan adoption agreement section on the method of allocating the contribution, the employer may fill in the blank that pertains to a percentage allocation in proportion to compensation, or alternately fill in the blank that pertains to a specific dollar amount per participant regardless of his or her compensation. Either type of allocation would be allowed under the master or prototype plan as described in the basic plan document. The employer simply elects its method of choice within the completed adoption agreement.

Prototype adoption agreements are categorized not only by type of plan, be it defined contribution or defined benefit, but also by standardized and nonstandardized content. A **standardized plan document** is a simple document that allows just a few options, eliminating many complex nondiscrimination tests for sponsoring employers as long as they operationally follow the terms of their plan documents. For example, a standardized prototype plan might provide no options for choosing eligibility requirements, compensation definitions, or allocation methods and instead mandate use of blanket provisions designed to ensure compliance with required nondiscrimination tests, thereby eliminating the need to perform them.

Conversely, **nonstandardized plan documents** allow the employer substantially more flexibility in choosing plan provisions, but these may result in additional nondiscrimination testing.

The master plan is differentiated from the prototype plan by the permitted investment choices. An employer adopting a master plan *must* use the investments chosen by the sponsor of the master plan; that is, the plan assets of all employers executing an adoption agreement under a master plan are pooled, with investments directed by the sponsoring organization of the master plan. Each employer participating in the master plan arrangement receives a separate accounting of its individual plan share in the pool.

An employer adopting a prototype plan is not restricted in this way since there is no pooling of plan assets between employers. In other words, using a master plan document eliminates certain investment and asset responsibilities for the plan sponsor while use of a prototype does not. Not surprisingly, prototype plans are more popular than master plans.

Over the past ten years there has been a significant increase in the use of master and prototype plans as a cost-effective way for employers to establish a qualified plan; an increase the IRS has encouraged by broadening the types of organizations that may create and offer these types of plans. Currently master and prototype plans are offered by financial institutions such as commercial and savings banks, mutual fund companies, broker-dealers and insurance companies (called **sponsoring organizations**); and by attorneys, accountants, actuaries and retirement plan professionals.

Master or prototype arrangements should not necessarily be viewed as overly rigid. There are options among sponsoring organizations that typically offer other retirement plan services in conjunction with plan document assistance, as well as choices to be made between master and prototype, or standardized and nonstandardized adoption agreements.

[B] Volume Submitter Plans

The IRS runs the volume submitter program which is generally used by attorneys and consulting firms that want the ease of approval available to the prototype users, but wish to offer their clients the appearance of a more custom-drafted plan and additional range in plan provisions. Like master or prototype plans, volume submitter documents are relatively easy to use documents with language pre-approved by the IRS. They consist of a **specimen plan** with optional provisions; that is, volume submitter plans are not in two parts, and there is no sharing of a base plan document. Notably, employers electing to use a **volume submitter plan** will enjoy the use of optional provisions not allowed in its master or prototype counterparts.

[C] Individually Designed Plans

An **individually designed plan** or custom plan document drafted by a qualified employee benefits attorney (often called an ERISA attorney) provides the widest range of plan specifications and the greatest amount of plan design flexibility. Employers who are most likely to require individually designed plans are entities with special needs. An example would be a company sponsoring a qualified plan that splits into two completely unrelated legal entities as the result of a corporate divestiture or sale of a division, with both unrelated companies wishing to continue use of the original qualified plan, thereby avoiding the costs of maintaining and operating separate but identical plans. Each would have to become sponsoring employers of the same plan, thus requiring a custom document.

[D] Trust Document

Whether the plan document is a master, prototype, volume submitter or individually designed, the language that creates a **qualified trust** (i.e. the legal instrument by which the plan's assets are held and maintained under local trust law) may be incorporated into the same single document as other plan provisions. In these instances, the single document is called the plan and trust and is signed and executed by both the plan sponsor and the trustee. Alternately, some trust instruments are drafted as completely separate documents containing only the governing provisions of the trust, such as those in which a brokerage firm is named fiduciary trustee.

The trust provisions, whether or not they are contained in a separate document, represent the legal agreement between the employer and the trustee. The trust agreement typically defines the extent of the trustee's powers and duties, particularly with regard to the authority to invest and manage the plan's assets.

For example, where the plan administrator has secured the services of an investment manager, the trust agreement might specify that the trustee is to be directed to make the investments as authorized by the investment manager, as long as the trustee fulfills his or her responsibilities as a plan fiduciary.

Other common trust provisions address how and when the assets in the trust will be valued, reconciled and account statements provided, as well as housekeeping items such as how a trustee might be appointed, resign or be succeeded in his or her position.

[E] Other Documents

In addition to the plan document, there are other statements of policies, forms, notices, descriptions, and similar documentation that must be prepared to comply with ERISA, the Internal Revenue Code and related statutes. These include, but are not limited to, the following:

- Resolution authorizing company officers and/or directors to take all actions necessary to adopt the qualified retirement plan;
- Notice to Interested Parties of the establishment of the plan;
- Investment Policy;
- Participant Loan Policy;
- Summary Plan Description (SPD); and
- Qualified Domestic Relations Order (QDRO) Policy.

§5.06 Implementation of the Plan

Once the plan has been designed and its written form determined, the plan and its supporting written policies must be installed or implemented within various legally-defined time periods, so as not to threaten the plan's qualified status.

[A] Adoption of a New Plan Document

The deadline by which a qualified plan document must be signed (often called executed or adopted) by the employer in order for its plan provisions and tax-qualified status to be considered in effect is based upon the concept of a plan year. Often, an employer defines the plan year of its qualified retirement plan by using the same tax-reporting period as its fiscal year. Thus, an employer with a July 1 to June 30 fiscal year would likely utilize the corresponding July 1 to June 30 period as its plan year for ease in areas such as accounting, administration, budgeting, and tax-reporting.

A plan year also may be the calendar year or any other 12-month reporting period designated as such by the plan document. Of note: short plan years of less than 12 months do exist. These may occur as the initial reporting year or as the result of a plan change.

The last day of the first plan year is the signing deadline for a qualified plan document for all non-401(k) plans. For example, a profit sharing plan established for the 2007 calendar year must be executed no later than December 31, 2007.

401(k) plans are subject to an accelerated deadline and must be adopted prior to the withholding of any elective deferrals. Thus, if elective deferrals were to begin with the payroll period ending January 15, 2007, the employer must sign the plan document before that payroll date.

[B] Investment Policy

A plan sponsor should establish an **investment policy** to serve as a guidebook for those given the responsibility of managing the plan's assets. By formalizing general investment instructions or guidelines for making fund selections and monitoring investment performance, the plan sponsor clarifies the plan's financial objectives and measurement standards both for itself and the plan's participants. While the presence of an investment policy is not required under ERISA, adherence to a written investment policy reduces the potential for arbitrary handling of assets, supports the plan sponsor in its responsibility to perform prudently in choosing investment options available for participant-directed accounts, and provides consistency in application of the plan's financial goals despite changes of assets or investment managers.

[C] Participant Loan Policy

If the plan allows a participant to borrow from his or her account, the employer must adopt a written **participant loan policy** as either a part of the plan document itself or as a separate document. Both the IRS and the DOL have issued guidance on participant loans and their administration.

Some of the major issues that must be addressed in the loan policy are:

- For what purposes loans will be allowed, such as buying a home;
- Minimum and maximum loan amounts;
- Repayment terms of the loans, such as the length of borrowing period and frequency of payment;
- What constitutes a reasonable interest rate;
- What may be used to secure the loan;
- What constitutes a defaulted loan;
- Procedures upon default; and
- Number of loans that may be outstanding at one time.

An extended discussion of participant loans may be found in Chapter 11.

[D] Summary Plan Description

Another intrinsic part of the installation of a qualified plan is the distribution to all eligible employees of a **summary plan description (SPD)**. Intended to be a plain language explanation of the terms of the qualified retirement plan, an SPD must be written so that the average employee may easily understand it. Use of examples is therefore encouraged, and where the composition of the workforce demands it, provisions for foreign language versions or foreign language assistance must be made. As such, the SPD functions as the primary method of disclosing to participants their rights under the plan, how the plan works, what benefits are provided, when those benefits will be paid, and how to request benefit payments.

For newly created plans, the SPD must be provided to each participant or beneficiary receiving benefits under the plan no later than 120 days after the new plan becomes subject to Title I of ERISA, which contains the rules for disclosure of information to participants. Generally, new plans are subject to the Title I provisions as of the *latest* of two dates: the date the plan is adopted or signed by the employer, or the effective date of the plan.

Example 5-2. SPD Deadline. A new profit sharing plan is installed for the plan year beginning January 1, 2007 and ending December 31, 2007. The plan sponsor signs the document on December 31, 2007. The later of the date the plan is adopted (December 31, 2007) or effective (January 1, 2007) is December 31, 2007. Therefore the SPD must be furnished no later than April 30, 2008.

After the initial plan document has been adopted, the employer must continue to update and provide SPDs to employees within certain timeframes.

- no later than 90 days after becoming a participant;
- if the plan has been amended in a manner which changes the material contained in the SPD, the SPD must be updated at least once every 5 years and distributed within 210 days after the end of plan year for which the SPD is updated; or
- at least once every ten years whether or not there have been any amendments to the plan document.

It should be noted that an SPD is not intended to replace the plan document, and if participants so desire, they may view or receive a copy of the entire plan document from the plan sponsor.

[E] Employee Elections

A host of employee election forms for use in the plan's operation and administration are generally created at the time a plan is installed and updated as necessary. Often, all the forms are provided to new participants, and again as a situation requires.

Participant election forms in all qualified plans may include, but are not limited to:

- Designation of beneficiaries;
- Application to request that a participant's retirement account under another qualified plan be transferred into the plan (rollover request);
- Distribution request upon separation from service with the employer;
- Participant loan application; and
- An application to request an in-service withdrawal.

Additional participant election forms for 401(k) plans may include, but are not limited to:

- Salary reduction agreement to make elective deferrals;
- Investment elections by the participant; and
- An application to request an in-service withdrawal of elective deferral contributions for financial hardship reasons.

Later chapters are devoted to a study of issues and administrative processes that surround the circumstances generating use of these forms.

§5.07 Fidelity Bond

In our post-Enron world, most people would not be surprised by the concept of a **fidelity bond**: an insurance contract in which the issuing agency agrees to pay sums up to the bond limit to reimburse the employer or plan for losses created by the actions of those individuals who handle plan assets or have other discretionary authority over the plan and its assets.

Most plans must obtain a fidelity bond covering all such individuals in order to protect the interest of the plan's participants. The amount of the bond must be the greater of $1,000 or 10 percent of the trust assets but is not required to be greater than $500,000. Each year, this bond amount is reported to the DOL on the financial information schedules of the plan's Form 5500 filing.

Understandably, plans covering only the owner of the employer, the owner and the owner's spouse, partners in a partnership, or partners and their spouses are not subject to fidelity bonding requirements. Plans of this nature are not considered employee benefit plans under ERISA given the composition of the plan population.

Under certain circumstances, plan sponsors of small retirement plans (generally, those with fewer than 100 participants) may choose to increase the amount of their fidelity bond coverage above the 10 percent of plan asset minimum or $500,000 maximum in order to waive the small plan audit requirements.

These DOL audit regulations were intended to increase the security of plan assets, limit fraud, and provide participants with sufficient information to monitor plan assets and the actions of those empowered to handle those assets. However, in acknowledgement that small employers may find the cost of an annual audit burdensome and disproportionately large in comparison to their other plan administrative costs, a small plan audit exemption was made available for plans with fewer than 100 participants, if their sponsors provided a measure of security for the plan assets.

This measure of security takes one of two forms: holding 95 percent of a plan's assets at the beginning of each plan year in qualifying assets, or obtaining additional bonding in an amount at least equal in value to those assets *not* meeting the definition of qualifying assets and disclosing this information to plan participants.

For these purposes, a **qualifying plan asset** is one that is held by:

- A bank or similar institution;
- An insurance company;
- A broker-dealer; or
- An organization authorized to hold IRA assets;

  Or, is in the form of:

- Qualifying employer securities (stocks or other marketable obligations of the employer);
- Loans to participants;
- Mutual fund shares issued by an investment company;
- Insurance company annuity or investment contract; or
- Assets in an individual account for which the participant directs investments, provided the participant receives an annual statement from a regulated financial institution.

The plan audit requirement and the small plan audit exemption will be further addressed in RPF-2, Chapter 15.

§5.08 Request for an IRS Determination Letter

With a plan's tax-qualified status stemming from the plan document as referential source, and with the operation and administration of the retirement plan being dictated by that plan document, what measure of assurance can a plan sponsor seek that its plan in written form actually conforms to the rules and regulations governing qualified plans? The answer lies in the guidance issued under the IRS Determination Letter program.

The most common type of application for an IRS determination letter is the request for plan document qualification. Volume submitter, master and prototype plan documents are sent to the IRS for approval by their respective sponsoring organizations to garner a favorable **opinion letter**, in the case of master and prototype plans, or an **advisory opinion**, in the case of volume submitter plans. Thereafter, employers who utilize one of these plan document types may look toward the accompanying favorable opinion letters or advisory opinions for a measure of reliance. However, reliance is not automatic. The plan sponsor must have adopted the mirror image of the master, prototype or volume submitter plan, choosing only from the options provided. Any deviation from the allowable language or options under these plans, however minute, would turn the plan document into an individually designed plan.

Individually designed plans do not have a sponsoring organization's favorable opinion letter or advisory opinion to rely on; therefore, they must submit an individual request to the IRS if they wish to receive a **determination letter** addressing their specific plan document. If they so choose, adopters of master, prototype and volume submitter plans could mimic their individually designed plan counterparts and submit an individual request to the IRS for a determination letter addressed to their particular plan document.

The determination letter program also extends beyond review of an initial plan document. Determination letters may be obtained for plan amendments, complete reissuance of the plan document (called a restatement or restatement in its entirety) and upon a plan termination. Although there is no requirement that an employer obtain a determination letter, and though receipt of a favorable determination letter is not a guarantee of qualified status, application for a determination letter is clearly the conservative and often recommended approach.

[A] Timing for Submission of Requests to IRS

As a matter of course, submission to the IRS should be made as soon as possible in order to maximize the time available for any amended language the IRS might require before issuance of a favorable determination letter. Also, for tax-deduction and funding purposes, employers adopting a new plan during their current fiscal year will usually file a determination letter application no later than the due date of their tax return, including extensions, since filing by that date typically allows the IRS to extend the time period for correcting any plan document defects found during review. Contributions to the plan may be accepted while the determination request is under consideration; however, most plans are drafted to require that any contribution be returned to the employer or employees should the IRS rule that the plan document is not qualified. When substantive law changes occur, the IRS may extend the time for submitting a plan for a determination letter in order to allow sufficient time for the document to reflect those substantive law changes.

[B] User Fees for Determination Letters

Determination letter program user fees are charged by the IRS in amounts dependent upon the type of plan document (master, prototype, volume submitter, or individually-designed), number of employees and other plan features for which a ruling is sought. The least costly user fees apply to standardized master or prototype applications, while applications involving individually designed plans understandably have higher fees. In some instances, user fees may be waived for plans sponsored by a small employer with 100 or fewer employees.

For an increased user fee, employers may also obtain IRS approval on additional issues extending beyond a review of the plan's written form. For example, the employer may be concerned whether the plan meets certain minimum coverage or nondiscrimination requirements. By providing actual plan data for a year and a summary of calculations, a plan sponsor could request that the IRS review both the plan language governing the nondiscrimination requirements and how the employer has operationally applied those requirements to the supplemental data provided.

Although any ensuing IRS approval will be limited to the particular year's data as submitted, the employer may gain confidence that the testing methodology undertaken by the plan, as illustrated by the chosen year's application of that methodology, does have merit and is compliant with IRS rules. Fortunately, this IRS review of additional issues is available whether the employer adopts a prototype, volume submitter or individually designed plan.

[C] IRS Forms Used to Request a Determination Letter

Each year, the IRS updates its Revenue Procedure for determination letter submissions. Currently, Rev. Proc. 2006-6 applies having superceded Rev. Proc. 2005-6. Different forms are required for different types of determination letter requests, and all may be downloaded or viewed from the IRS website (www.irs.gov). Some of the forms utilized are:

- Form 2848 – Power of Attorney and Declaration of Representative. Completed by plan sponsors, it empowers a representative who is enrolled to practice before the IRS, such as an attorney, to speak with the IRS on behalf of the plan sponsor regarding plan issues.
- Form 8821 – Tax Information Authorization. Completed by the plan sponsor, it empowers a representative, who is not enrolled to practice

before the IRS, such as a Retirement Plan Administrator who is not a CPA, an Actuary, an Attorney or Enrolled Agent, to receive information from the IRS with regard to specific plan issues.

- Form 5300 – Application for Determination for Employee Benefit Plan. For the most part used by plan sponsors of individually designed plans, it may also be required when more complex plan designs are to be reviewed by the IRS.
- Form 5307 – Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans.
- Form 5310 – Application for Determination for Terminating a Plan.
- Form 6088 – Distributable Benefits from Employee Benefit Plans. Applicable to defined benefit plan sponsors, it accompanies Form 5310.
- Form 6406 – Short Form Application for Determination for Minor Amendment of Employee Benefit Plan. It is employed to request a determination letter for a minor amendment on individually designed or volume submitter plans.
- Form 8717 – User Fee Form. This accompanies and facilitates payment of the proper amount.
- Schedule Q – Nondiscrimination Requirements Form. An optional form with participant and testing data, it supports a request that the IRS also review the nondiscrimination, minimum coverage, and participation language in the plan as well as how the plan is applying these requirements as evidenced by the data supplied.

§5.09 Key Terms

Adoption Agreement: A “fill-in-the-blank” document containing employer information and specific plan provisions.

Advisory Letter: A letter issued to the sponsoring organization of a volume submitter plan indicating preapproval status regarding plan qualification.

Basic Plan Document: Contains language addressing common provisions and definitions that will apply for *all* employers choosing to use or adopt the master or prototype plan.

Determination Letter or **Letter of Determination**: Letter issued by the IRS representing a determination as to whether or not a plan submitted has satisfied the requirements for qualification.

Fidelity Bond: An insurance contract in which the issuing agency agrees to pay sums up to the bond limit to reimburse the employer or plan for losses created by the actions of those individuals who handle plan assets or have other discretionary authority over the plan and its assets.

Individually Designed Plan: A custom plan document drafted by a qualified employee benefits attorney providing the widest range of plan specifications and the greatest amount of plan design flexibility.

Investment Policy: General investment instructions or guidelines for making fund selections and monitoring investment performance that serves as a guidebook for those given the responsibility of managing the plan's assets.

Master or Prototype Plan: Usually a two part document. One part is the basic plan document that contains language and definitions, which are the same for all plans. The other part is an adoption agreement, which is a "fill-in-the-blank" document containing employer information and specific plan provisions.

Non-Standardized Plan: A master or prototype plan document that gives the employer more flexibility than a standardized document.

Opinion Letter: A letter issued to the sponsoring organization of a master or prototype plan indicating preapproval status regarding plan qualification.

Participant Loan Policy: Adopted as part of the plan or as a separate document outlining the rules regarding participant loans from the plan.

Prototype Plans: See Master Plan.

Qualified Trust: The legal instrument by which the plan's assets are held and maintained under local trust law.

Qualifying Plan Assets: Plan assets held by a bank or similar institution, an insurance company, a broker-dealer or an organization authorized to hold IRA assets or in the form of qualifying employer securities (stocks or other marketable obligations of the employer), loans to participants, mutual fund shares issued by an investment company, insurance company annuity or investment contract or assets in an individual account for which the participant directs investments, provided the participant receives an annual statement from a regulated financial institution.

Sponsoring Organization: Financial institutions such as commercial and savings banks, mutual fund companies, broker-dealers and insurance companies or attorneys, accountants, actuaries and retirement plan professionals that sponsor master and prototype plans.

Standardized Plan: A master or prototype plan document that allows just a few options. These documents are designed such that the plan automatically satisfy coverage and nondiscrimination requirements.

Summary Plan Description (SPD): A detailed, but easily understood, summary describing a qualified plan's provisions that must be provided to participants and beneficiaries.

Volume Submitter Plan: Documents that look like individually designed documents or master and prototype plans and have been preapproved by the IRS.

§5.10 Review of Key Concepts

- When an employer/plan sponsor decides to adopt a qualified plan, advice should be sought from a retirement plan professional, attorney and/or accountant to determine which type of plan is appropriate for the company.
- Some of the factors that affect plan design are employee demographics, level of employer's profits, tax-deductibility of contributions, and plan features available to encourage participant salary deferrals under the plan.
- Tax deductibility of employer contributions is limited to 25 percent of eligible compensation for defined contribution plans.
- An excise tax of 10 percent is imposed when a plan sponsor contributes more than what is deductible.
- Certain types of defined contribution plans (i.e. money purchase plans) are subject to minimum funding requirements. A 10 percent penalty is imposed for failure to meet the minimum funding requirements.
- Employee contributions include after-tax employee contributions, mandatory employee contributions, qualified voluntary employee contributions (QVECs), deemed IRAs and rollover contributions (including transfers from other qualified plans). Elective deferrals are considered employer contributions.
- The types of plan documents are master or prototype, volume submitter and individually designed.
- Master or prototype plans are usually a two-part document consisting of the adoption agreement and the basic plan document.
- In addition to the plan document, there are other documents, such as the SPD, that must be prepared to comply with the Internal Revenue Code, ERISA and related statutes.
- If a plan is required to obtain a fidelity bond, the minimum amount of the bond is 10 percent of the trust assets or $500,000, whichever is less. In any event, the bond must not be less than $1,000.

- Although it is not a plan qualification requirement for an employer or plan sponsor to obtain an IRS favorable determination letter, the letter can provide assurance that a plan, in its written form, conforms to the rules and regulations governing qualified plans.

§5.11 Review Questions

[A] True or False

______1. Receiving a favorable determination letter on a plan guarantees the qualified status of the plan.

______2. Nonstandardized plan documents are more flexible that standardized plan documents but may require additional nondiscrimination testing.

______3. Competition for employees is a factor that influences plan design.

______4. Mandatory contributions are considered employer contributions.

______5. An opinion letter is a letter preapproving language in a volume submitter document.

______6. An excise tax of 10 percent applies to employer contributions that are nondeductible.

[B] Multiple Choice

7. All of the following are factors that influence plan design, **EXCEPT**:

   A. Employee vacation schedules
   B. Employee familiarity with investments
   C. Employee years of service to retirement
   D. Employee age
   E. Employer profitability

8. Based on the following information, determine the amount of the fidelity bond necessary to satisfy the small plan audit waiver requirements:

   - Profit Sharing Plan with 75 participants
   - Total Assets = $4,000,000
   - Amount in Qualifying Assets = $3,000,000

   A. $ 400,000
   B. $ 500,000
   C. $1,000,000
   D. $4,000,000
   E. $7,000,000

9. All of the following are considered employee contributions, **EXCEPT:**

   A. Qualified nonelective contributions
   B. Rollover contributions
   C. Qualified voluntary elective contributions
   D. After-tax employee contributions
   E. Deemed IRA contributions

10. Based on the following information, determine the maximum deductible contribution to the profit sharing plan:
    - Total compensation for all eligible participants is $500,000.
    - The profit sharing plan is the only retirement plan sponsored by the employer.

   A. $0
   B. $50,000
   C. $75,000
   D. $125,000
   E. $500,000

11. All of the following are characteristics of prototype plans, **EXCEPT**:

   A. Relatively low cost
   B. More flexible than individually designed plans
   C. Include an adoption agreement
   D. Preapproved plan document language
   E. Include a basic plan document

12. All of the following statements regarding fidelity bond requirements are **TRUE, EXCEPT**:

   A. Generally, the maximum bond amount is $500,000.
   B. Generally, the minimum bond amount is $1,000.
   C. A bond is not required if the owner is the only participant.
   D. The bond amount is based on plan assets.
   E. A large plan filer may need a bond in excess of the maximum to satisfy additional audit requirements.

13. All of the following are often considerations when implementing a new plan, **EXCEPT**:

   A. Preparation of an investment policy
   B. Preparation of a plan amendment
   C. Preparation of a QDRO policy
   D. Preparation of an SPD
   E. Application for a fidelity bond

§5.12 Answers

1. **False.** The favorable determination letter assures the plan is qualified in form. The plan also has to be administered correctly (qualified in operation). §5.08

2. **True.** Standardized plans have fewer options than nonstandardized plans but are designed to automatically satisfy coverage and nondiscrimination requirements. §5.05 [A]

3. **True.** A key design element may be the need to attract and/or retain employees so competition for employees in the marketplace is a plan design consideration. §5.03

4. **False.** Mandatory contributions are employee contributions. §5.04 [D]

5. **False.** An opinion letter is issued for master and prototype plans, an advisory letter is a letter issued to volume submitter plans. §5.08

6. **True.** An employer contribution that exceeds the maximum deductible limit is subject to a 10 percent excise tax. §5.04 [C]

7. The correct answer is **A.** §5.03

   A. Correct. This statement is false because employee vacation schedules do not influence plan design.
   B. Incorrect. This statement is true because employee familiarity with investments does influence plan design.
   C. Incorrect. This statement is true because the number of employee years of service to retirement influences plan design.
   D. Incorrect. This statement is true because employee age does influence plan design.
   E. Incorrect. This statement is true because employer profitability does influence plan design.

8. The correct answer is **C.** The normal bond amount is 10 percent of plan assets up to a maximum of $500,000. However, in order to satisfy the small plan audit requirements, nonqualifying assets must be completed bonded. The amount of nonqualifying assets is $1,000,000 ($4,000,000 - $3,000,000) so the bond needs to be that amount. §5.07

9. The correct answer is **A.** §1.04 [D]

   A. Correct. This statement is false because qualified nonelective contributions are considered employer contributions not employee contributions.
   B. Incorrect. This statement is true because rollover contributions are considered employee contributions.
   C. Incorrect. This statement is true because qualified voluntary elective contributions are considered employee contributions.
   D. Incorrect. This statement is true because after-tax employee contributions are considered employee contributions.
   E. Incorrect. This statement is true because deemed IRA contributions are considered employee contributions.

10. The correct answer is **D.** The maximum deductible contribution to a profit sharing plan is 25 percent of eligible compensation. The total compensation for eligible participants is $500,000 so the maximum deductible contribution is $125,000 ($500,000 x 25%). §1.04 [B]

11. The correct answer is **B.** §1.05 [A]

   A. Incorrect. This statement is true because prototype plans are relatively low cost plans to implement.
   B. Correct. This statement is false because individually designed plans are more flexible than prototype plans.
   C. Incorrect. This statement is true because a prototype plan includes an adoption agreement.
   D. Incorrect. This statement is true because a prototype plan includes preapproved plan document language.
   E. Incorrect. This statement is true because a prototype plan includes a basic plan document.

12. The correct answer is **E.** §1.07

   A. Incorrect. This statement is true because in general, the maximum bond amount is $500,000.
   B. Incorrect. This statement is true because in general, the minimum bond amount is $1,000.
   C. Incorrect. This statement is true because a bond is not required if the owner is the only participant.
   D. Incorrect. This statement is true because the bond amount is based on plan assets.
   E. Correct. This statement is false because a large plan filer does not need an additional bond amount to satisfy additional audit requirements.

13. The correct answer is **B.** §5.06

    A. Incorrect. This statement is true because preparation of an investment policy is a consideration when implementing a new plan.
    B. Correct. This statement is false because preparation of a plan amendment is not a consideration when implementing a new plan.
    C. Incorrect. This statement is true because preparation of a QDRO policy is a consideration when implementing a new plan.
    D. Incorrect. This statement is true because preparation of an SPD is a consideration when implementing a new plan.
    E. Incorrect. This statement is true because application for a fidelity bond is a consideration when implementing a new plan.

Chapter 6:
Basic Plan Document Language

§6.01 Learning Objectives

- List the various sections found in most basic plan documents.
- Define highly compensated employees (HCEs).
- Define key employees.
- Explain the statutory eligibility and participation requirements.
- Determine when an employee meets the eligibility requirements and when an employee is permitted to enter a plan as a participant.
- Explain the concept of vesting.
- Determine a participant’s applicable vesting percentage.
- Calculate the vested portion of a participant’s account balance or accrued benefit.

§6.02 Introduction

The plan document functions as the rulebook for the operation of the plan under the qualification in operation doctrine as expressed earlier in Chapter 5. Failure to follow the terms of the plan document constitutes an operational flaw that at a minimum would require corrective measures and at its ultimate would constitute a loss of qualified status under the Internal Revenue Code and ERISA. Familiarity with the plan document, therefore, is a necessity. In addition to containing the rules for eligibility and participation under the plan, it outlines the manner in which participants or beneficiaries may be entitled to receive benefits from the plan and the amount of those benefits.

Certain provisions must be in the plan to support its qualification under ERISA and the Internal Revenue Code, while others may be in the plan where areas of individual plan design are permitted. Also, Congress may have enacted legislation subsequent to the adoption or most recent amendment of the plan that supersedes one or more of the provisions in the plan. Plan documents and recent legislation must be reviewed carefully to ensure the correct application of provisions.

Regardless of whether the plan is a defined benefit or defined contribution plan, certain basic provisions will be part of the written document. This chapter begins a study of the plan document by presenting those sections that are uniformly found in either type of plan.

The topics covered in this chapter include:

- Plan definitions;
- Definitions of highly compensated employee (HCE) and key employee; and
- Eligibility, participation, and vesting standards.

§6.03 What Is in the Plan Document?

The following sections—representing basic retirement plan fundamentals, important to the administration of any qualified plan—will normally be listed in the table of contents for a plan document, although not necessarily in this order.

- Definitions;
- Eligibility and Participation;
- Contributions;
- Benefits (if a defined benefit or target benefit plan);
- Allocations (if a profit sharing, money purchase, or 401(k) plan);
- Vesting;
- Top-heavy provisions regarding Key Employees;
- Normal, Early, or Late Retirement;

- Death, Disability, and other benefits;
- Loans (may be in a separate document);
- Plan Amendment and Termination; and
- Trustee duties and administration (may be contained in a separate trust document).

Much of the language in the plan document as represented by these sections is text required either under the Internal Revenue Code or its regulations. With experience one begins to distinguish between the more standard IRS-approved language and the customized language that will vary from plan to plan.

§6.04 Common Definitions Section

To uniformly identify key words or phrases in a plan document, plan document drafters capitalize the first letter of such words or phrases to indicate that the term can be found in the definitions section of the document. These definitions play an important role in the operation and administration of the plan. By incorporating a defined term into a particular provision of the plan, the definition acts to expand or narrow the application of the provision. Inaccurate application of a defined term, or failure to apply the definition as set forth, will affect the cost of the plan to the employer, and the plan's qualified status.

After reading the definitions section of a plan document, one should be able to identify the following provisions of a specific plan:

- Compensation to be considered for plan purposes such as allocations;
- Eligible and ineligible classes of employees for coverage under the plan;
- Plan and fiscal year;
- Normal retirement date and age defined as the normal retirement age;
- Hours of service and how they are counted;
- Year of service for eligibility and vesting purposes;
- Leaves of absence; and
- A break in service under the plan.

Following are examples of the possible provisions or language that may appear in the definitions section of a plan document.

[A] Compensation

The definition of compensation is normally referenced in the benefit and contribution or allocation sections of a plan document. Compensation for benefit and contribution purposes often includes the total compensation of a participant. However, plan sponsors are allowed to include certain components of compensation, such as elective deferrals, and exclude certain components, such as moving expenses, so long as the result is a definition of compensation that does not disproportionately favor higher-paid employees. In this manner, sponsors have a degree of flexibility in limiting the eligible compensation that will be utilized by the plan for calculating benefits.

For example, in allocating an annual profit sharing contribution to plan participants that is a percentage of the participants' compensation, the employer may include elective deferrals in the definition of compensation. Certain amounts contributed by the employer at the election of the employee into various health and retirement plans, such as a cafeteria health benefit plan under which an employee may use his or her pre-tax contributions to choose and purchase health benefits from the cafeteria-like selection available, may also be included. Additionally, qualified transportation fringe benefits can be part of the definition of compensation. These result from an arrangement under which employees make salary reduction contributions to cover certain job-related transportation expenses.

Example 6-1. Compensation. Mary earns $50,000 annually and elects to defer $5,000 into her employer's 401(k) plan. She also pays for her commuter transit pass with pre-tax dollars in the amount of $1,200 through a qualified transportation fringe benefit program. The 401(k) plan document defines compensation for purposes of the profit sharing contribution allocation as inclusive of elective deferrals and qualified transportation fringe benefits. The profit sharing allocation for the year is 2% of plan compensation. Although Mary's taxable income is $43,800 ($50,000 less $5,000 less $1,200), her profit sharing allocation will be $1,000 (2% x $50,000).

The plan document's compensation definition also may exclude compensation earned prior to becoming eligible and participating under the plan (eligibility and plan participation are further discussed later in this chapter).

Additionally, a plan sponsor may choose to disregard specific forms of compensation such as bonuses or overtime pay from the definition of the plan's eligible compensation. If the plan sponsor does so, it will be necessary to prove that the resulting compensation considered for plan purposes is nondiscriminatory in nature.

For example, if only the lower-paid employees receive overtime pay, and only the higher-paid receive bonuses, including bonuses and excluding overtime pay when allocating a contribution or calculating a benefit based on compensation will likely result in a compensation definition that overtly favors the higher-paid employees and would violate nondiscrimination requirements. (Nondiscrimination testing for compensation is covered in more advanced ASPPA courses.)

The compensation definition also must include the Internal Revenue Code's maximum compensation limit: $150,000 (as indexed) for plan years beginning after 1993. For years beginning on or after January 1, 2002, EGTRRA set the compensation limit to $200,000, indexed in $5,000 increments.

For example, the limit for 2007 is $225,000. Thus, even though a participant's compensation may be $300,000 in 2007, only $225,000 of that compensation would be included for contribution and allocation purposes that year. Please refer to Appendix A for a summary of the various plan limits, including limits on compensation.

[B] Eligible Employees

Identifying those employees who are allowed to participate or are covered under the plan and those who are excluded from coverage begins with the definition of employees and eligible employees. For example, the definition of employee often provides that all employees are eligible to participate in the plan except non-resident aliens with no U.S. source income and those employees subject to a collective bargaining agreement, i.e., union employees.

The term eligible employee normally states that an employee who meets the definition of employee and who has met the eligibility requirements is an eligible employee. Because of the cross-referencing to eligibility determination, sometimes these definitions are found in the eligibility and participation sections of the plan document instead of the definitions section.

[C] Fiscal and Plan Year

The plan sponsor's fiscal year will be referenced in the definitions section of the plan document, as will the plan year. These periods may not always coincide. For example, employers might use the calendar year as a fiscal year for administrative ease, given that they must issue W-2s and similar tax and accounting filings to employees on a calendar year basis.

Another example is a an S Corporation that may use the calendar year as the fiscal year so that income passes through to the employee shareholders for reporting on individual tax returns but uses a non-calendar year for the plan year. In this case, the definition of fiscal year would be defined as the twelve consecutive month period ending December 31, where the definition of Plan Year might be the twelve consecutive month period commencing July 1 and ending June 30.

[D] Normal Retirement Date and Age

Some drafters of plan documents separate the definitions of normal retirement date and normal retirement age, while others combine the two into one definition. The definition of normal retirement age typically is age 65 or age 65 and 5 years of participation. (The later of age 65 or 5 years of participation is the statutory limit under the Internal Revenue Code.)

The definition of normal retirement date can vary. Sometimes it is the exact date a participant attains normal retirement age, and sometimes it is defined as the end of the plan year in which a participant attains the normal retirement age. Normal retirement date is used in benefit calculations, particularly in terms of the number of years of service a participant may have earned by normal retirement. It is also used for distribution timing requirements, so the distinction between it and normal retirement age, if any, is important.

[E] Hours of Service

The hours of service definition is a fairly standard definition in all qualified plans as it must mirror Internal Revenue Code and DOL requirements. Employees usually earn or accrue hours of service for any hour paid, which may include time for vacation, holidays, jury duty, illness or military leave. Also, the application of the provision indicates the number of hours needed during the plan year, if any, to satisfy eligibility, vesting and contribution allocation requirements.

Because the statutory maximum number of hours an employee can be required to earn to become eligible is 1,000 hours, this provision in most plan documents will typically require 1,000 hours. Determining the number of hours of service for which an employee receives credit can sometimes become complex depending on the method the plan employs for counting or crediting hours worked for year of service calculations.

[F] Year of Service

There are several routinely employed definitions of year of service. The most common is defined as a consecutive 12-month period in which the employee has worked or is entitled to payment for at least 1,000 hours of service. To simplify vesting calculations (explained later in this chapter) and the allocation of contributions (explained in RPF-2) the 12-month period will generally be the same as the plan year, as this assures that all participants' service will be measured over the same twelve months.

When determining an individual employee's eligibility to participate in the plan, the first year of the service measurement period is usually the twelve consecutive months ending on the anniversary of the date of hire of the employee. If the employee has not completed 1,000 hours in the first 12-month period beginning with his or her date of hire, the period for determination of a year of service for eligibility will usually switch to the plan year. However, this is not always the case, and the plan document should be carefully reviewed for the definitions of the second measurement period and subsequent years of service.

Example 6-2. Year of Service. Mark is hired on June 10, 2006, and works 40 hours per week. As of June 9, 2007 Mark is credited with a year of service as he has worked more than 1000 hours in the twelve month period beginning with his date of hire.

To lessen the burden of recording hours worked for each individual employee, plan sponsors may utilize the elapsed time method, which measures service in a straightforward fashion from hire date to termination date, including termination due to retirement, death or disability. Each employee's service relates strictly to the time that has passed between these two dates.

Another commonly used method of counting years of service called hours equivalency modifies the elapsed time method by requiring a minimum number of hours or days to be worked during a given period if an employee is to be credited with service for that period. Service periods may be measured by days, weeks, months or semi-monthly.

Understanding how a plan measures years of service is essential for eligibility, benefit, and vesting computations. Consequently, the Year of Service definition employed by the plan must be carefully scrutinized and followed to ensure the integrity of these calculations.

[G] Leave of Absence

The plan document should be reviewed for definitions regarding a break in service since it affects eligibility and vesting year computations. The definition of a one-year break in service is based on Internal Revenue Code requirements and usually is a 12-month period corresponding to the plan year in which a participant does not complete more than 500 hours of service.

The Retirement Equity Act of 1984 (REA), the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), and the Family and Medical Leave Act (FMLA) mandated military, maternity, paternity and medical leave of absence rules. When an employee is on a leave of absence for military, maternity, paternity and for certain employers, family medical reasons, these various Acts require plans to credit that employee with enough hours to avoid a break in service.

If any individuals on the employer's census information are indicated to be on leave of absence at any time during the year, there may be special plan rules beyond those mandated by the Internal Revenue Code and DOL regulations regarding treatment of those individuals for contribution, benefits, vesting, and other plan purposes. The leave of absence definition within the plan document should address these special rules in conjunction with the application of the break-in-service rules.

§6.05 Highly Compensated and Key Employees

[A] Highly Compensated Employee

One of the central tenets of qualified plan status is that a plan may not discriminate against the lower-paid employees and disproportionately favor the higher-paid employees in terms of plan coverage (discussed in RPF-2), the level or amount of benefits provided (discussed in RPF-2) or the availability of a benefit, right or feature of the plan (an advanced topic covered under more advanced ASPPA courses).

Basic to this tenet is the statutory definition of a **highly compensated employee (HCE)**. Generally, an HCE is any employee who satisfies either the ownership or the compensation test.

<u>1. Ownership Test</u>

An employee satisfies the **ownership test** if he or she is a 5% owner. As we discussed in Chapter 2, a **5% owner** is defined as any employee who owns, directly or indirectly, <u>more</u> than 5 percent of the business regardless of compensation.

Ownership status in either the current year or the 12-month period immediately preceding the current year (the **lookback year**) is considered.

<u>2. Compensation Test</u>

An employee satisfies the **compensation test** if he or she earns more than $80,000 (as indexed) in the lookback year. The compensation used is the employee's total compensation including any elective deferrals, such as those to 401(k) plans and cafeteria plans, as well as qualified transportation fringe benefits.

For 2007, an employee satisfies the compensation test if he or she earned more than $100,000 in 2006. Please refer to Appendix A for a summary of the various plan limits, including limits applicable to the compensation test.

3. Top-Paid Group Election

The employer may elect to add a requirement that, in addition to satisfying the compensation test, the employee be in the top 20 percent of employees when ranked by compensation to be considered an HCE. This election, known as the **top-paid group election**, must be in the plan document, or the plan document must be amended to add the election should the employer wish to use it. Use of the top-paid group election does not affect the 5% owner test.

For purposes of determining the number of employees to include in the top 20 percent, the following employees may be excluded from the calculation:

- Those who have not completed six months of service by the end of the year;
- Those who normally work less than six months per year;
- Those who normally work less than 17½ hours per week; and
- Those younger than age 21.

Example 6-3. Top-Paid Group Election. The plan year is the calendar year. Of the 100 employees who worked during 2006, ten were hired in September. There were 20 employees earning more than $100,000 during 2006, and the plan document specifies use of the top-paid group election. Consequently, the top 18 employees earning over $100,000 when ranked by compensation will be considered HCEs for 2007 (100 less 10 with fewer than six months of service by December 31, 2006 x .2 = 90 x .2 = 18.) 5% owners not included in the top-paid 18 are also HCEs.

An employer may want to make the top-paid group election because it limits the number of employees considered HCEs which may produce better results for coverage and nondiscrimination testing. Since the top-paid group election, if made, can cause an employee with compensation over the HCE indexed limit to be considered an NHCE, inclusion of this election in the HCE definition section of the plan document must be carefully noted.

[B] Non-Highly Compensated Employee

Any employee, who is not an HCE, is a **non-highly compensated employee (NHCE).**

[C] Key Employee

The plan document is also required to contain sections that explain the top-heavy requirements for qualified plans. Top-heavy plans are those plans that are deemed to benefit primarily a group of participants called key employees, and as a consequence, these plans must meet special standards regarding vesting and minimum contributions or benefit accruals.

For purposes of top-heavy testing, a **key employee** is any employee or former employee who, during the testing period, is a 5% owner, a 1% owner or an includible officer.

1. 5% Owner

As we discussed in Chapter 2, a **5% owner** is defined as any employee who owns, directly or indirectly, more than 5 percent of the business regardless of compensation.

2. 1% Owner

A **1% owner** is any employee who owns, directly or indirectly, more than 1 percent of the business and whose annual compensation exceeds $150,000. Note that this compensation limit is not indexed.

3. Includible Officer

Generally, an officer whose annual compensation is $130,000 or more (as indexed) is considered a key employee. However, under this classification, the maximum number of officers to designate as key employees is 50, or, if less, the greater of 10 percent of the employees or three. Thus, not all officers are **includible officers** for determining key employee status.

EGTRRA changed the categories of key employees and statutorily changed the officer compensation limit from $70,000 to $130,000. For 2007, the limit is $147,000. Please refer to Appendix A for a summary of the various plan limits, including limits applicable to the includible officer test.

4. Compensation

The definition of compensation used for the key employee determination is the same as the definition of compensation used for the HCE determination: the employee's total compensation including any elective deferrals, such as those to 401(k) plans and cafeteria plans, as well as qualified transportation fringe benefits.

Also, note that a 5% owner would be both an HCE and a key employee. However, the differences in compensation limits for the inclusion of 1 percent ownership and officer status within the definition of key employees will usually serve to create more HCEs than key employees.

§6.06 Eligibility and Participation

The definitions section of the plan document will typically incorporate a reference as to how a participant fulfills the plan's eligibility requirements. The eligibility and participation section will generally narrow the definition of eligible or participating employees by listing groups of employees who will be excluded from plan coverage, such as:

- Those employees who have not worked a certain minimum number of hours or months; or
- Have not attained a certain age; or
- Who are members of a specific group, such as union employees.

This section varies considerably from plan to plan because each plan sponsor will select permissible eligibility and participation requirements that best suit its goals and reflect the composition of its workforce.

[A] Eligibility Date

The Internal Revenue Code permits an employer to require an employee to reach age 21 and complete a year of service before the employee becomes eligible to participate in a plan. For plans that provide full and immediate vesting (immediate 100% ownership of benefits upon entry into the plan) an employer may condition participation on the completion of more than one year of service. In such cases, the maximum service period that can be required is two years. There is an important exception to this rule for the 401(k) feature of profit sharing plans, under which the maximum eligibility period for elective deferrals may never exceed one year, regardless of vesting provisions.

In a plan with eligibility requirements of one year of service and attainment of age 21, any employee who meets the eligibility requirements must be eligible to participate in the plan no later than the earlier of two dates:

- The first day of the plan year beginning after the date the employee met the eligibility requirements, or
- The date six months after the age and service requirements are met.

Example 6-4. Eligibility. Amy is age 25 when she begins working for QRS Company on August 4, 2006. The QRS retirement plan uses a calendar plan year and requires one year of service and attainment of age 21 for plan eligibility. Amy completes the eligibility requirements as of August 3, 2007 and must be eligible to become a participant in the plan no later than January 1, 2008.

[B] Entry Date

Note that there is a distinction between the date an employee becomes eligible to participate in the plan by completing all requirements for eligibility and the date that the employee actually becomes a participant under the plan. The effective date of an employee's participation is the plan entry date, or simply the **entry date**.

Eligibility and participation are not the same thing, and the distinction between them is a very important one. Deductibility of contributions, required contributions, minimum benefits or contributions, coverage and nondiscrimination requirements all directly relate to these definitions. Therefore the plan document should be carefully studied to determine when an employee becomes eligible to participate in the plan, and when that employee actually begins to participate or enters the plan.

Many plan documents define the entry date in the definitions section and additionally state that the first entry date will be the effective date of the plan. Plan sponsors may set as many plan entry dates as they wish under any method as long as the statutory requirements are met.

§6.07 Vesting

[A] Vesting Rules

The **vested** portion of the participant's account is the portion owned by the participant and is the amount that will be paid to him or her upon a distributable event, such as retirement or other occurrence when the Internal Revenue Code or ERISA would allow the plan to distribute benefits. Employees usually earn full ownership of their accounts in increments based on the number of years of service completed with the employer. In this manner, continued service with the plan sponsor is rewarded by steadily increasing ownership of the retirement benefits provided by that plan sponsor.

The schedule of increasing ownership, or **vesting schedule**, generally appears as a table with one column listing years of service and the second column showing the corresponding vested percentage. For example, a commonly used vesting schedule is the six-year graded (or 2/20) vesting schedule:

Years of Service	Vested %
Less than 2	0%
2	20%
3	40%
4	60%
5	80%
6 or more	100%

[B] How to Apply a Vesting Schedule

A participant's vested portion is calculated by multiplying the participant's account balance for defined contribution plans, or benefit amount (accrued benefit) for defined benefit plans, by the vesting percentage that corresponds to the participant's credited years of service.

Not all years of service are required to be counted in the computation of the vesting percentage. These excluded years generally are either noted in the vesting section or in the definitions section where year of service is explained. For example, a plan may exclude years of service earned prior to age 18 or prior to the inception date of the plan. Additionally, either of these sections may discuss how to determine for vesting purposes the years of service to be credited to a former participant who has been reemployed.

Example 6-5. Vesting. Eric participates in a profit sharing plan with a six-year graded vesting schedule, has been employed full time for the last three years, and has a profit sharing account balance of $10,000. His three years of service makes him 40% vested. Thus, his vested profit sharing account balance is $4,000 ($10,000 x 40%). This is the amount that he owns and would be distributed to him should he cease employment prior to earning another year of service.

[C] Types of Contributions

The various types of contributions under a qualified plan are subject to different vesting requirements under the Internal Revenue Code and ERISA, and therefore a plan document may contain more than one vesting schedule. As an example, in a 401(k) plan, the employee elective deferrals must always be 100% vested because the employee fully owns them at the time of their deposit into the plan. The employee could have elected to be paid these amounts as wages rather than defer them into the qualified plan.

In contrast, matching contributions made by the employer are often subject to vesting schedules. Effective with plan years beginning on or after January 1, 2002, the matching contributions in a 401(k) plan must vest at least as quickly as either the six-year graded schedule shown above or a three-year cliff vesting schedule (i.e. no vesting in years zero, one and two, and 100% vesting in year three, the cliff year).

Effective for plan years beginning in 2007, all defined contribution plans (except collectively bargained plans) must also vest at least as rapidly as either the six-year graded schedule or the three-year cliff vesting schedule. This is applicable to profit sharing contributions and may apply only to those contributions made in plan years beginning in 2007.

Note however, a plan may not exceed the three-year cliff or six-year graded vesting schedule for any money source in years in which it is top-heavy. Top-heavy status is discussed further in RPF-2.

It should be noted that the vesting requirements under the Internal Revenue Code and ERISA set out maximum numbers of years to achieve vesting, and plan sponsors may choose to vest more generously than these maximums. A customized vesting schedule is only permissible provided it is at least as generous in each year of the schedule as the applicable statutory schedule would be. For example, an allowable matching contribution schedule would be a two-year cliff (0% for the first year and 100% after year two), or a schedule under which a participant becomes vested in 25% increments beginning with year one with full vesting after four years of service.

[D] Full Vesting

The Internal Revenue Code and ERISA also require that full vesting, that is, 100% vesting, be granted at attainment of the plan's normal retirement age. At retirement, participants who may otherwise not have the required number of years of service under the plan's vesting schedule will nevertheless become fully vested. Also, qualified plans often, but not always, provide full vesting upon the death or disability of a participant, a provision that will be set forth in the plan document.

Vesting provisions under the plan are of paramount importance, not just when calculating how much a plan should distribute in benefits to a terminated or retired employee. Participants may routinely be provided with periodic statements of their retirement benefits that disclose the vested percentages applied to their various benefits. As vesting reflects ownership and may be viewed as a reward for continued service, accurate application of vesting provisions is essential to the success of the qualified plan.

§6.08 Key Terms

1% Owner: An individual who owns more than 1 percent of a business and earns more than $150,000. Used when determining key employees.

5% Owner: An individual who owns more than 5 percent of a business. Used when determining key employees and HCEs.

Compensation Test: An individual earning more than the indexed amount in the lookback year satisfies the compensation test. Used when determining HCEs.

Entry Date: The effective date of an employee's participation.

Highly Compensated Employee (HCE): An employee who, (1) during the current or preceding year, is or was a more than 5% owner, or (2) received compensation in excess of the specified dollar limit for the preceding year.

Includible Officer: Generally, an officer whose annual compensation is $130,000 or more (as indexed). Used when determining key employees. Note that the maximum number of officers (those includible) is 50, or, if less, the greater of 10 percent of the employees or three.

Key Employee: A participant who, at any time during the plan year is: (1) an includible officer who earns $130,000 or more, as indexed, (2) a 5% owner, or (3) a 1% owner.

Lookback Year: The year preceding the current year. Used when determining HCEs.

Non-Highly Compensated Employee (NHCE): Any employee not considered an HCE.

Ownership Test: An individual who is a 5% owner in the current or lookback year satisfies the ownership test. Used when determining HCEs.

Top-Paid Group Election: An election made when determining HCEs whereby in addition to satisfying the compensation test, the employee must be in the top 20 percent of employees when ranked by compensation to be considered an HCE.

Vested: The amount owned by a participant.

Vesting Schedule: The schedule of increasing ownership based on years of service.

§6.09 Review of Key Concepts

- Plan drafters ensure that key words or phrases in a plan document are uniformly identified by capitalizing the first letter of such words or phrases. Generally, capitalized words or phrases are specifically defined in the plan document, usually in the definitions section.

- Determining which plan participants are HCEs involves both ownership and compensation criteria. It is the first step in a testing process designed to ensure that a plan does not discriminate against its lower-paid employees in terms of plan coverage, the level or amount of benefits provided or the availability to a participant of a benefit, right or feature under the plan.

- Determining which plan participants are key employees, using ownership, compensation, and officer status criteria, identifies a select group of plan participants. When a plan is deemed to benefit primarily this select group of plan participants, it is considered top-heavy and the plan is required to meet special standards regarding vesting and minimum contribution or benefit accruals.

- Eligibility and participation are not the same thing. An employee may meet a plan's eligibility requirements, but not enter the plan (become a participant) until a subsequent entry date.

- Vesting represents the participants' ownership in their benefits. In determining the vested benefit under a defined benefit plan, the vesting percentage is applied to the accrued benefit. In a defined contribution plan, the vesting percentage is applied to the account balance.

§6.10 Review Questions

[A] True or False

______ 1. An employee may be required to attain age 21 to be eligible to participate in a plan.

______ 2. All employees who are officers with compensation in excess of the indexed limit are key employees.

______ 3. Years of service earned prior to a plan's effective date must be included in determining years of service for vesting purposes.

______ 4. All HCEs are considered key employees.

[B] Multiple Choice

5. All of the following are considered HCEs, **EXCEPT:**

   A. An individual who owns 20 percent of the business
   B. The spouse of an individual who owns 6 percent of the business
   C. An individual in the top 20 percent of employees who earned $150,000 in the lookback year
   D. An officer who earned $60,000 in the lookback year
   E. An individual who owned 10 percent of the business in the lookback year

6. All of the following statements regarding the definition of compensation found in a plan document are **TRUE, EXCEPT:**

   A. Compensation can exclude certain components as long as it does not disproportionately favor higher-paid employees.
   B. Amounts contributed to a cafeteria plan may be included in the compensation used to calculate benefits.
   C. Compensation may exclude compensation earned prior to becoming eligible to participate in the plan.
   D. Compensation must be limited to $225,000 in 2007.
   E. Compensation may exclude bonuses only for lower-paid employees.

7. All of the following are considered key employees, **EXCEPT**:

   A. An individual who owns 10 percent of the business
   B. An individual who earned $200,000 and owns 2 percent of a business
   C. An includible officer who earned $50,000
   D. The spouse of a sole proprietor
   E. An includible officer who earned $180,000

8. Based on the following information, determine the vested portion of the participant's account:

   - The plan is a money purchase pension plan that does not allow for rollover or after-tax employee contributions.
   - The participant's account balance is $400,000.
   - The participant is 40% vested.

   A. $16,000
   B. $100,000
   C. $160,000
   D. $220,000
   E. $400,000

9. Based on the following information, determine the employee's entry date:

   - The plan is a calendar year plan.
   - The plan's eligibility requirements are age 21 and one year of service.
   - One year of service is defined as a 12-month period in which an employee works 1000 hours of service.
   - The entry dates are the first day of the plan year or the first day of the seventh month of the plan year following when the eligibility requirements are met.
   - The employee works full time.
   - The employee's date of birth is September 21, 1985.
   - The employee's date of hire is February 4, 2006.

   A. July 1, 2006
   B. September 21, 2006
   C. January 1, 2007
   D. February 3, 2007
   E. July 1, 2007

10. All of the following statements regarding vesting are **TRUE, EXCEPT**:

    A. Elective deferrals are always 100% vested.
    B. Vesting must be 100% upon death.
    C. A top-heavy plan is required to use a vesting schedule at least as favorable as the six-year graded or the three-year cliff vesting schedules.
    D. Vesting must be 100% upon normal retirement.
    E. Matching contributions must vest at least as favorably as the six-year graded or the three-year cliff vesting schedules.

11. Based on the following information, determine the participant's vesting percentage as of December 31, 2006:

    - A vesting year of service is defined as a calendar year in which the participant worked more than 1000 hours of service.
    - The vesting schedule is a six-year graded schedule.
    - The plan is a profit sharing plan effective March 1, 1985.
    - The plan's normal retirement date is age 65.
    - The participant is a fulltime employee who was hired January 20, 2003.
    - The participant's date of birth is October 25, 1970.

    A. 20%
    B. 40%
    C. 60%
    D. 80%
    E. 100%

12. All of the following are found in retirement plan documents, **EXCEPT:**

    A. Vesting schedule
    B. Normal retirement benefits
    C. Contributions
    D. Vacation benefits
    E. Eligibility requirements

§6.11 Answers

1. **True.** In general, the statutory maximums for eligibility are age 21 and one year of service. For non 401(k) plans, or the non deferral portion of a 401(k) plan, that provide for immediate vesting, the maximum may be extended to two years of service. §6.06 [A]

2. **False.** The number of officers considered key employees is limited to 50, or, if less, the greater of 10 percent of the employees or three. Thus, not all officers are included when determining key employee status. §6.05 [C] 3

3. **False.** Years of service prior to a plan's effective date may be excluded when determining years of service for vesting purposes. §6.07 [B]

4. **False.** The definitions for determining HCE and key employees are different. HCEs may be considered key employee, or vice versa, but it is not always the case that the groups are identical. §6.05 [C] 4

5. The correct answer is **D.** §6.05 [A]

   A. Incorrect. This statement is true because an individual who owns 20 percent of the business is an HCE.
   B. Incorrect. This statement is true because the spouse of an individual who owns 6 percent of the business is an HCE.
   C. Incorrect. This statement is true because an individual in the top 20 percent of employees who earned $150,000 in the lookback year is an HCE.
   D. Correct. This statement is false because an officer who earned $60,000 in the lookback year is not an HCE unless they satisfy the ownership test.
   E. Incorrect. This statement is true because an individual who owned 10 percent of the business in the lookback year is an HCE.

6. The correct answer is **E.** §6.04 [A]

   A. Incorrect. This statement is true because compensation can exclude certain components as long as it does not disproportionately favor higher-paid employees.
   B. Incorrect. This statement is true because amounts contributed to a cafeteria plan may be included in the compensation used to calculate benefits.
   C. Incorrect. This statement is true because compensation may exclude that compensation prior to becoming eligible to participate in the plan.
   D. Incorrect. This statement is true because compensation must be limited to $225,000 in 2007.
   E. Correct. This statement is false because compensation may not exclude bonuses only for lower-paid employees.

7. The correct answer is **C.** §6.05 [C]

   A. Incorrect. This statement is true because an individual who owns 10 percent of the business is a key employee.
   B. Incorrect. This statement is true because an individual who earned $200,000 and owns 2 percent of a business is a key employee.
   C. Correct. This statement is false because an includible officer who earned $50,000 is not a key employee.
   D. Incorrect. This statement is true because the spouse of a sole proprietor is a key employee.
   E. Incorrect. This statement is true because an includible officer who earned $180,000 is a key employee.

8. The correct answer is **C.** The $400,000 account balance is subject to 40% vesting. The participant's vested portion (the portion owned) is $160,000 ($400,000 x 40%). §6.07

9. The correct answer is **E.** The employee attains age 21 on September 21, 2006 and completes a year of service on February 3, 2007. The later of these two dates is February 3, 2007. The employee will enter the plan on July 1, 2007 (the entry date coincident with or next following February 3, 2007). §6.06 [B]

10. The correct answer is **B.** §6.07

    A. Incorrect. This statement is true because elective deferrals are always 100% vested.
    B. Correct. This statement is false because while common, vesting need not be 100% upon death.
    C. Incorrect. This statement is true because a top-heavy plan is required to use a vesting schedule at least as favorable as the six-year graded or the three-year cliff vesting schedules.
    D. Incorrect. This statement is true because vesting must be 100% upon normal retirement.
    E. Incorrect. This statement is true because matching contributions must vest at least as favorably as the six-year graded or the three-year cliff vesting schedules.

11. The correct answer is **C.** The participant was worked more than 1000 hours in 2003, 2004, 2005 and 2006. As of December 31, 2006 the participant has been credited with 4 years of vesting service. Using a six-year graded vesting schedule, the participant is 60% vested. §6.07

12. The correct answer is **D.** §6.03

    A. Incorrect. This statement is true because vesting schedules are found in plan documents.
    B. Incorrect. This statement is true because normal retirement benefits are found in plan documents.
    C. Incorrect. This statement is true because contributions are found in plan documents.
    D. Correct. This statement is false because vacation benefits are not found in plan documents.
    E. Incorrect. This statement is true because eligibility requirements are found in plan documents.

Chapter 7:
Plan Qualification

§7.01 Learning Objectives

- Discuss the benefits of sponsoring and/or participating in a qualified plan.
- Discuss ERISA's impact on retirement plans and describe its four titles.
- Identify the different types of issued guidance regarding qualified plans and their position in the hierarchy of authority.
- Discuss the role of the IRS, DOL and PBGC in the enforcement of laws affecting retirement plans.
- Differentiate among temporary, proposed and final regulations.
- Discuss the concept of plan qualification including the general requirements for plan qualification.

§7.02 Introduction

The fundamental benefit granted by qualified plan status cannot be overstated: favorable tax treatment for the employer who sponsors the plan, the trust and the participants covered by the plan. Achieving and maintaining qualified status through compliance with the statutes of ERISA and the Internal Revenue Code are therefore essential to the success of any retirement benefit program desiring this favored tax status.

It also cannot be overemphasized that qualification is not a static state. In addition to meeting qualification standards at the time they are first established or adopted by an employer, plans must evolve to reflect any new legislation affecting qualified retirement plans or lose their qualified status. Therefore, both in written form and in the course of day-to-day operation, a plan must conform to current qualified plan requirements.

Fortunately, guidance is available on many fronts for both plan sponsors and retirement plan professionals to assist in the protection of a plan's qualification. Beginning with an awareness of the genesis of retirement plans and an understanding of the tax advantages they wish to preserve, knowledge of the sources of legislation that dictate and surround qualified plan status, as well as the various forms of guidance those sources issue will serve as valuable aids when seeking and securing plan qualification under the Internal Revenue Code and ERISA.

This chapter will cover the fundamental requirements for a plan to attain qualification and the advantages that qualified status bestows upon those involved in the plan. It also includes discussion of:

- ERISA and subsequent retirement plan law;
- Roles of various government agencies charged with overseeing retirement plans; and
- The hierarchy of guidance in the form of regulations, rules, procedures, notices and other letters and memoranda.

§7.03 Plan Qualification

[A] Benefits of Qualified Plan Status

The special characteristics of qualified retirement plans described in ERISA and the Internal Revenue Code must be adhered to in order for a plan to be tax-qualified, that is, to provide favorable tax treatment to:

- Plan sponsors;
- Plan trusts, which are the legal means under which funds or assets of the plan are held in trust (separate from the employer's assets); and

- Plan participants and their beneficiaries.

This favorable tax treatment is exhibited in four principal instances.

First, contributions made by the plan sponsor, within specific limits, are deductible as a legitimate business expense on the employer's tax return.

Second, interest income and investment gains on funds within the plan's trust are tax-exempt, so benefits under the plan typically accumulate on a tax-deferred basis.

Third, employees may reduce their current taxable income through elective deferrals as allowable, and participants and their beneficiaries are generally not taxed on their benefits under a qualified plan until those benefits are distributed from the plan.

Fourth, distributions from the plan may be subject to reduced tax rates, or payment of taxes in certain circumstances may be postponed by transferring (often called rolling over) the distributed amounts to an IRA or another employer's qualified plan. It's an arguable win-win situation for all.

[B] Growth of Employer-Sponsored Plans

Historically, the origins of formal employer-sponsored plans in the United States lay more than one and a quarter century in the past. A scant few years after the American Express Company established its plan in 1875, the Baltimore and Ohio Railroad Company became the second sponsor of a retirement plan in 1880. Thereafter, railroad, banking and public utility employers led their industrial counterparts in the creation of several hundred plans during the next 50 years.

Insurance companies emerged as the first retirement plan service-providers in 1921, when the Metropolitan Life Insurance Company issued an annuity contract designed to provide benefits to a group of employees. In 1924, Equitable Life Assurance Society of the United States became Metropolitan Life's first competitor, and thus began the inklings of retirement plan professional as a designated career.

<u>1. Pre-ERISA Regulatory Environment</u>

The IRS's role as a regulator of retirement plans pre-dates ERISA and originates in the Revenue Acts of 1921 and 1926. These Acts granted tax advantages to employers and employees by allowing deductions from corporate income for retirement plan contributions, tax-deferred accumulation of investment income within the plan, and deferral of taxation until benefits were distributed with the stipulation that plans attained minimum coverage and met employer contribution conditions.

Disclosure of information rules were added and more stringent participation standards established with the Revenue Act of 1942 as the nation's economy expanded, and the numbers of retirement plans grew significantly.

When legislation in 1959 was enacted empowering employees with monitoring ability over their employer plans to minimize the potential for abusive mismanagement of plan funds, the DOL joined the IRS as a regulatory agency regarding retirement plans, assuming its proper role as an advocate for employees as plan participants.

Under the Welfare and Pension Plans Disclosure Act of 1959, sponsoring employers, including labor unions, had to make available to participants and their beneficiaries copies of plan descriptions and annual financial reports which were also filed with the government. Later in 1962, again to address mismanagement and abuse of plan funds, the Secretary of Labor was endowed with the power to interpret, investigate and enforce the retirement plan rules.

However, despite this history, the legislative environment for the 50 years prior to ERISA was comparatively very limited in scope and influence.

[C] ERISA

On September 2, 1974, Congress enacted the **Employee Retirement Income Security Act (ERISA)** as federal law. To say that retirement plan legislation as we know it effectively did not exist prior to ERISA would not be viewed by many as an understatement, for ERISA made sweeping and extensive changes affecting the legal, tax, investment, labor, reporting, disclosure, benefit and funding aspects of corporate and self-employed retirement plans.

ERISA was Congress's answer to public concerns regarding previous inadequacies in the law. Among them those that permitted loss of promised retirement benefits due to insufficient funding, early terminations of plans after employers deducted contributions but prior to paying benefits and lack of plan provisions dictating when employees were considered to own or have a non-forfeitable or vested right to part or all of their benefits.

Therefore, ERISA codified when an employee must be allowed to participate in a plan, how long an employee must wait before owning benefits, how much and how often an employer must contribute to the plan, what information about the plan must be disclosed to participants, rules of conduct for those administering the plan and its assets and avenues for enforcing these qualified plan rules. Additionally, ERISA established two new important concepts: plan termination insurance (administered by the PBGC), and IRAs for those taxpayers not covered by an employer's qualified retirement plan.

Notably, while ERISA does not apply to all employer-sponsored plans, as explained in Chapter 1, the broad reach of ERISA should not be underestimated. In general, federal laws such as ERISA will supercede state laws whenever they are in conflict.

1. ERISA Titles

ERISA consists of four numbered sections known as Titles. It is not unusual to encounter references to ERISA by title numbers, which are as follows:

- Title I relates to the protection of employee rights under employee benefit plans and is often thought of as containing the labor provisions. Included are requirements for:

    1) reporting and disclosure of plan information;
    2) the crediting or accrual of benefits;
    3) the method and payment of benefits;
    4) participation;
    5) ownership or vesting;
    6) funding;
    7) standards of conduct for those empowered to administer the plan and handle plan assets; and
    8) the enforcement of Title I.

  For example, Title I created the right of participants, beneficiaries and the DOL to file suit regarding retirement benefits.

- Title II applies only to qualified retirement plans and contains various amendments to the Internal Revenue Code, some of which were effected to create tax provisions which parallel and reflect the new labor law provisions of Title I.

  Included are specific conditions for tax qualification such as minimum coverage; maximum benefit limits; top-heavy compliance; provisions for deductibility of contributions; and taxation of distributions.

- Title III concerns the jurisdiction, administration and enforcement of ERISA, including the coordination of regulatory authority between the IRS and DOL. Also included are provisions regarding educational requirements for actuaries, who as professionals in the area of statistical probability perform certain required benefit and funding-related calculations for defined benefit plans.

- Title IV created the Pension Benefit Guaranty Corporation (PBGC) and established the termination insurance program for defined benefit plans.

[D] Subsequent Legislative History

In the absence of a national policy, Congress has repeatedly acted to protect the rights of participants and beneficiaries from sometimes real and sometimes perceived abusive employer practices. Post-ERISA legislation has been robustly pursued, and the body of employee benefits-related law is now substantial and under constant scrutiny for revision and expansion.

While a detailed history of the numerous laws enacted subsequent to ERISA is beyond the scope of this course, and indeed might decrease clarity of understanding since new laws often change, eliminate or make obsolete provisions contained in their predecessors, please refer to Appendix C for a summary of retirement plan legislation.

[E] The Order of Authority

Because laws quite often are broadly-stated, incomplete or unclear, supportive and clarifying guidance in various forms are issued from time to time that serve to explain and interpret these laws, providing employers and retirement plan professionals with a methodology when dealing in complicated and ambiguous areas.

There is an inherent order of authority or hierarchy of reliance that is created by the scope of application for a particular form of guidance. For example, the highest order of authority or reliance is placed on laws issued by Congress, for these apply to everyone in the land. At the lowest end of the hierarchy, with the smallest scope of application, would be that guidance issued at the private or specific request of an individual taxpayer, since the response is directed to and limited by that individual's particular circumstances.

To assist in an awareness of the contextual application of existing guidance, some of which is discussed in the remainder of this chapter, the order of authority, in descending hierarchical reliance, may be summarized as follows:

- Laws as enacted by Congress (ERISA and the Internal Revenue Code);
- Court Decisions, since federal law generally preempts state law, (U.S. Supreme Court, Federal Courts of Appeal, Federal District or Tax Courts);
- Legislative History (Committee Reports, Blue Books);
- Treasury or Department of Labor Regulations - Final, Proposed and Temporary;
- Revenue Rulings;
- Revenue Procedures;
- Notices and Announcements – includes News Releases, General Counsel and Technical Advice Memoranda, Field Assistance Bulletins, Information Letters; and
- Private Letter Rulings and Advisory Opinions.

§7.04 Regulations Issued by the IRS and DOL

[A] Responsibility for Enforcement

The responsibility for enforcement of the Internal Revenue Code is placed with the Secretary of the Treasury (Secretary), who is empowered to prescribe rules and regulations. The IRS, with the approval of the Secretary, is responsible for interpreting statutory authority, administering the Internal Revenue Code and developing a uniform tax enforcement policy.

As the result of ERISA, Congress created the IRS's Office of Employee Plans and Exempt Organizations (EP/EO Office) that was subsequently eliminated and succeeded by the **Tax Exempt and Government Entities division (TE/GE)**. Within the IRS, the TE/GE or Employee Plans division oversees retirement plans. In particular, it administers the Title II provisions of ERISA and provides a wealth of information via its website (www.irs.gov/ep).

The provisions of Title I of ERISA are administered by a separate agency within the DOL called the **Employee Benefits Security Administration (EBSA)**. (The EBSA website is www.dol.gov/ebsa.) Headed by an Assistant Secretary of Labor, EBSA's stated mission is to "assist workers in getting the information they need to exercise their benefit rights; assist plan officials to understand the requirements of the relevant statutes in order to meet their legal responsibilities; develop polices and regulations that encourage the growth of employment-based benefits; [and] deter and correct violations of the relevant statutes through strong administrative, civil, and criminal enforcement efforts to ensure workers receive promised benefits."

Because of the parallel provisions within Titles I and II of ERISA where the tax laws were amended to mirror the labor laws, there were areas of joint responsibility between the IRS and DOL. Subsequently, in 1978 the IRS became primarily responsible for the participation, funding, and ownership or vesting rules, while the DOL assumed primary responsibility for the reporting, disclosure and standards of conduct requirements.

Responsibility for enforcement of Title IV of ERISA rests with the agency created by Title IV: the PBGC. Since the PBGC's termination insurance program applies only to defined benefit plans, further discussion of the PBGC is provided in RPF-2.

Given the complexities of the tax and labor laws, as well as the need to maintain uniformity in their application, both the IRS and the DOL have developed multifaceted administrative policies that include interpretation of statutory authority, drafting of regulations, rulings on substantive issues and disseminating information to the general public. Because the emphasis in this course is placed on gaining knowledge regarding qualification for purposes of tax advantages, the ensuing discussion will concentrate more fully on IRS issuances.

[B] Treasury or Labor Regulations (Treas. Reg. §1.xxx or Reg. §.xxx)

The pronouncements by the IRS and DOL that have the broadest impact are **Treasury Regulations** and **Labor Regulations**. Generally speaking, there are two types of Regulations: Legislative and Interpretative.

1. A **Legislative Regulation** is one issued under specific authority delegated by Congress to set standards or establish policy. Legislative Regulations are given the full force and effect of law unless the IRS or DOL goes beyond the scope of its delegated power.

2. An **Interpretative Regulation** is a statement of opinion on the meaning of ERISA or the Internal Revenue Code and, while not having the force and effect of law, such regulations are generally accorded great weight by the courts. Interpretative Regulations are subject to substantive judicial review as to whether the position adopted by the IRS or DOL correctly interprets the statute.

[C] Final, Proposed or Temporary Regulations

<u>1. What Does a Regulation Do?</u>

A regulation is a broad expression of the issuing agency's interpretation of a statutory provision under ERISA or the Internal Revenue Code. Regulations often contain examples of typical fact patterns to illustrate the narrative explanation and are binding on both the taxpayer and the IRS or DOL. However, a regulation is not meant to cover all situations. Employers and retirement plan professionals will therefore look to other forms of guidance offering increased specificity to supplement their understanding.

Regulations are designated as one of the following:

- **Final Regulations** must be published in the Federal Register and provide for adequate notice, comments and public hearing.
- **Proposed Regulations** must be published according to specific procedural requirements and are intended to become final regulations. Proposed regulations are issued to solicit public written comments, and public hearings are held if written requests are made.
- **Temporary Regulations** are published to provide guidance in an area of immediate concern or to cover a situation that may exist only for a short period of time.

All regulations must be issued in proposed form before being published in final form. A temporary regulation may also be designated as a proposed regulation if such regulation conforms to the procedural requirements.

It is common for the IRS and DOL to announce that reliance on a proposed regulation will not adversely affect the employer. Once a final regulation is issued time will be given either to conform retroactive transactions to the final regulation or an exception will be made for previously completed transactions under a process called grandfathering.

A proposed regulation or a temporary regulation has the same force and effect of law as a final regulation and is subject to the same judicial review. While not a common occurrence, proposed or temporary regulations may be withdrawn prior to becoming final regulations.

2. Regulation Citations

Citations to Treasury Regulations appear as “Treas. Reg. §1.” while Labor Regulations appear as “Reg. §.” Contained in the numbering system of both sets of regulations is a reference to the section of the Internal Revenue Code or ERISA (also referred to as the Act) that the regulation interprets. Please refer to Appendix D for a brief table with descriptions of the IRC Sections applicable to retirement plans by section number.

For example, IRC §401(a), which contains the requirements for plan qualification, is interpreted by Treas. Reg. §1.401(a), and IRC §401(k) has as its companion Treas. Reg. §1.401(k). (Of note: Treasury Regulation numbers always begin with “1.”)

With regard to citation examples of ERISA and Labor Regulations, Act §408(b) regarding loans made to certain participants under the plan, is interpreted by Reg. §2550.408b, while Act §503, regarding procedures pertaining to claims for plan benefits, should be read with Reg. §2560.503 at hand.

§7.05 Rulings, Procedures and Determination Letters

The IRS Rulings Program advises taxpayers in advance how the IRS will interpret the Internal Revenue Code and affiliated Regulations with regard to distinct factual situations. The program offers guidance in two categories:

1. Revenue Rulings, and
2. Private Letter Rulings.

[A] Revenue Rulings (Rev. Rul. yyyy-x)

Revenue Rulings are construed as an official interpretation by the IRS regarding how the law is applied to a particular subject using a specific set of facts. Although an individual Revenue Ruling would not apply to fact patterns that deviate from those stated within the Ruling, its purpose is to ensure that the issue it addresses will be handled uniformly throughout the country.

One might think of a Revenue Ruling as an explanation of the effect of the Internal Revenue Code or a Treasury Regulation upon a prescribed set of circumstances that have general application. Thus, Revenue Rulings may be relied upon by taxpayers, as long as any limits or factual prescriptions contained within the Rulings are met.

For example, Rev. Rul. 2004-11 explains the effect of a portion of the minimum coverage requirements upon the retirement plan of an employer who has experienced a company merger, acquired another company or sold part of itself during the 12-month period considered the plan year. Any employer who has undergone a similar merger, acquisition, or sale conforming to the fact pattern established by Rev. Rul. 2004-11 could therefore rely on its guidance.

<u>1. Revenue Ruling Citations</u>

A Revenue Ruling citation contains the year it was issued and a number representing the order of its issuance. As an example, Rev. Rul. 2004-11 was the eleventh Revenue Ruling of 2004. Of note: Revenue Rulings issued prior to year 2000 exhibit only the last two digits of their issuance year. Therefore, the first Revenue Ruling issued in 1998 was Rev. Rul. 98-1.

[B] Revenue Procedures (Rev. Proc. yyyy-x)

Revenue Procedures use the same citation system as Revenue Rulings, which may at first glance allow a Ruling to be mistaken for a Procedure. However, the two are in form and content quite distinct. A **Revenue Procedure** is precisely what its name implies: it embodies an official statement of the procedural steps one must take to comply with the Internal Revenue Code, related statutes, tax treaties and other regulations.

By publishing a how to guide towards accomplishing compliance, the IRS ensures that what should be a matter of public knowledge has broad impact. Like Revenue Rulings, a Revenue Procedure has less force and effect than Treasury Regulations, but taxpayers are expected to conform to the Procedure's dictates. Indeed, Revenue Procedures represent extremely useful guidance as the explanations they contain are often undertaken in great detail.

For example, Rev. Proc. 2004-6 explains what information and forms must be provided to the IRS when requesting a favorable determination letter, how to withdraw an application, where to send the application, how to request a status conference, what will happen if an application submission is incomplete and even such minutia as what identifying information regarding an employer should be contained in the cover letter to the IRS if an employer is sponsoring more than one plan and wishes to submit all of its plan documents at the same time.

[C] Private Letter Rulings (PLR yyyywwxxx)

A **Private Letter Ruling (PLR)** is published in response to a request from an individual taxpayer wishing to ascertain the IRS's position with respect to the private set of facts presented. As such, a PLR issued to a taxpayer may be relied upon only by that taxpayer. To emphasize the specificity of its application, the PLR bears the legend: "This document may not be used or cited as precedent."

Inquisitive natures aside, those who peruse PLRs are often attempting to glean insight into how the IRS might be expected to respond to their own situations, and thus PLRs have their place in the hierarchy of available guidance. However, another taxpayer with the same or similar factual circumstances described in a published PLR must request a separate Private Letter Ruling to be assured of the same result. Also of note: PLRs are not issued as answers for questions regarding whether or not a plan is qualified.

1. PLR Citations

PLRs are identified by the year, week, and issuance number. Hence, PLR 199938052 was the 52nd Private Letter Ruling issued in the 38th week of 1999. Prior to 1999, only the last 2 digits of the year were used as identifiers.

[D] Determination Letters

Assurance that a plan in written form constitutes a document compliant with qualification requirements remains the domain of IRS Determination Letters rather than PLRs. Upon submission of the plan documents to the IRS for review, a request for determination letter process is initiated to culminate in receipt of a letter illustrating approval of the plan's provisions. This is known as a **favorable determination letter**.

As part of the quest for a favorable letter, during the approval process, any deficiencies in the plan documents are identified and corrected. In the event of a legislative change, plan documents may be updated in response and later resubmitted for a current determination letter that cites approval of the plan document in its present form.

Understandably, plans that have enjoyed a lengthy history often have several determination letters: the current, most recently dated determination letter conferred upon the last application to the IRS and previous letters that applied at various stages in the evolution of the plan.

It is important to take heed of a cautionary tale: if a favorable determination letter is issued to a qualified plan but the plan is found to operate in a manner which does not comply with its written provisions, it may be disqualified since the determination letter does not guarantee qualified status of the plan.

§7.06 News Releases, Notices, Announcements, Information Letters and Advisory Opinions

There is an abundance of additional guidance from the IRS and DOL available to keep the public informed, albeit communicated via different techniques and of varying degrees of application.

The IRS uses **News Releases, Notices** and **Announcements**

- To inform the public of current developments,
- To present information of general interest, and
- To summarize new tax law or to publicize procedural matters.

Principally, the material contained within the News Release, Notice or Announcement does not present a question of fact or involve an issue of reliance or substantive interpretation of the Internal Revenue Code. For example, a Notice may relate what a Regulation will say in situations where issuance of the Regulation is pending and not expected in the near future.

Announcements are intended to have only immediate or short-term value: thus, an announcement may be made to remind taxpayers of approaching deadlines for filing or conforming a transaction to a new statute. However, as noted in Rev. Rul. 87-138, these communications are intended to be relied on by taxpayers and are "the equivalent of revenue rulings and revenue procedures."

The DOL also offers News Releases regarding retirement and labor issues. The IRS and DOL employ non-binding **Information Letters** to call attention to well-established principles or interpretations as part of their general service to the public.

The DOL will also provide an **Advisory Opinion**, something akin to a Labor Department version of the PLR, in answer to inquiries from individuals and organizations regarding the application of the Act to a restricted set of facts. In addition, both agencies advertise "contact us" technical assistance via their respective websites and phone lines.

In retrospect then, plan sponsors and retirement plan professionals have several avenues to explore when searching for guidance regarding the obtainment of plan qualification under the Internal Revenue Code and ERISA. The listing above is by no means exhaustive. Consequently, the ability to research, identify and ultimately grasp the legal underpinnings of retirement plan rules and their accompanying guidance, as well as the authority and breadth of their application, will serve to strengthen awareness and understanding of the basic and fundamental requirements for plan qualification as set forth in these laws.

§7.07 Qualification Requirements

[A] Fundamental Requirements

It only makes good business sense for an employer to select the plan design which best meets the employer's objectives. Although plans can be established which are not tax-qualified and do serve to uphold certain business criteria, the tax savings of a qualified plan usually argue convincingly and successfully for its adoption as the employer's optimal choice. In this light, there are four fundamental requirements for any plan to be considered qualified for tax purposes:

1. The plan must be established and maintained by the employer for the exclusive benefit of its employees or their beneficiaries;
2. The employer must intend that the plan be permanent;
3. The plan must be in writing; and
4. The plan must be communicated to the employees.

[B] Qualification in Form

In addition, IRC §401(a) contains the basic requirements for qualified plans. Among the more notable of these are:

- Contributions made or benefits under the plan must not disproportionately favor the highly compensated; that is, the plan must not discriminate against lower-paid employees [IRC §401(a)(4)].
- The plan must not require a participant to work more than a maximum period of time before being granted ownership of his or her benefits. Benefits once owned may not be taken away and returned to the employer [IRC §401(a)(7)].
- Plans under which a specified majority of the benefits has been credited to a key group of employees, called top-heavy plans, must satisfy additional requirements concerning faster vesting and minimum contributions or benefits [IRC §401(a)(10)(B)].
- A plan must provide for the payment of benefits in the form of a "qualified joint and survivor annuity." That is, the plan should normally pay

retirement benefits to a married participant for his or her lifetime and then continue payments (the payment amount may be reduced) to his or her surviving spouse for the remainder of the spouse's lifetime [IRC §401(a)(11)]. There are exceptions for certain profit sharing plans.

- The plan must provide that on merger or consolidation of the plan with another plan each participant shall be entitled to a benefit after the merger that is no less than his or her benefit before the merger [IRC §401(a)(12)].
- The plan must specify that benefits earned by a participant may not be "assigned" or "alienated." They may not be granted to another party or attached by outside parties such as the participant's creditors [IRC §401(a)(13)].
- Unless the participant elects otherwise, the plan must provide that the payment of benefits shall commence no later than 60 days after the end of the 12-month period designated as the plan year in which the latest of three dates occur: 1) reaching the plan's usual or normal retirement age, 2) the tenth anniversary of the date the employee became a plan participant, or 3) the date the participant terminated service with the employer [IRC §401(a)(14)].
- The plan must not allow the level of contributions or benefits provided to a participant to exceed certain maximum amounts [IRC §415].
- The plan must cover or provide benefits for a required minimum number of employees of the employer [IRC §410(b)].
- The plan must limit the amount of an individual's compensation that can be taken into account for determining contributions and benefits to $200,000 (as indexed for cost of living adjustments) [IRC §401(a)(17)].
- Defined benefit plans must specify what assumptions will be used in calculating and converting benefits from one payment form to another so that an employer may not change them at will [IRC §401(a)(25)].

  For example, a plan may use an investment rate of return assumption and an estimated lifetime assumption (or mortality assumption) to offer a terminating participant the following choice: "$1,000 per month for the rest of your lifetime with payments to begin when you reach age 65, or what has been determined as an equivalent amount: a lump sum payment of $100,000 right now."

The plan document must provide these basic requirements at a minimum in order to become a qualified plan.

[C] Qualification in Operation

It also is necessary for the plan to operate in compliance with its written requirements; in other words, the plan must exhibit qualification in operation. Even though a plan document may have been approved by the IRS as a qualified plan in form, the plan may still be disqualified if it is administered contrary to the provisions of either its document or current law.

§7.08 Key Terms

Advisory Opinion: The DOL version of a private letter ruling.

Announcement: Issued by the IRS to inform the public of current developments, present information of public interest, summarize new tax law and publicize procedural matters.

Employee Benefits Security Administration (EBSA): The division under the Department of Labor which administers the non-tax (regulatory and administrative) provisions of ERISA. The EBSA issues opinion letters and other pronouncements, and requires certain information forms to be filed with it by plan sponsors.

Employee Retirement Income Security Act (ERISA): The basic labor law covering qualified plans, it incorporates both the pertinent Internal Revenue Code provisions by reference and labor law provisions.

Favorable Determination Letter: A letter illustrating approval of the plan's provisions regarding form for qualification purposes.

Final Regulation: Must be published in the Federal Register and provide for adequate notice, comments and public hearing.

Information Letter: A non-binding letter that calls attention to well-established principles or interpretations of the law.

Interpretive Regulation: A statement of opinion on the meaning of ERISA or the Internal Revenue Code.

Labor Regulation: Regulations interpreted by the DOL.

Legislative Regulation: Issued under specific authority delegated by Congress to set standards or establish policy.

News Release: Issued by the IRS to inform the public of current developments, present information of public interest, summarize new tax law and publicize procedural matters.

Notice: Issued by the IRS to inform the public of current developments, present information of public interest, summarize new tax law and publicize procedural matters.

Private Letter Ruling (PLR): A private ruling issued by the IRS in response to a request from a taxpayer as to the tax consequences of a proposed or completed transaction. Private letter rulings are published informally by several publishers. They are not considered as precedent for use by taxpayers other than for the individual who requested the ruling, but they do give an indication of the IRS' current attitude as to a particular type of transaction.

Proposed Regulation: Must be published according to specific procedural requirements and are intended to become final regulations.

Revenue Procedure (Rev. Proc.): Issued by the IRS, a Rev. Proc. is similar to a revenue ruling. However, it focuses on procedural matters or details the requirements to be followed in connection with various dealings with the IRS. Rev. Procs. also may set forth guidelines that the IRS follows in handling certain tax matters.

Revenue Ruling (Rev. Rul.): Issued by the IRS, these rulings express the IRS' views as to the tax results that apply to a specific problem.

Tax Exempt and Government Entities division (TE/GE): The DOL agency that administers the provisions of Title I of ERISA.

Temporary Regulation: Published to provide guidance in an area of immediate concern or to cover a situation that may exist for a short period of time.

Treasury Regulation: Regulations interpreting the Internal Revenue Code are technically Treasury regulations. The IRS is a part of the Treasury Department.

§7.09 Review of Key Concepts

- ERISA established significant guidelines for employer-sponsored retirement plans, including extensive reporting and disclosure rules.

- ERISA established two new important concepts: plan termination insurance, administered by the PBGC, and IRAs for those taxpayers not covered by an employer's qualified retirement plan.

- Congress creates tax statutes, or laws. The Internal Revenue Code contains these tax laws. Supportive and clarifying guidance is issued from time to time that serves to explain and interpret these laws.

- The IRS has responsibility for the enforcement and interpretation of the Internal Revenue Code, the issuance of Regulations and other rulings, and provision of guidance with respect to application of the Internal Revenue Code.

- The DOL has primary responsibility for the enforcement of the reporting, disclosure, and standards of conduct requirements of ERISA.

- The fundamental benefit of a qualified plan is favorable tax treatment for plan sponsors, the trust and the participants.

- Temporary regulations provide guidance in an area of immediate concern, while proposed regulations are intended to become final regulations.

- In order to be tax-qualified, a retirement plan must meet certain basic requirements found in the Internal Revenue Code, such as the plan must be established and maintained by the employer for the exclusive benefit of its employees or their beneficiaries.

§7.10 Review Questions

[A] True or False

______ 1. A plan must exhibit qualification in operation and maintain a qualified written document to be assured of its qualified status.

______ 2. The IRS is responsible for interpreting statutory authority, administering the Internal Revenue Code and developing uniform tax enforcement policy.

______ 3. EBSA is responsible for assisting workers in obtaining information they need to exercise their benefit rights.

______ 4. Tax deferral is a major reason to maintain a qualified plan.

______ 5. Title IV of ERISA created the PBGC.

[B] Multiple Choice

6. All of the following statements regarding ERISA are **TRUE, EXCEPT**:

   A. It provided rules to determine when a participant is vested in benefits.
   B. It established plan termination insurance.
   C. It established IRAs.
   D. It established educational requirements for actuaries.
   E. It mandated retirement benefits for all workers.

7. All the following can be issued by the IRS, **EXCEPT**:

   A. Legislative regulations
   B. Corrective regulations
   C. Temporary regulations
   D. Final regulations
   E. Proposed regulations

8. All of the following are general requirements that must be met for a plan to be qualified, **EXCEPT**:

   A. It must be communicated to employees
   B. It must be established for all employees
   C. It must be permanent
   D. It must be in writing
   E. It must be for the exclusive benefit of the employees

9. All of the following statements regarding proposed regulations are **TRUE, EXCEPT**:

   A. Proposed regulations are issued at the specific request of an individual taxpayer.
   B. A proposed regulation may be withdrawn prior to becoming a final regulation.
   C. All regulations must be issued in proposed form prior to being published in final form.
   D. Proposed regulations are issued to solicit public comments.
   E. A proposed regulation has the same force and effect as a final regulation.

§7.11 Answers

1. **True.** A plan must exhibit qualification in operation and form (written document) to be assured of its qualified status. §7.07

2. **True.** The IRS is responsible for interpreting statutory authority, administering the Internal Revenue Code and developing uniform tax enforcement policy. §7.04 [A]

3. **True.** EBSA is responsible for assisting workers in obtaining information they need to exercise their benefit rights. §7.04 [A]

4. **True.** Tax deferral is a major reason to maintain a qualified plan. §7.03 [A]

5. **True.** Title IV of ERISA created the PBGC. §7.03 [C]

6. The correct answer is **E.** §7.03 [C]

   A. Incorrect. This statement is true because ERISA provided rules to determine when a participant is vested in benefits.
   B. Incorrect. This statement is true because ERISA established plan termination insurance.
   C. Incorrect. This statement is true because ERISA established IRAs.
   D. Incorrect. This statement is true because ERISA established educational requirements for actuaries.
   E. Correct. This statement is false because ERISA did not mandate retirement benefits for all workers.

7. The correct answer is **B.** §7.04 [B] and §7.04 [C]

   A. Incorrect. This statement is true because the IRS issues legislative regulations.
   B. Correct. This statement is false because the IRS does not issue corrective regulations.
   C. Incorrect. This statement is true because the IRS issues temporary regulations.
   D. Incorrect. This statement is true because the IRS issues final regulations.
   E. Incorrect. This statement is true because the IRS issues proposed regulations.

8. The correct answer is **B.** §7.07 [A]

   A. Incorrect. This statement is false because a qualified plan must be communicated to employees.
   B. Correct. This statement is true because a qualified plan need not be established for all employees.
   C. Incorrect. This statement is false because a qualified plan must be permanent.
   D. Incorrect. This statement is false because a qualified plan must be in writing
   E. Incorrect. This statement is false because a qualified plan must be for the exclusive benefit of the employees

9. The correct answer is **A.** §7.04 [C]

   A. Correct. This statement is false because private letter rulings, not proposed regulations are issued at the specific request of an individual taxpayer.
   B. Incorrect. This statement is true because a proposed regulation may be withdrawn prior to becoming a final regulation.
   C. Incorrect. This statement is true because all regulations must be issued in proposed form prior to being published in final form.
   D. Incorrect. This statement is true because proposed regulations are issued to solicit public comments.
   E. Incorrect. This statement is true because a proposed regulation has the same force and effect as a final regulation.

Chapter 8:
Enrolling Employees

§8.01 Learning Objectives

- List and describe types of communication often provided to employees entering the plan as participants.

- Explain the process of rollover of assets into qualified retirement plans.

§8.02 Introduction

After the employer has established a plan, eligible employees need to be notified of the plan's existence and how to participate in the plan. Communication is the key to successful enrollment and maximum levels of participation in the plan.

This chapter addresses:

- Initial communications;
- Participation and investment elections;
- Required plan information; and
- Forms and procedures attributable to special plan features.

§8.03 Initial Communications to Participants

[A] Initial Communications

All plan communications to participants should be carefully prepared. Of particular importance is the method by which the plan is first introduced to participants. Both the time and financial commitments made by the employer to the communication process are significant. The return for those commitments should be a plan that is viewed by the participants as a valuable benefit. This will create a lasting impression for which the initial communication lays the groundwork.

The methods used and time taken to introduce a plan to participants can vary widely. Some employers take several months to build up enthusiasm for the plan through a sequence of announcements, distribution of detailed plan information, and subsequent group or individual enrollment meetings. These meetings provide an opportunity to review plan information, answer questions, and help participants with the completion of enrollment paperwork.

The nature of the employer's business, as well as the locations and working hours of staff dictate how the introduction and enrollment of a plan will take place. Larger employers with multiple locations may use videotapes, conference calls, employer intranet mail or websites in conjunction with written materials.

The following items are usually included in the detailed enrollment information provided when the plan is introduced to eligible employees:

- Beneficiary designation form;
- Application to participate (if applicable);
- Salary reduction election (if applicable);
- Investment information, including a description of each option, historical return performance, and prospectuses (if applicable);
- Investment direction form (if applicable);
- Summary plan description (SPD); and
- Rollover contribution forms.

Care must be taken to ensure that there are no discrepancies between the provisions described in the initial plan communications, including the enrollment materials, and the SPD. Participants need to feel confident in the administration of their retirement savings accounts for the plan to be successful.

[B] Beneficiary Designation

Immediately upon plan entry, each participant should complete a **beneficiary designation form**, informing the plan to whom the participant's vested benefit will be distributed in the event of the death of the participant. Most beneficiary designation forms request the selection of a secondary or contingent beneficiary in addition to a primary beneficiary in the event that the primary beneficiary does not survive the participant.

If the participant is married, the most common primary beneficiary is the participant's spouse. In the event that a married participant wishes to designate someone other than their spouse as beneficiary for more than 50% of the benefit, the spouse must consent to the designation in writing and an authorized plan representative or a notary public must witness the spouse's signature.

The beneficiary designation form should request the following information: beneficiary name, the relationship of the beneficiary to the participant and the percentage of the account balance or benefit assigned to the beneficiary. More than one person may be designated as primary or secondary beneficiary as long as the division of benefits is appropriately detailed. For example, a participant may wish to designate her two children as primary beneficiaries, each entitled to 50% of her vested account balance.

It also is allowable to designate an estate or trust as beneficiary rather than a specific individual or individuals. For example, an unmarried participant with minor children might wish to designate a trust established for the benefit of the children as primary beneficiary.

[C] Application to Participate

The plan administrator should establish a system to ensure that all eligible employees enter the plan at the applicable entry dates upon completion of the plan's eligibility requirements. While enrollment is generally automatic where all benefits are to be contributed by the employer, some plans choose to offer a formal application to enroll which also may be used to decline participation irrevocably if the plan so allows. Failure to complete an **application to participate** will not prevent an employee from becoming a participant.

[D] Salary Reduction Election

The **salary reduction election form** for 401(k) plans (sometimes known as the elective deferral election form) confirms the amount (either dollar or percentage) of pre-tax elective deferrals or designated Roth contributions that will be withheld from the participant's paycheck. As of January 2006, plans may change their elective deferral forms to include designated Roth contributions if their plan documents are amended and their recordkeeping systems can account separately for these after-tax elective deferrals.

The employer and the plan administrator should keep copies of all salary reduction election forms, including those which show a zero election, to confirm that all eligible employees have been given the opportunity to participate.

Some plans also permit employees to have plan contributions deducted from their paychecks on an after-tax basis (these after-tax employee contributions are different than the designated Roth contributions). A separate after-tax employee contribution election form may be used to document these participant elections, or the salary reduction election form may include a section for the participant to elect after-tax employee contributions, also known as voluntary or employee contributions. The investment gains attributable to these contributions will accumulate under the qualified plan on a tax-deferred basis.

Additionally, some plan sponsors choose to make matching contributions based on both elective deferrals and after-tax employee contributions. With the 2006 advent of the designated Roth contributions, where the investment gains accumulate tax-free rather than tax-deferred, after-tax employee contributions may no longer be an attractive option for 401(k) plans.

Under certain circumstances, a 401(k) plan may include a provision for automatic enrollment, sometimes called a negative election. In these scenarios, a participant is set up automatically for a specific elective deferral percentage, such as 3% of compensation or an increasing percentage over time.

These automatic elective deferrals will commence according to the timeframes established by the plan unless the participant chooses to replace the automatic percentage with either a zero election or a different percentage or dollar election. The salary reduction election form will address any automatic enrollment provision in depth, and the participant must be given ample opportunity to elect out of this provision at any time.

[E] Investment Direction Form

The **investment direction form** identifies how contributions are to be invested among the menu of investment options made available to participants. For example, if a plan has a money market option, a bond fund option and two stock fund options, participants must designate how contributions to their respective accounts are to be allocated among these four selections.

The investment direction form may be designed to detail both initial investment elections upon plan entry and any subsequent changes. Additionally, the form may provide the flexibility to invest future contributions differently from existing account balances.

With the advent of web-based applications and voice-activated response systems, many plans also are designed to accept telephone or electronic investment direction and provide confirmation of those elections in suitable fashion such as email, fax or paper mailings.

The investment direction form, in concert with the SPD, should inform participants in full detail of the following:

- How frequently investment changes are permitted;
- The charges and/or penalties, if any, that apply to transfers between funds; and

- Limitations, if any, that may apply to the percentage or dollar amount that can be transferred between funds in a particular period.

§8.04 Summary Plan Description

A copy of the **summary plan description (SPD)** must be provided to participants within 90 days after becoming a participant, and whenever the SPD is updated. SPDs must accurately reflect the plan's major provisions and need to be written in a way that is easily understood by participants. At a minimum, the SPD must address the following:

- Eligibility requirements;
- Permitted employer and employee contributions;
- Contribution allocation provisions;
- Fees charged against participant accounts;
- Vesting schedules;
- Distribution of benefits;
- Policies surrounding in-service withdrawals;
- Administrative contacts including identification of the plan sponsor, plan administrator, and trustee;
- Name and contact information of the plan trustee;
- ERISA §404(c) requirements (if applicable); and
- Participant rights under ERISA.

For documentation purposes, the plan administrator may require that each participant sign an acknowledgment of receipt of the SPD. In addition to an SPD, an abbreviated outline of the plan's provisions may be provided as a one-page easy reference.

§8.05 Rollover Contribution Forms

A rollover contribution occurs when a qualified plan accepts a participant's distribution from another qualified plan, SEP, IRA or tax-sheltered annuity plan. By rolling the distribution into another qualified plan, the employee continues to defer the payment of taxes that would otherwise be applicable at the time of the distribution from the prior qualified plan. After the money is rolled into the new plan, it is subject to the rules and regulations of that plan.

The plan and SPD will specify whether or not rollover contributions from a SEP, IRA, tax-sheltered annuity plan or other qualified plans are allowed, and also describe when and under what conditions they may be accepted.

If the plan administrator accepts a rollover contribution from another qualified plan, a separate account is set up and maintained for the employee. If the plan document allows, rollover contributions may be accepted for employees before they fulfill eligibility requirements for participation under the plan. In these instances, the employee is treated as a limited participant for the rollover account purposes only.

Since the employee owns his or her rollover account from the time it is created, the account is fully vested at all times. Often a plan will permit the employee to withdraw all or any portion of the rollover contribution while still employed.

To facilitate the acceptance of an allowable rollover contribution, many plan sponsors require an employee to fill out a **rollover contribution form** to provide proof that the rollover came from an acceptable source. The employee also may need to complete an investment election form for the rollover amounts where applicable.

§8.06 Key Terms

Application to Participate: A formal application used to enroll employees as participants. May be used to decline participation irrevocably but not used by all plans.

Beneficiary Designation Form: Specifies the individual or individuals to whom a participant’s vested benefit will be distributed in the event of the participant’s death.

Investment Direction Form: Identifies how contributions are to be invested for participants.

Rollover Contribution Form: Used to provide proof that a participant’s rollover into the plan came from an acceptable source.

Salary Reduction Election Form: Used in 401(k) plans to confirm the amount of participant elective deferrals that will be withheld from a participant’s paycheck.

Summary Plan Description (SPD): A detailed, but easily understood, summary describing a qualified plan's provisions that must be provided to participants and beneficiaries.

§8.07 Review of Key Concepts

- The following may be provided when enrolling new participants:

  1) Beneficiary designation form;
  2) Application to participate (if applicable);
  3) Salary reduction election (if applicable);
  4) Investment information, including a description of each option, historical return performance, and prospectuses (if applicable);
  5) Investment direction form (if applicable);

6) Summary plan description (SPD); and
7) Rollover contribution forms.

- Assets may be rolled into a qualified plan from another qualified plan, SEP, IRA or tax-sheltered annuity, if permitted by the plan, in order to defer the payment of taxes.

- To facilitate the acceptance of a rollover contribution, many plan sponsors require an employee to fill out a rollover contribution form to provide proof that the rollover came from an acceptable source.

§8.08 Review Questions

[A] True or False

______ 1. A retirement plan must allow rollover contributions into the plan prior to the participant having met the eligibility requirements.

______ 2. A beneficiary designation form details who will receive the participant's benefit in the event of the participant's death.

______ 3. A typical form of distribution in a profit sharing plan is a lump sum distribution.

[B] Multiple Choice

4. All of the following must be addressed in the SPD, **EXCEPT**:

A. Eligibility requirements
B. Permitted contribution and allocation provisions
C. Distribution of benefits
D. Submission date of the SPD to the IRS
E. Vesting schedules

5. All of the following may be provided to employees upon their becoming eligible to participate in a 401(k) plan, **EXCEPT**:

A. Beneficiary designation form
B. Tax withholding form
C. Investment direction form
D. Salary reduction agreement
E. One page summary of key plan provisions

§8.09 Answers

1. **False.** A retirement plan often lets employees rollover balances before they meet the eligibility conditions, but it is not a requirement. §8.05

2. **True.** A beneficiary designation form details who will receive the participant's benefit in the event of the participant's death. §8.03 [B]

3. **True.** A typical form of distribution in a profit sharing plan is a lump sum distribution. §8.05

4. The correct answer is **D.** §8.04

   A. Incorrect. This statement is true because eligibility requirements must be addressed in the SPD.
   B. Incorrect. This statement is true because permitted contribution and allocation provisions must be addressed in the SPD.
   C. Incorrect. This statement is true because distribution of benefits must be addressed in the SPD.
   D. Correct. This statement is false because SPDs are not submitted to the IRS.
   E. Incorrect. This statement is true because vesting schedules must be addressed in the SPD.

5. The correct answer is **B.** §8.03

   A. Incorrect. This statement is true because beneficiary designation forms are provided to employees at eligibility.
   B. Correct. This statement is false because tax withholding forms are provided to employees at distribution not at eligibility.
   C. Incorrect. This statement is true because investment direction forms are provided to employees at eligibility.
   D. Incorrect. This statement is true because salary reduction agreements are provided to employees at eligibility.
   E. Incorrect. This statement is true because a one page summary of key plan provisions may be provided to employees at eligibility.

Chapter 9:
Disclosure and Communication

§9.01 Learning Objectives

- State the Form 5500 annual reporting requirements applicable to a qualified plan including required schedules and the deadline for filing.
- Describe the plan distribution and reporting requirements for Form 1099-R and Form 945.
- List the events that require disclosures to plan participants and beneficiaries over and above the annual disclosures.

- Name the disclosures that must be provided to participants and beneficiaries.
- Identify acceptable disclosure methods that plan administrators may use to provide required plan information to participants and beneficiaries.
- Identify the various rules that apply when electronically disclosing plan information to participants.

§9.02 Introduction

The dual task for plan administrators and sponsors of reporting to various governmental agencies and disclosing information about those reports to participants and beneficiaries is substantial and vital to any plan's qualified status. ERISA's Title I initiated many of today's requirements, while ongoing legislative changes have continued to extend and adjust those requirements. The result is an abundance of forms, notices, regulations and due dates to be considered during the course of any plan year.

This chapter outlines some of these disclosure and reporting rules, with particular emphasis on how broad plan-level events and progress reviews are addressed and communicated both externally to the government and internally to the plan's population. The chapter also addresses electronic communication and the DOL safe harbor regulations published in 2002. Although plans are not required to comply with the new safe harbor rules, for those that do, the plan's electronic delivery method would be deemed to satisfy the disclosure requirements under ERISA and the Internal Revenue Code. The regulations are expected to improve the timeliness, quality and accessibility of information for participants and their beneficiaries.

§9.03 Disclosure—In General

Reporting to various governmental agencies and disclosure to participants and beneficiaries is a function of forms, notices, communications, due dates and compliance regulations, all of which are designed to:

- Ensure that the plan complies with the requirements of ERISA and the Internal Revenue Code; and,
- Increase the awareness of individual participants and beneficiaries of plan benefits and their right to those benefits.

Two broad categories of reporting and disclosure are required:

- Annual reports that the plan administrator can always anticipate completing; and,
- Requirements related to the occurrence of an event under the plan, termed special event reporting for purposes of this course.

Failure to file a required form on a timely basis or to supply information about the plan to participants within the allowed period of time usually subjects the plan, its administrator, and/or sponsor to imposition of a specific fine or civil penalty.

The DOL can assess a fine against a plan administrator of up to $1,100 for each day beyond the filing deadline that a Form 5500 Annual Return/Report is late. The penalty for failure to comply within 30 days to a request for information that a plan administrator is required to provide to a participant or beneficiary is $110 per day, and a plan sponsor incurs an $11 penalty for each employee who does not receive an employee benefits statement as required by ERISA.

Additionally, to enforce reporting and disclosure requirements, ERISA grants the Department of Justice (DOJ), DOL, IRS, PBGC, participants and beneficiaries legal recourse against the trustee, plan administrator and plan sponsor in the form of civil and criminal lawsuits. Willful failure to comply or making false statements while complying can lead to imprisonment and heavy fines for the plan administrator, trustee and/or plan sponsor.

§9.04 Who is Subject to Reporting and Disclosure Requirements?

Title I of ERISA includes the reporting and disclosure provisions of the law, and consequently these provisions apply to all employee welfare benefit plans and employee pension benefit plans covered by ERISA. As discussed in Chapter 1, the following plans are not subject to ERISA:

- Government plans that are partially exempt from ERISA provisions;
- Church plans that are partially exempt from ERISA provisions unless they elect to comply with ERISA;
- Plans maintained solely to comply with workers' compensation laws, unemployment compensation, or disability insurance laws;
- Plans maintained outside the U.S. primarily for nonresident aliens; and
- Unfunded excess benefit plans, which are plans with no underlying assets that are designed to provide benefits that exceed the maximum benefits allowed under the Internal Revenue Code.

Some of ERISA's reporting and disclosure requirements depend on whether an employee pension benefit plan is a defined benefit plan or a defined contribution plan. For example, many funding status disclosures are pertinent only to defined benefit plans, given the nature of their benefit promise. Also, differing ERISA rules apply for single employer plans, multiple employer plans and multiemployer plans.

- A **single employer plan** is a plan under which only the employees of one employer are eligible to participate and to which only one employer contributes, whether or not the plan is maintained pursuant to a collective bargaining agreement. All trades or businesses that are linked by common ownership control are typically considered a single employer and each may contribute to the single employer plan.

- A **multiple employer plan** is a plan under which more than one unrelated employer contributes and is not maintained pursuant to a collective bargaining agreement.
- A **multiemployer plan** is a plan under which more than one employer is required to contribute, is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and satisfies other requirements that the Secretary of Labor may prescribe by regulation.

Clearly, therefore, knowledge of the particular notices and reports that a plan must complete begins with an understanding of the specific plan and its features.

§9.05 Annual Reporting

Each year, plans subject to ERISA's Title I can expect to perform a series of reporting and disclosure tasks. Much of the yearly effort concentrates on completing and filing the **Form 5500 Annual Return/Report of Employee Benefit Plan** with the **Employee Benefits Security Administration (EBSA)**, which is part of the DOL.

A narrative summary of the Form 5500 known as the **Summary Annual Report (SAR)** discloses to participants and beneficiaries the essential financial information contained in the DOL filing and provides instructions on how to view the full Form 5500 if desired.

Other annual reports center on the dissemination of distribution information to participants and the IRS via Form 1099-R, payment of premiums to the PBGC for defined benefit plans, and preparation of Form 945 for the reconciliation of taxes withheld and deposited by employers with the government for distributions paid from the plan during the year.

[A] Form 5500 Schedules and Attachments

The following describes the plan's annual return/report due to the EBSA within the DOL. Each plan files schedules as required by the plan's participation size, design, provisions and investment options.

<u>Form 5500</u>	General form for both large plan filers (100 participants or more) and small plan filers (under 100 participants) and Direct Filing Entities (DFEs). One-participant retirement plans (owner or owner and spouse) and partnership retirement plans covering only partners or partners and spouses are not subject to ERISA reporting but must file Form 5500-EZ.

Schedule A	Insurance Information – Contains information about the plan's insurance contracts/policies.
Schedule B	Actuarial Information – Contains actuarial information for defined benefit plans subject to minimum funding requirements.
Schedule C	Service Provider Information (large plan filers only) – Lists fees paid by the plan to a service provider of $5000 or more and list any accounting/enrolled actuarial firm no longer providing services.
Schedule D	DFE/Participating Plan Information – Contains information regarding a plan's investments with certain financial institutions that hold certain types of investments.
Schedule E	ESOP Information - Contains stock type, loan and dividend information.
Schedule G	Financial Schedules (large plan filers only) – Contains information regarding non-exempt transactions, such as prohibited transactions.
Schedule H	Large Plan and DFE Financial Information – Contains information regarding the plan's assets and liabilities and income and expenses, or in the case of a DFE filing all plans invested with the DFE.
Schedule I	Small Plan Financial Information – Contains information regarding the plan's assets and liabilities and income and expenses.
Schedule P	Annual Return for Fiduciary of Employee Benefit Trust – contains information on plan trustees; filing starts the statute of limitations under the IRC. This form is not required for plan years beginning in 2006
Schedule R	Retirement Plan Information – Contains information on distributions, minimum funding requirements and coverage testing.
Schedule SSA	Statement Identifying Separated Participants With Deferred Vested Benefits – Contains information reported to the Social Security Administration.

Accountant's <u>Report</u>	Prepared by CPA; required for all large plans and those small plans that do not meet the small plan audit waiver requirements.

[B] Form 5500 Requirements

The appropriate Form 5500 to be filed in a given year relates to the year in which the plan year commenced. For example, if the plan year starts on February 1, 2006 and ends on January 31, 2007, the appropriate Form 5500 to be filed is the 2006 Form, even though the plan year ended in 2007, and the form need not be filed until August 31, 2007 (seven months after January 31, 2007).

The size of the filer influences which schedules are attached to the Form 5500. A filer is considered a **small plan filer** if at the beginning of the plan year it has less than 100 participants**.** **Large plan filers** have 100 or more participants at the beginning of the plan year, but under certain circumstances, large plans may continue to employ the small plan schedules. This is usually beneficial since small plans have more limited filing requirements and thereby may have lower administrative costs associated with preparation of the filing.

A plan that had less than 100 participants in prior years but currently has more than 99 but not more than 120 participants as of the beginning of the plan year may continue to file as a small plan. This is commonly called the 80-120 rule. As long as this small plan filer exemption is used in the previous year and the participant count remains at or below 120, the plan may be considered a small plan and can continue to use the small plan schedules in the next filing year.

Under the 80 portion of the rule, a large plan whose participant count drops below 100 but not below 80 participants as of the beginning of the plan year can continue to file as a large plan if so desired.

The deadline for filing Form 5500 is generally seven months following the plan year end. An extension for filing may be granted by either filing Form 5558 (allowing for an additional 2½ months) or for plan years that match the employer's tax year by filing for an extension of the employer's filing (i.e. 1½ months for a corporate entity).

The importance of the accuracy of Form 5500 filings cannot be overemphasized. These annual forms provide more than the number of participants or financial statistics regarding contribution, distribution and earnings accountings. They also provide the DOL and the IRS, who share the Form 5500 filing data, information about the plan's operation and compliance with regulations. As examples, plans must disclose on the Form 5500 whether deposits of contributions have been made on a timely basis, if loans are in default, and if the plan has engaged in any prohibited transactions. Since the Form 5500 filings also serve as the plan audit database for the IRS and DOL, strict adherence to standards of completion, accuracy, full disclosure and timely filing is necessary.

[C] Form 1099-R and Form 945

Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., is used to report distributions from qualified retirement plans, including periodic payments, nonperiodic payments that are not total distributions and total distributions. In general, all distributions made during the calendar year are reported on the 1099-R regardless of the plan year. Distributions totaling $10 or less need not be reported.

Participants or beneficiaries who receive payments from qualified retirement plans must receive Form 1099-R by January 31 of the year after distribution. Generally, Form 1099-R is used for reporting income tax withholding on the payee's tax return. However, participants who take distributions from a qualified plan and roll the assets over to another qualified plan or IRA also receive a Form 1099-R even though no taxable event occurs as a result of the rollover.

Form 1099-Rs and **Form 1096**, Annual Summary and Transmittal of U.S. Information Returns which is used to summarize the Form 1099-R information, must be filed by the withholding firm with the IRS by the last day in February. If magnetic media is used to transmit Forms 1099-R to the IRS, Form 4808, not Form 1096, must accompany such submission.

When the Form 1099-Rs are filed with the IRS electronically the due date is delayed until the end of March. The required electronic file layout is released as a Revenue Procedure in the summer of the year for which the Form 1099-Rs are filed. The Revenue Procedure is released each year as Publication 1220.

[D] Form 945

Plans or the service organizations that withhold federal income tax are required to deposit the taxes withheld to the IRS at least monthly. Firms that handle large amounts of tax withholding are, or plans that file the Form 1099-R under the plan sponsor's EIN may be required to remit deposits more frequently than monthly (e.g. semi-weekly).

Annual filings with the total amount of the withheld tax for the year are no longer allowed. Failure to timely file a required report can result in a $25 per day penalty of to a maximum of $15,000.

By January 31 of each year, a **Form 945** providing details regarding the withholding liabilities and any remaining tax deposits is to be filed with the IRS.

If no tax deposits are due, the deadline for filing Form 945 is extended until February 10th.

[E] Annual Reporting Calendar

Please refer to Appendix E for a sample Annual Reporting Calendar showing typical plan reporting due dates and disclosure requirements. Often, a calendar such as this is customized for an individual plan to reflect items specific to plan design, such as the annual notice to participants required of safe harbor 401(k) plans and items related to internal operations, such as timing of data request reports, accumulation of asset information, budgeting, auditing and other tasks relating to plan administration. Use of such a calendar often facilitates timely compliance with the many reporting tasks demanded of plan sponsors and administrators.

§9.06 Special Event Reporting

Much of the plan administrator's reporting and disclosure responsibilities are dedicated toward fulfilling requirements related to the occurrence of an event under the plan. An event may be as common and repetitive as an employee becoming a participant or as rare as a plan termination.

ERISA specifies over 70 separate events or occurrences that require action on the part of the plan administrator other than completion of the annual reporting requirements summarized above. Please refer to Appendix F for a summary of Special Event Reporting which addresses some of these occurrences.

§9.07 Disclosures to Plan Participants

In addition to the annual governmental filings, reports that are part of the regular annual administration process as prepared by the retirement plan administration firm include several disclosures to participants.

[A] Participant Statements

Upon written request by a participant or beneficiary, plan administrators of employee pension benefit plans are required to furnish a statement indicating the total benefit accrued by the individual. This statement includes pertinent vesting information, such as the nonforfeitable percentage of the benefit accrued as of the date of the statement or the earliest date on which benefits become nonforfeitable.

The benefit statement must be furnished to the participant or beneficiary by the later of:

- 60 days after receipt of the request, or
- 120 days after the end of the plan year that immediately preceded the plan year in which the request is made.

Thus, a participant requesting a statement at the beginning of the plan year may be required to wait up to 120 days before receiving the requested benefit statement. Those participants requesting statements later in the plan year would wait no more than 60 days.

As an illustration, in a calendar year plan, 120 days after the end of the immediately preceding plan year would be April 30. Thus, any written request received in January or February would be due a response by April 30. Written requests received after March 1 would create a 60-day period after receipt for compliance with the requests, since the 60-day response period would extend beyond April 30.

Statements also must be given to participants who terminate service with the employer or incur a one-year break in service. (The definition of a one-year break in service is based on Internal Revenue Code requirements and usually is a 12-month period corresponding to the plan year in which a participant does not complete more than 500 hours of service.)

A plan is required only to provide one statement, upon request, to a participant during a 12-month period. However, most plans ordinarily provide benefit statements to participants on a regular basis. The frequency with which statements are generated can range from annually to daily, although most often a formal statement is provided once a quarter for defined contribution plans and annually for defined benefit plans.

[B] Summary Annual Report

The plan administrator is required to supply to participants and beneficiaries receiving, or who will receive, benefits a financial accounting of the plan in the form of a Summary Annual Report (SAR). The SAR must be furnished prior to:

- Nine months after the close of the plan year; or
- If later, two months after the due date (with extension) of the Form 5500 series return.

The SAR is a synopsis of the information reported on the plan's annual Form 5500 series filing with the EBSA. The information provided in the SAR includes the total income received and expenses incurred by the plan, the number of participants in the plan, the total amount of benefits paid to participants and beneficiaries, the earnings from investments, the value of plan assets, compliance with minimum funding standards, information related to satisfaction of small plan audit exemption requirements and additional disclosures as deemed necessary.

Defined benefit and money purchase plans are subject to minimum funding requirements, and consequently the SAR for those types of plans contains a statement as to whether or not those minimum funding requirements have been satisfied. Most plans utilize sample SAR language provided by the DOL to comply with these disclosure rules governing the content of SARs.

SARs also inform recipients of their right to request a full copy of the Form 5500 filing, or information pertaining to the small plan audit waiver, either from their employer or the DOL.

[C] Distribution Disclosures

The employer must provide an explanation of the distribution options available to the participants and beneficiaries due to retirement, death, disability or termination of employment of the participant. These disclosures might include joint and survivor annuity explanation and waiver of benefit election options, income tax withholding and a direct rollover election.

[D] Confirmation of Participant-Generated Changes and Elections

As part of the overall administration of a qualified plan, confirmation of various participant-generated elections and changes are issued both as documentation and acknowledgement of receipt of the requested change. An application to participate or decline participation in the plan, a designation of beneficiary, an investment direction election, distribution or withdrawal request all generate some kind of plan response in confirmation of the initiated participant request.

[E] Individual Participant Disclosures and Requests for Information

A plan generates other disclosures to individual participants upon the occurrence of specific events. For example, plans are required to inform the affected participants whenever a domestic relations order is submitted to the plan for review as a Qualified Domestic Relations Order (QDROs are discussed in Chapter 10).

Additionally, a plan participant is entitled to receive, upon request, plan documents beyond the current SPD or full Form 5500 filings. For example, under ERISA, participants may contact the plan administrator for copies of the plan and trust documents, contracts, and collective bargaining agreements that cover the plan.

§9.08 Plan-Related Disclosure Requirements

[A] Pension Plan-Related Disclosures

For a plan subject to minimum funding requirements, such as money purchase plans, the retirement plan administration firm will send a statement to the plan sponsor concerning the required contributions to the plan and the due date for such contributions.

Given the nature of their promised retirement benefit and the fact that the employer retains responsibility for funding those promised benefits as well as the absorption of investment risk affiliated with plan assets, defined benefit plans engender a host of other disclosure requirements concerning plan assets, benefit liabilities and accrual of benefits.

Money purchase plans also are subject to additional disclosures to participants regarding the funded status of the plan, usually communicated via the SAR, and disclosures regarding any significant reduction in the level of benefit accrual.

[B] Plan Design-Related Disclosures

Plan designs such as safe harbor 401(k)s or plans that utilize automatic enrollment into elective deferral programs have additional annual notice and disclosure requirements. Thus, a 401(k) plan electing to provide a safe harbor alternative to nondiscrimination testing issues a safe harbor notice to all participants not more than 60 days nor less than 30 days before the end of the plan year.

Similarly, plans that automatically enroll participants for a specified deferral election, typically 3% of compensation, need to advise participants at least annually of their ability to increase, decrease or eliminate their elective deferrals.

Plans that have a discretionary match formula may announce prior to the beginning of a plan year what the match formula is for the forthcoming year so that participants may make salary deferral elections accordingly.

The purpose behind these plan design-related disclosures is to inform plan participants of their benefits under the plan, to explain the basis for the calculation of the employer contribution and whether their deferral election influences the amount of the employer contribution they may receive, to allow them the opportunity to modify their deferral elections, as well as to further their understanding of the nature of those benefits and how those benefits are provided.

[C] Application for a Determination Letter

Although applying for a letter of determination is optional, the plan sponsor must give notice to all interested parties when applying for a determination letter from the IRS concerning the qualified status of a plan. Notification must occur before the application is filed and between ten and 24 days prior to the effective date of the application.

Any reasonable method that ensures all interested parties are notified may be employed, including electronic notification that is discussed later in this chapter. In compliance with this Internal Revenue Code regulation, notices are issued to inform interested parties that the plan is requesting a determination letter for the initial qualification of the plan or for the continued qualification upon amendment, restatement or termination of the plan.

[D] Other Plan-Related Disclosures

To be considered qualified a plan must be in written form and communicated to all employees. The SPD is generally the means used to satisfy this notice requirement. The benefits, rights and features provided by a plan must be available to all participants on a nondiscriminatory basis and must be communicated to all participants.

For example, a participant loan program necessitates disclosure to all participants of the availability of loans on a nondiscriminatory basis. If only the HCEs take advantage of participant loans because the rank and file NHCEs are not adequately informed of the existence of the program, the plan fails to comply with the disclosure rules surrounding the participant loan feature. Again, communication of the benefits, rights and features provided by a plan are primarily handled via the SPD.

§9.09 Methods of Disclosure

Plan administrators may employ any of a number of available options for disclosing information to participants and beneficiaries. These include:

- Hand-delivery to the participant in the workplace;

- Inclusion in a newsletter or other communication piece provided regularly to employees (posting on a workplace bulletin board generally does not suffice);

- Delivery by mailing via first class, second class or third class mail. If second or third class mail is used, return or forwarding postage must be guaranteed, address correction requested and delivery by first class mail or hand-delivery at the workplace provided for any returned mail; and

- Electronic delivery for certain disclosures such as the SPD when the means of electronic delivery conforms to specific standards regarding confidentiality, accessibility, offer of paper forms when requested and assurance of receipt and agreement to electronic delivery when required under the law.

§9.10 Electronic Disclosure

Company and retirement plan administration websites, CD ROMs, voice response units and call centers all provide opportunities for the plan sponsor to disclose plan information to plan participants. In some cases, the medium also is used for participants to communicate their requests to the plan administrator or recordkeeper. Electronic media is an efficient and cost-effective means of plan administration. The DOL regulations, finalized in 2002, cover electronic delivery of documents and other communication and are summarized below.

[A] Disclosures Communicated Electronically

In accordance with the regulations issued by the DOL, the plan administrator may, in its discretion, electronically deliver plan disclosures under Title I of ERISA. This includes but is not limited to the following documents:

- Summary Plan Descriptions (SPD)
- Summary of Material Modifications (SMM)
- Summary Annual Report (SAR)
- Participant Account Statements
- Form 5500
- Decisions on Benefit Claims
- Loan Information
- Investment Related Materials Required Under ERISA §404(c)
- Distribution and Rollover Options Disclosure
- Notice to Interested Parties
- Qualified Domestic Relations Orders

[B] Access Issues

The DOL addresses accessibility issues and confidential data security associated with paper delivery of documents by prescribing a safe harbor for electronic delivery of disclosures. The safe harbor for electronic communication is applicable to communication through electronic media to two categories of individuals:

> Category 1 - Plan participants who have the ability to effectively access documents in electronic form at any location where the participant is reasonably expected to perform his or her duties as an employee and with

respect to whom access to the employer's or plan sponsor's electronic information system is an integral part of those duties.

Category 2 - Plan participants, beneficiaries, and other persons entitled to plan disclosures who consent to receiving documents electronically.

The above definitions apparently exclude electronic delivery of disclosures under the safe harbor for employees who are not reasonably expected to access an employer's electronic information system, even if terminals for receipt of these documents are available around the workplace.

[C] Safe Harbor Communication Procedure

1. Category 1 Plan Participants

Before the plan administrator delivers any document electronically, it must be established that Category 1 individuals have the ability to effectively access these documents at any location where the participant is reasonably expected to perform his or her duties as an employee and access to the employer or plan sponsor's electronic information system is an integral part of those duties. Category 1 individuals have a right to request and obtain paper versions of the electronically furnished documents. When requested, the plan administrator must furnish the document to the participant and beneficiaries free of charge; however, if the plan administrator incurs charges in furnishing the paper version, a reasonable charge may be imposed under the safe harbor rule.

2. Category 2 Plan Participants

For those participants, beneficiaries and other persons entitled to receive disclosures who may receive documents electronically beyond the workplace and therefore beyond the control of the plan or plan sponsor, the plan administrator must take steps to assure that they have consented to receive electronic disclosures after having received a clear statement (in electronic or nonelectronic form) that describes:

- the types of documents to which the consent applies;
- the individual's right to withdraw the consent at any time without charge;
- the procedures for withdrawing consent and for updating addresses;
- all software and hardware requirements to access the electronic documents;
- the right of individual to request and obtain a paper version of an electronically furnished document; and
- whether or not the paper document is free of charge.

For those individuals who access documents beyond the control of the plan or plan sponsor, if there are changes in the software or hardware requirements that may create a risk that an individual is not be able to access documents electronically, the plan administrator must provide a statement of the revised hardware or software requirements for access and retention of documents as well as the right to withdraw consent without charge. Before the plan administrator delivers documents electronically to such a participant, a new consent must be obtained.

3. General Rules

Regardless to whom documents are electronically communicated, some general rules apply:

- All electronic documents must be prepared and delivered in a manner that is consistent with the style, format and content requirements applicable to the particular document.
- The plan administrator must confirm that documents delivered electronically are received. This can be accomplished by confirming receipt using return receipt, the notice of undeliverable electronic mail feature, periodically reviewing or surveying to confirm receipt or other notification.
- Additionally, the plan administrator must take steps to reasonably assure that the participant's confidentially is protected (i.e. by requiring a Personal Identification Number [PIN] or password). Although the DOL does not define a specific method to protect confidentiality, whatever method used should be designed to prevent unauthorized receipt of or access to information by individuals other than the individual to whom information is intended.
- The regulations also require that each individual required to receive a disclosure receive notice of the significance of the document being provided electronically. The plan administrator must alert the participant to the significance of all electronic documents via a timely separate explanation unless the purpose and significance of the document is readily apparent.
- The plan administrator must also advise the participant of his or her right to receive a paper version upon request.

4. Company Websites

Special rules for furnishing disclosures electronically via the company website apply.

- The participant distribution list is comprehensive and up-to-date (e.g. all of the parties who are required to have the disclosure have access to the website);

- Participants and beneficiaries are notified of the availability of the document and its significance and are directed to the document on the website;
- A prominent notice appears on the front page of the site advising readers that the publication contains important information about rights under the plan;
- The plan administrator takes appropriate measures to ensure the actual receipt of the document; and
- Information on how to obtain a lost or forgotten password should it be needed to access the plan disclosures is included on the website homepage.

§9.11 Key Terms

Employee Benefits Security Administration (EBSA): Employee Benefits Security Administration, the division under the Department of Labor which administers the non-tax (regulatory and administrative) provisions of ERISA. The EBSA issues opinion letters and other pronouncements, and requires certain information forms to be filed with it by plan sponsors.

Form 945: Form filed to report withholding liability on distributions made from qualified retirement plans.

Form 1096: Form filed summarizing the Form 1099-R filings for a year.

Form 1099-R: Form filed to report distributions from a retirement plan.

Form 5500: Annual tax filing for a plan reporting various information to the IRS and DOL.

Large Plan Filer: For Form 5500 purposes a file who has 100 or more participants as of the beginning of the plan year.

Multiemployer Plan: A plan under which more than one employer is required to contribute, is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and satisfies other requirements that the Secretary of Labor may prescribe by regulation.

Multiple Employer Plan: A plan under which more than one unrelated employer contributes and is not maintained pursuant to a collective bargaining agreement.

Single Employer Plan: A plan under which only the employees of one employer are eligible to participate and to which only one employer contributes, whether or not the plan is maintained pursuant to a collective bargaining agreement.

Small Plan Filer: For Form 5500 purposes a filer who at the beginning of the year has less than 100 participants, or otherwise satisfies the 80-120 rule.

Summary Annual Report (SAR): A narrative summary of a plan's Form 5500 filing for the year disclosed to participants and beneficiaries.

§9.12 Review of Key Concepts

- Reporting and disclosure requirements for retirement plans are designed to ensure that plans comply with ERISA and the Internal Revenue Code and to increase participants' awareness of the plan's benefits and their rights to those benefits.

- The reporting and disclosure requirements vary depending on whether an employee plan is a pension plan or a nonpension plan, a defined benefit plan or a defined contribution plan and whether the plan is a single employer, multiple employer, or multiemployer plan.

- Form 5500 and appropriate Schedules must be filed with the EBSA within seven months following the plan year-end (9½ months if a Form 5558 extension has been filed).

- Form 5500 has specific schedules that are required based on the plan's participation size, design, provisions and investment options.

- Plan distribution and tax withholding information is reported using Forms 1099-R, 1096 and 945.

- There are special reporting requirements when the plan is adopted, amended or terminated; when participants terminate with vested benefits; or when changes occur with the plan sponsor or administrator.

- Disclosures made to plan participants include participant statements, SAR and distribution disclosures.

- Plan administrators may employ any of a number of available methods such as electronic delivery for disclosing information to participants and beneficiaries.

§9.13 Review Questions

[A] True or False

______ 1. Participant statements showing benefits/account balances are required to be given to a participant no later than 120 days after the end of the plan year.

______ 2. Form 1099-R is required to be provided to participants who received distributions during the calendar year by January 31st of the following year.

[B] Multiple Choice

3. All of the following are methods that may be used to provide information to participants, **EXCEPT**:

   A. Hand delivery
   B. First class mail
   C. Inclusion in a regularly provided newsletter
   D. Posting on a workplace bulletin board
   E. Electronic delivery for certain disclosures

4. All of the following statements regarding electronically disclosing information to participants are **TRUE, EXCEPT**:

   A. The plan administrator must confirm that documents delivered electronically have been received.
   B. The document transmitted electronically must be protected with password sensitive encryption.
   C. Participant confidentiality must be protected.
   D. A notice of the significance of the document being transmitted electronically must be provided.
   E. The participant must be advised of the right to receive the information by paper.

5. All of the following statements regarding Form 5500 are **TRUE, EXCEPT**:

   A. Generally, it is due seven months after the end of the plan year.
   B. The Form 5500 to be filed relates to the year in which the plan year ends.
   C. Generally, a small plan filer is one who has less than 100 participants at the beginning of the plan year.
   D. A small plan filer will file Form 5500 and at least Schedule I.
   E. A defined benefit plan will file Form 5500 and at least Schedule B.

6. All of the following are disclosures automatically provided to participants, **EXCEPT**:

   A. Summary Annual Report
   B. Participant Statements
   C. Distribution Options Notice
   D. Beneficiary Designation Form
   E. Summary Plan Description

§9.14 Answers

1. **False.** A participant statement is not a requirement and only must be delivered upon request of the participant. §9.07 [A]

2. **True.** The deadline for providing Form 1099-R to participants is the January 31 following the year of distribution. §9.05 [C]

3. The correct answer is **D.** §9.08

   A. Incorrect. This statement is true because hand delivery may be used to provide information to participants.
   B. Incorrect. This statement is true because first class mail may be used to provide information to participants.
   C. Incorrect. This statement is true because inclusion in a regularly provided newsletter may be used to provide information to participants.
   D. Correct. This statement is false because posting on a workplace bulletin board is not an acceptable method of delivering information to participants.
   E. Incorrect. This statement is true because electronic delivery for certain disclosures may be used to provide information to participants.

4. The correct answer is **B.** §9.09

   A. Incorrect. This statement is true because the plan administrator must confirm that documents delivered electronically have been received.
   B. Correct. This statement is false because the document transmitted electronically need not be protected with password sensitive encryption.
   C. Incorrect. This statement is true because participant confidentiality must be protected.
   D. Incorrect. This statement is true because a notice of the significance of the document being transmitted electronically must be provided.
   E. Incorrect. This statement is true because the participant must be advised of the right to receive the information by paper.

5. The correct answer is **B.** §9.05

   A. Incorrect. This statement is true because without extension Form 5500 is due seven months after the end of the plan year.
   B. Correct. This statement is false because the Form 5500 to be filed relates to the year in which the plan year begins.
   C. Incorrect. This statement is true because in general, a small plan filer is one who has less than 100 participants at the beginning of the plan year.
   D. Incorrect. This statement is true because a small plan filer will file Form 5500 and at least Schedule I.
   E. Incorrect. This statement is true because a defined benefit plan will file Form 5500 and at least Schedule B.

6. The correct answer is **B.** §9.07

   A. Incorrect. This statement is true because a summary annual report is automatically provided to participants.
   B. Correct. This statement is false because participant statements need only be provided upon request, it is not automatic.
   C. Incorrect. This statement is true because a notice of distribution options is automatically provided to participants.
   D. Incorrect. This statement is true because a beneficiary designation form is automatically provided to participants.
   E. Incorrect. This statement is true because a summary plan description is automatically provided to participants.

Chapter 10:
Withdrawals While Actively Employed

§10.01 Learning Objectives

- Describe the various types of withdrawals available to qualified plan participants who are still employed by the plan sponsor.
- Identify the types of plans that may permit in-service withdrawals.
- List the basic requirements for hardship withdrawals in a plan.
- Identify the restrictions plans may impose on hardship withdrawals.
- Explain the difference between the events test and the needs test in a general standard (fact and circumstances) hardship withdrawal.
- List the six safe harbor hardship withdrawal events.
- Identify the tax consequences associated with hardship withdrawals.

- Define who may be an alternate payee in a domestic relations order (DRO).

§10.02 Introduction

Qualified plans and retirement plan administrative firms often refer to payments of plan benefits to participants while they are still employed as withdrawals, reserving the term distribution for use in connection with the distribution options available due to severance of employment, death or disability. As a broad category, **in-service withdrawals** encompass all payments to participants while they remain in-service to their employer. As a discrete term describing a sub-category of in-service payments, in-service withdrawals often refer to those withdrawals available after performance of a particular number of years of service, attainment of a certain pre-retirement age or when the funds for withdrawal have been invested in the plan for a minimum specified period of time.

The various types of payment of plan benefits while still employed include the following:

- Withdrawals of after-tax employee contributions;
- Withdrawals of rollover funds;
- Financial hardship withdrawals;
- In-service withdrawals based on service, participant age or length of investment of funds;
- Withdrawals associated with divorces and other domestic relationships;
- Normal retirement age distributions;
- Required minimum distributions;
- Corrective distributions associated with nondiscrimination rules or benefit limitations;
- Loans to participants; and
- Payments upon termination of the plan.

§10.03 In-Service Withdrawals

Although it is often assumed that qualified retirement plans provide only retirement funds, the range of avenues available for active plan participants to receive qualified retirement plan monies while still employed speaks of the evolution of plans to accommodate the modern worker and economic climate. Changes in lifestyle and savings habits, the growing emphasis on contributory plans over strictly employer-funded plans and the now uncommon practice of working for only one employer throughout a career have all served to induce qualified plans, primarily nonpension plans, to offer a variety of in-service withdrawals.

[A] After-Tax Employee Contributions

After-tax employee contributions, i.e. voluntary and mandatory after-tax contributions, are always 100% vested upon deposit into qualified plans. While plans are not required to allow in-service withdrawals of after-tax employee contributions, most plans permit these contributions to be withdrawn in whole or in part at any time, together with applicable earnings.

The plan and tax consequences of a withdrawal of after-tax employee contributions should be carefully considered by the requesting participant. For example, plans that condition receipt of employer contributions upon mandatory after-tax employee contributions may cause the employer-derived benefits to be forfeited if the employee is less than 100% vested in these benefits and the mandatory after-tax employee contributions are withdrawn.

Should the employee experience a forfeiture in this manner, the plan contains provisions for restoration of the employer-derived benefits if the employee pays back the withdrawal within an allowed period. Also, while withdrawals of after-tax employee contributions are not subject to the 10% additional income tax for early distributions (those prior to age 59½), the earnings on those after-tax employee contributions, which had been accumulating on a tax-deferred basis within the qualified plan, are subject to the additional income tax as applicable.

Any withdrawal, including withdrawals of after-tax employee contributions made after December 31, 1986, must include a pro rata share of the earnings on the contributions unless otherwise prohibited by the plan and the Internal Revenue Code. If the participant chooses an annuity or other series of partial payments, an initial ratio is established to determine the percentage of the distribution that is subject to taxation and the percentage that is not taxable. Once the ratio is established, it applies to all future payments. The ratio calculation is dependent upon several variables including the form of the withdrawal and the period of time over which the payments are to be made. Since the calculation can be complex, it is considered in greater depth in more advanced ASPPA courses.

[B] Rollover Contributions

An in-service withdrawal to a participant, other than a hardship withdrawal or required minimum distribution, may be rolled over or transferred by that participant to another qualified plan or an IRA. When eligible rollover amounts are transferred directly between qualified plans, no taxable event occurs. Thus, no federal or state tax or additional income tax is withheld or owed.

Not all qualified plans accept rollovers, and when accepted, not all plans require the contributor to be an eligible participant for other purposes under the plan. As an illustration, a 401(k) plan may allow an employee to roll over funds into the plan before that employee has met the preliminary age and service requirements in order to make elective deferrals.

Since the presence of rollover funds within a qualified plan represent the employee's previous decision to deposit fully-owned monies into the plan, typically plans accepting rollovers allow participants to withdraw them at any time. However, plans are not required to offer in-service withdrawals of rollovers and restrictions on when they can be withdrawn may be imposed.

Participants may have many different reasons for rolling funds into their current employer's qualified plan, perhaps taking advantage of investment options or fund management resources under the plan. Should they subsequently decide to withdraw these funds and complete an eligible rollover into another qualified plan, again, no taxable event ensues. If the participant is retaining the funds and requests a withdrawal made payable to the participant, the withholding, required minimum distribution and additional income tax rules apply.

[C] In-Service Withdrawals

Stock bonus and profit sharing plans, including 401(k) plans, are permitted to allow withdrawals of employer contributions, other than elective deferrals, safe harbor contributions, and qualified nonelective (QNEC) and matching contributions (QMACs), after these contributions have remained in the plan for the required length of time as stated in the plan documents. This fixed period cannot be less than two years. (401(k) plans are covered in greater detail in the RPF-2 course.)

Importantly, this is a separate concept from hardship withdrawal rules or other withdrawals allowed because of the occurrence of a particular event, such as a plan termination. Here, the availability of the withdrawal is contingent solely upon the length of time the funds have been maintained under the plan.

Other in-service withdrawal options under plans other than defined benefit, money purchase and target benefit plans include the opportunity for withdrawals to currently employed participants after the completion of a fixed number of years of service or participation. For example, a plan may allow participants with at least 15 years of participation to request and receive in-service withdrawals.

Employee stock ownership plans (ESOPs) are somewhat unusual in that the terms of the plan may require the offering of in-service withdrawals to participants who have both reached a certain age and fulfilled a minimum number of years of service. Since ESOPs are designed to hold plan assets primarily in the form of company stock, when participants approach retirement they need to be allowed to diversify the investment of their benefits out of employer stock. One of the methods by which ESOPs can choose to comply with the diversification requirement is to incorporate an in-service withdrawal of any amounts subject to these rules. (The qualification and operating strictures for ESOPs are very complex and are the subject of more advanced ASPPA courses.)

In addition, under certain circumstances, nonpension plans may offer in-service withdrawals due to the attainment of any age. Permitted plans could provide for age 59½ in-service withdrawals, as an example. Since an in-service withdrawal to a participant under the age of 59½ results in a 10% additional income tax for early distribution (in addition to ordinary income taxes), setting the requisite age to 59½ before in-service withdrawals are provided eliminates this additional income tax.

Also, because participants cannot withdraw 401(k) monies prior to age 59½ if still employed unless for hardship or plan termination reasons, if a plan includes both 401(k) monies and non-401(k) monies such as profit sharing contributions, using 59½ as the threshold age allows the plan to maintain one in-service withdrawal provision applicable to all funds under the plan. In contrast, note that defined benefit, money purchase and target benefit plans, as pension plans, are restricted from including provisions for in-service withdrawals for reasons of age, unless that age is at or later than normal retirement age.

[D] Normal Retirement Age Distributions

Every qualified retirement plan defines the age or event that constitutes normal retirement age, utilizing the maximum normal retirement age parameters discussed previously. For example, normal retirement might be defined as the later of age 65 or the fifth anniversary of plan participation. At normal retirement age, the participant becomes 100% vested, regardless of the vesting schedule under the plan.

Once normal retirement age is reached, participants may be allowed to begin in-service withdrawals of their retirement benefits. Depending on the options available in the plan, the participant may choose to receive benefits in a lump sum, an annuity or installment payments.

[E] Corrective Distributions

Occasionally, a plan may need to make corrective distributions to participants to meet nondiscrimination and other qualification rules. For example, a participant might inadvertently contribute in excess of the individual elective deferral limit for the year, or the plan might not be able to meet the special nondiscrimination tests for 401(k) plans without making distributions to certain HCEs.

When the plan utilizes these in-service withdrawals to meet the requirements of the Internal Revenue Code, the 10% additional income tax for early distribution usually does not apply if the corrections are accomplished within the legislatively-prescribed timeframes. The timing of the corrective distribution and the reason for the correction generally dictate when the participant must include the distributed amounts in his or her taxable income. (Corrective distributions form an advanced topic in ASPPA courses.)

[F] Required Minimum Distributions (RMDs)

The listing of allowable and required withdrawals while remaining in-service to one's employer would not be complete without an acknowledgement of required minimum distributions, discussed in detail in Chapter 12. The required minimum distribution is not eligible for rollover treatment and therefore is not subject to 20% mandatory tax withholding.

It should be noted that participants may elect to withdraw amounts in excess of the minimum amounts. In these instances, the funds withdrawn in excess of the minimum amounts are rollover-eligible. As such these additional withdrawals made in conjunction with the receipt of required minimum distributions are subject to the 20% mandatory federal income tax withholding rules and applicable state tax withholding rules.

§10.04 Hardship Withdrawals

[A] Hardship Introduction

A **hardship withdrawal** is an in-service withdrawal from a qualified retirement plan to a participant who has an immediate and heavy financial need as the result of an unexpected or extraordinary event. Plans are not required to permit hardship withdrawals, but plans that do define the particular financial circumstances that constitute a hardship event under the plan. Illustrations of these circumstances are unforeseen, non-reimbursed medical expenses or mortgage payments to prevent foreclosure upon one's principal place of residence.

The type of qualified plan also dictates when and to what extent hardship withdrawals can be available within a plan. As examples, pension plans have more restrictions on distributable events than nonpension plans, and therefore hardship withdrawals may only be available to participants in pension plans on or after normal retirement age. In addition, plans may limit the types of money available for hardship withdrawal, such as only after-tax employee contributions or elective deferrals.

The term hardship withdrawal came into being in the regulations under IRC §401(k). In reality, the employer money in nonpension plans can be withdrawn without the restrictions imposed by the IRC §401(k) hardship requirements. However, in practice most nonpension plans apply the IRC §401(k) provision to all sources of money that the plan identifies as available for hardship withdrawal.

For simplicity, we will focus our discussion on the hardship requirements for 401(k) money, i.e. elective deferrals. Be aware, however, that all of these requirements can be applied to any money in a nonpension plan that the plan identifies as available for hardship withdrawal.

Hardship withdrawals were added to the 401(k) regulations in acknowledgement of the specific financial hardship legislation that pertains to those plans. In fact, hardship withdrawals are the 401(k) plan's only permissible method of in-service withdrawals of elective deferrals prior to age 59½. While other types of plans may provide for hardship withdrawals, such as Tax-Sheltered Annuities (TSAs), distribution rules often cause non-401(k) hardship-related distributions to be placed within the context of other broad withdrawal categories.

As an illustration, defined benefit, money purchase, and target benefit plans, as pension plans, cannot provide for in-service withdrawals until a participant has reached normal retirement age. If still employed post-normal retirement, a participant might request a hardship-related withdrawal, but this withdrawal would more generally be considered a retirement withdrawal or payment.

Profit sharing and stock bonus plans have increased flexibility in terms of in-service withdrawal opportunities and can include financial hardship as a triggering event for an in-service withdrawal request. Where participants are permitted to make elective deferrals under a 401(k) plan or a 401(k) portion of a plan, specific hardship withdrawal regulations under the Internal Revenue Code apply.

Given that the purpose of a hardship withdrawal is to satisfy an immediate and heavy financial need—tapping into one's retirement savings as a last resort—it follows that hardship withdrawals are not eligible for rollover treatment, become includable in ordinary income, and are subject to the 10% additional income tax on early distribution unless the participant has reached age 59½. Additionally, participants are suspended from making elective deferrals to the plan for a period of six months following receipt of a hardship withdrawal.

In general terms, a hardship withdrawal is a withdrawal by a plan participant who is still employed and who has an immediate and heavy financial need. A plan's hardship provisions must:

- Define hardship;
- Be applied uniformly to all participants in the determination of whether a situation meets the plan's definition of hardship;
- Be applied uniformly to all participants in the determination of the amount of the hardship withdrawal; and
- Not allow the amount of a hardship withdrawal to exceed the lesser of the participant's vested account balance or the immediate need itself.

Please refer to Appendix G for a sample hardship provision notice.

[B] Two-Part Test for Hardship Withdrawals

In order for a withdrawal to qualify as a hardship withdrawal, the withdrawal must be for reason of an immediate and heavy financial need (**events test**), and necessary to satisfy the financial need (**needs test**).

The IRS regulations allow two standards, each containing an events test and a needs test, for use in demonstrating compliance with hardship withdrawal rules for qualified plans:

- The **general standard** (also referred to as facts and circumstances); and
- The **safe harbor standard** (pre-approved IRS language using specifically-named hardship events and stipulated additional procedures that are deemed to meet both the events and needs tests).

The plan document must authorize hardship withdrawals and specify which standard to apply to determine if a withdrawal satisfies the hardship requirements. Of note: the plan can choose to apply different standards for either the events test or the needs test.

For example, a non-401(k) profit sharing plan might decide to apply the safe harbor standard for the events test and the general standard for the needs test. Regardless of which standard is applied, the plan document's language and summary plan description (SPD) should clearly delineate for plan participants what constitutes the hardship events and needs tests applied by the plan.

§10.05 The General Standard

[A] The Events Test

Under the general standard, the plan sponsor determines whether a participant has an immediate and heavy financial need justifying the hardship withdrawal request. This decision must be based upon all relevant facts and circumstances and be made in a nondiscriminatory and objective manner. To aid in this determination of whether a suitable event has occurred in satisfaction of the hardship events test, the criteria employed are incorporated into a written procedure contained in the plan document. Even if reasonably foreseeable or voluntarily incurred by a participant, a need may still be considered immediate and heavy.

Typical examples of events that may cause a participant to have an immediate and heavy financial need are funeral expenses, college tuition or the purchase of an automobile so that one can commute to work. In contrast, the submission of a hardship withdrawal application to fund an elaborate vacation trip to a foreign destination might not meet ready acceptance for withdrawal processing.

[B] The Needs Test

The relevant facts and circumstances surrounding the withdrawal request also apply in determining if a withdrawal from the qualified plan is necessary to satisfy the stated need. As part of this needs test, the withdrawal is not considered necessary if the amount of the withdrawal is in excess of the amount required to relieve the financial burden or more than the participant's vested account balance or benefit. For these purposes, the amount required may include appropriately estimated taxes and penalties.

Additionally, given the tax consequences of a hardship withdrawal and remembering that the primary purpose of the qualified plan is to provide retirement income, before the participant's retirement monies are relinquished by the plan, the plan sponsor must be assured that a hardship withdrawal represents the only reasonable alternative for the participant to meet the financial need.

Therefore, the participant's available financial resources such as personal savings accounts are evaluated before granting or refusing the hardship withdrawal request. These available resources include those of the participant's spouse and minor children as well as qualified plan loans. If the participant qualifies for a loan from the plan, the participant is required to obtain a loan before requesting a hardship withdrawal, unless the loan would serve to exacerbate rather than alleviate the amount of the hardship need.

For example, if the hardship event is the down payment on the purchase of a home, and a qualified plan loan would increase the participant's debts such that the terms of the negotiated mortgage are negatively impacted, then the participant would not have to take a loan from the plan prior to receiving a hardship withdrawal.

To lessen the administrative burden of a lengthy exploration of the participant's personal finances, the plan sponsor may rely on a written statement signed by the participant indicating that the withdrawal is necessary to satisfy the need. This statement usually encompasses the participant's avowal that the hardship need cannot be relieved by any of the following:

- Reimbursement or compensation by insurance;
- Liquidation of the participant's assets;
- Ceasing elective deferrals under the plan, as allowed;
- Distributions or nontaxable loans from other plans in which the employee participates; or
- Borrowing from commercial sources on reasonable commercial terms.

Despite the presence of the written statement, if the plan sponsor has knowledge that the participant is able to draw upon any of the above-mentioned resources, the statement must not be relied upon, and the hardship withdrawal request should be denied. To support the plan's qualified status which in part relies on the plan's distributing assets at the proper time, sham or unsupported withdrawal requests must not be allowed by the plan's administrator and sponsor.

§10.06 The Safe Harbor Standard

[A] The Events Test

Under the safe harbor standard, specific rather than general sets of facts and circumstances are acknowledged as suitable hardship events. As set forth in the 401(k) regulations, the events test is deemed satisfied if the withdrawal request pertains to any of the following:

- Medical expenses for the participant, the participant's spouse or dependents;
- Costs directly related to the purchase of a principal residence for the participant (excluding mortgage payments);
- Payment of tuition and related educational fees that are an integral part of education, including room and board for the next twelve months of post-secondary education for the participant, spouse, children or dependents;
- Expenditures necessary to prevent eviction of the participant from the participant's principal residence or foreclosure on a mortgage on that residence;
- Payment of funeral expenses; and
- Payment of expenses relating to the repair of damage to an employee's principal residence.

Under the safe harbor standard test, the employer does not have any flexibility regarding the determination of an immediate and heavy financial need. The limited scope of the safe harbor events standard carries both potentially positive and negative effects for careful weighing by the plan sponsor before adoption.

On one hand, immediate and heavy financial need becomes distinctly determinable, making it easier for the plan sponsor to apply the standard in a nondiscriminatory and objective manner for all participants. On the other hand, the safe harbor standard excludes justifiable financial hardship situations, such as obtaining funds to rent an apartment and establish a new residence due to a separation or divorce, which may be accepted under the general standard events test.

[B] The Needs Test

The safe harbor standard deems the needs test fulfilled if the following requirements are met:

- The amount of the distribution does not exceed the amount necessary to relieve the financial need or more than the participant's vested account balance. For these purposes, the amount necessary can include applicable taxes and penalties;
- The participant has obtained all available distributions (other than hardship withdrawals) and all nontaxable loans from all plans maintained by the employer; and
- The participant is not permitted to make elective deferrals to the plan or to any other plans maintained by the employer for at least six months following the date the hardship withdrawal is received.

With regard to the third requirement, the argument is that if a participant must use a hardship withdrawal of retirement funds to meet a current, severe financial need, then that participant should not be able to afford to defer part of his or her salary at the same time. If a participant can afford to continue depositing part of current income into the qualified plan, then perhaps the immediate financial need might be satisfied by suspending deferrals instead of applying for a hardship withdrawal.

Of note: the Secretary of the Treasury is empowered to designate other safe harbor events and other methods of deemed satisfaction of the safe harbor needs test.

§10.07 Other Hardship Withdrawal Issues

[A] Amount Available for Hardship Withdrawal

Under a profit sharing or stock bonus plan the calculation of the hardship amount available is quite simple. It is the exact amount of the financial need itself not to exceed the participant's vested account balance.

A 401(k) plan generally allows hardship withdrawals from only the salary deferral portion. In this case, the calculation is a little more complicated because only a portion of the participant's elective deferral account is available for hardship withdrawals. Generally, the maximum hardship withdrawal consists of the sum of the participant's historical elective deferrals, including catch-up contributions, ignoring earnings or losses, and reduced by prior hardship withdrawals not to exceed the elective deferral account balance. In other words, the participant may withdraw for hardship reasons those monies he or she had elected to defer into the plan over the course of plan participation, as long as that amount doesn't exceed the current elective deferral account balance.

Employer-derived monies, such as qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), and safe harbor 401(k) plan contributions together with all earnings must remain in the plan.

If the plan so allows, the maximum hardship amount may be increased by certain amounts credited to the participant's elective deferral account by December 31, 1988, or the last day of the plan year ending prior to July 1, 1989, if later. These monies that also may be withdrawn for financial hardship are earnings on the elective deferrals, QNECs, QMACs, and earnings on those QNECs and QMACs. Use of this option would of course require the plan sponsor to keep track of account balances from 1988 or 1989 in addition to the historical elective deferrals of each participant. Where this recordkeeping process proves administratively burdensome or not economically feasible, a plan sponsor can choose to forego the option.

Additionally, while the regulations allow the amount of the hardship withdrawal to include the applicable federal, state and local taxes and penalties resulting from the distribution, inclusion of these taxes and penalties must not cause the hardship withdrawal to exceed the above limitations.

Example 10-1. Hardship Limit Calculation. A participant has the following balance information:

Elective deferral balance at 12/31/88:	$3,250
Elective deferral contributions from 1/1/89 to 12/31/06:	$9,200
Elective deferral balance at 12/31/06:	$9,072
Hardship withdrawal in 1995:	$4,000

The maximum amount available for hardship withdrawal as of 12/31/06 is **$8,450**. This is calculated as elective deferral balance at 12/31/88 + elective deferral contributions from 1/1/89 to 12/31/06 – prior hardship withdrawals ($3,250 + $9,200 - $4,000 = $8,450).

[B] Taxation of Hardship Withdrawals and Penalties

Hardship withdrawals are not eligible rollover distributions, and therefore are not subject to the mandatory 20% federal withholding and applicable state rules. Since the hardship withdrawal would be considered a non-periodic payment from the plan, that is, not part of a series of regular payments such as those of an annuity, 10% withholding applies unless the participant is permitted to and elects either no withholding or a different withholding percentage.

If the hardship withdrawal is paid to a participant who has not attained age 59½, the hardship withdrawal is subject to the 10% additional income tax on early distributions. This penalty tax is payable with the participant's personal tax return filed for the year in which the hardship withdrawal is received.

Under the regulations, the amount of the withdrawal for the hardship may be increased to include the applicable federal, state and local taxes and penalties resulting from the distribution. If the participant so chooses, he or she would coordinate this request with the withholding election.

Example 10-2. Hardship Calculation. Harvey, age 29, needs $3,000 for college tuition and qualifies for a hardship withdrawal from his employer's 401(k) plan. Harvey is in a 15% federal tax bracket, a 5% state tax bracket and will be subject to the 10% additional income tax on early distributions. He requests that his hardship amount be increased by the taxes he must pay as a result of his hardship withdrawal.

Therefore, Harvey's hardship withdrawal request is for $4,285.71 calculated as follows, where the 30% represents his tax liability (15% federal, 5% state, 10% additional):

Hardship request = Taxes due + college tuition
Hardship request = (30% x hardship request) + $3,000
70% x hardship amount = $3,000
Hardship amount = $3,000 / .70
Hardship amount = $4,285.71

§10.08 Qualified Domestic Relations Orders (QDROs)

[A] Definition

With the enactment of the Retirement Equity Act of 1984 (REA) came the recognition that funds held within a qualified plan by a participant represent an asset that should be available for division and distribution from the plan in situations such as a divorce. Since one of the directives for qualified status under the Internal Revenue Code and ERISA is that the plan be maintained for the sole benefit of participants and their beneficiaries, REA created an exception to this exclusive benefit requirement in the concept of an alternate payee. An alternate payee is someone other than the participant to whom the participant's benefits may be payable according to the terms of a **Qualified Domestic Relations Order (QDRO)**.

QDROs are issued under state domestic relations law and provide for payment of all or a portion of a participant's benefits to a spouse, a former spouse, the children or other dependents of the participant as **alternate payees**. Common misconceptions are that QDROs arise only in conjunction with divorces and may only be issued by a court. On the contrary, QDROs can provide for child support, alimony payments or other property settlement rights and while usually issued by a court, they likewise may be issued by another state authority such as a state's child support enforcement agency.

While the QDRO regulations do not apply to IRAs or nonqualified plans, QDROs may be submitted to pension and nonpension plans, governmental plans, certain church plans, 403(b) plans and 457 plans.

Generally speaking, under the Internal Revenue Code and ERISA, a domestic relations order constitutes a qualified domestic relations order only if it conforms to the legal definition of a QDRO. A QDRO must identify the participant, alternate payee, and plan to which it applies, explain what specific benefits are to be granted to the alternate payee, when those benefits are to be paid and how long those payments are to be made. There must be absolute clarity with regard to what portion of the participant's qualified plan benefits are to be transferred to the alternate payee or payees. Consequently, QDROs similarly should explain what occurs in the event of the death of either the participant or the alternate payee.

For example, a QDRO may designate that a former spouse is to be treated as the participant's current spouse for purposes of any QJSA or QPSA under the plan. Alternately a QDRO might be negotiated by the parties to provide that in the event of the death of the alternate payee prior to a distribution of the alternate payee's benefits under the plan the alternate payee's award of benefits is restored to the participant.

The Internal Revenue Code and ERISA also delineate what a QDRO cannot do: it cannot require a plan to increase benefits, to change the type of benefit under the plan, or force the plan to add different optional forms of benefit. Moreover, a QDRO cannot decree payment of benefits to an alternate payee that have already been assigned to another alternate payee under a prior QDRO.

As one might imagine, multiple QDROs can be submitted to the plan for a single participant. Post-death QDROs do exist as well in instances where the participant may be deceased but the plan has not yet paid out death benefits. Once a QDRO has been accepted by the plan, the alternate payee becomes a beneficiary under the plan and has the rights of a plan beneficiary, such as disclosure of plan information.

For purposes of taxation, QDRO distributions do not incur the 10% additional income tax on early distributions. If the alternate payee under the QDRO is a child or other dependent of the participant, the participant remains responsible for paying income taxes on any QDRO distribution, even though the participant did not receive the distribution. Spouses and former spouses as alternate payees are responsible for payment of the income taxes associated with their QDRO distributions.

Notably, QDRO benefits paid to alternate payees who are spouses and former spouses are eligible for rollover treatment, and where no rollover is chosen, these payments are subject to mandatory 20% withholding. Additionally, alternate payee benefits under qualified plans must comply with required minimum distribution regulations and any involuntary distribution provisions under the plan.

Plans are permitted to allocate reasonable expenses associated with QDRO determinations directly to the participant's account. The SPD should note when the plan permits this expense to be withdrawn directly from the account of the individual.

[B] Administrative Actions Required for a DRO

When a plan trustee receives a domestic relations order (DRO), the following steps are taken:

1. Notify the participant and each alternate payee of the receipt of the DRO and the plan's procedures for determining its qualified status;

2. Determine if the DRO is a QDRO and promptly notify the participant in writing and each alternate payee of the determination within a reasonable period after receipt of the DRO;

3. During the period in which the determination of whether a DRO is a QDRO, separately account for the amounts (segregated amounts) that would have been payable to the alternate payee during such period if the DRO had been determined to be a QDRO; and

4. If within the 18 month period beginning with the date on which the first payment under the DRO would be required, the DRO is determined to be a QDRO, pay the segregated amounts to the alternate payee; or if within the 18 month period it is determined the DRO is not a QDRO or the determination is not made, pay the segregated amounts and interest to the person or persons who would have been entitled to such amounts if there had been no DRO.

If a properly executed QDRO is submitted to a qualified plan, the plan must comply with the provisions therein. To assist participants and potential alternate payees, plans must have written QDRO procedures to explain the QDRO acceptance and administration process. Failure of the plan administrator to follow these written procedures or the plan's acceptance of a flawed QDRO may jeopardize the plan's qualified status.

§10.09 Key Terms

Alternate Payee: A spouse, former spouse, child or other dependent of the participant.

Events Test: The immediate and heavy financial need test applicable to hardship withdrawals.

General Standard: The facts and circumstances standard applicable to hardship withdrawals.

Hardship Withdrawal: A distribution that is on account of an immediate and heavy financial need and must be necessary to satisfy that financial need.

In-Service Withdrawal: A withdrawal of vested money from a qualified plan to an employee who is still actively employed. Also referred to as an in-service distribution.

Needs Test: The amount necessary to satisfy financial needs test applicable to hardship withdrawals.

Qualified Domestic Relations Order (QDRO): An order issued under state domestic relations law that relates to the payment of child support or alimony or to marital property rights. A QDRO creates or recognizes or assigns to an alternate payee the right to receive plan benefits payable to a participant. The alternate payee may be the participant's spouse, former spouse or dependent.

Safe Harbor Standard: Pre-approved IRS language using specifically-named hardship events and stipulated additional procedures.

§10.10 Review of Key Concepts

- An in-service withdrawal is a withdrawal of vested money by a participant who is still actively employed.

- Withdrawals of after-tax employee contributions often have tax consequences, since a pro rata share of earnings must be withdrawn on after-tax employee contributions made after December 31, 1986.

- Certain types of in-service withdrawals are rollover eligible, and therefore current tax consequences can be avoided by rolling the distribution to an IRA or other qualified plan.

- Once normal retirement age is reached, participants may be allowed to begin in-service withdrawals of their retirement benefits.

- A plan may need to make in-service corrective distributions due to a failure to satisfy nondiscrimination and other qualified plan rules.

- Required minimum distributions are not eligible for rollover treatment, and therefore are not subject to the mandatory 20% withholding rules.

- In-service withdrawals from nonpension plans may be conditioned upon attainment of a specified age or number of years of service.

- A hardship withdrawal is a withdrawal from a qualified retirement plan to a participant who has an immediate and heavy financial need as the result of an unexpected or extraordinary event. Plans that offer hardship withdrawals define the particular financial circumstances that constitute a hardship event under the plan.

- In order for a distribution to qualify as a hardship withdrawal, it must be on account of an immediate and heavy financial need (events test) and must be necessary to satisfy the financial need (needs test) under the IRS regulations.

- The IRS regulations allow two standards to determine if the requirements are met: the general standard and the safe harbor standard.

- Under the general standard, all the relevant facts and circumstances surrounding the financial hardship are the basis for satisfying the events test and the needs test.

- Under the safe harbor standard, the basis for satisfying the events test is limited to six specific events. The withdrawal must be on account of medical expenses, purchase of a principal residence, payment of tuition or related educational fees, to prevent eviction or foreclosure, to pay funeral expenses or to repair damage to an employee’s principal residence.

- The amount available for a hardship withdrawal includes the participant’s elective deferral account balance as of 12/31/88 plus the cumulative elective deferrals (without earnings) since 1/1/89 less any prior hardship withdrawals.

- Hardship withdrawals are not considered eligible rollover distributions and therefore are not subject to the mandatory 20% federal and applicable state withholding rules.

- QDROs are issued under state domestic relations law and provide for payment of all or a portion of a participant’s benefits to an alternate payee, who may be a spouse, a former spouse, the children or other dependents of the participant.

§10.11 Review Questions

[A] True or False

______ 1. A hardship withdrawal made to a participant, age 45, is subject to the 10% additional income tax on early distributions.

______ 2. A hardship withdrawal is one made on account of an immediate and heavy financial need.

______ 3. An alternate payee in regard to a QDRO must be someone other than the participant.

______ 4. Mandatory 20% withholding applies to hardship withdrawals that are not rolled over.

______ 5. Under the general standard for hardship withdrawals, a request should be denied if the plan sponsor is aware that there are other resources available to satisfy the hardship need.

[B] Multiple Choice

6. All of the following statements regarding in-service withdrawals are **TRUE, EXCEPT**:

   A. A participant may withdraw the non-vested employer match paid on after-tax employee contributions under these rules when the after-tax employee contributions are withdrawn.
   B. Employer contributions must have been held in the plan at least two years.
   C. A 10% additional income tax applies in addition to ordinary income tax that must be paid for distributions prior to age 59½.
   D. A plan may require that a participant complete a fixed number of years of participation prior to receiving an in-service withdrawal.
   E. An ESOP may allow withdrawals in order to satisfy the diversification requirements.

7. All of the following statements regarding hardship withdrawals are **TRUE, EXCEPT**:

   A. The plan's hardship provisions must be defined.
   B. The definition of hardship must be applied in a uniform manner.
   C. The amount available must be determined in a uniform manner.
   D. Hardship withdrawals must be offered in all 401(k) plans.
   E. A hardship withdrawal may be available from employer contributions.

8. All of the following are allowable in-service withdrawals, **EXCEPT**:

    A. Withdrawal of after-tax employee contributions
    B. Withdrawal of rollover contributions
    C. Withdrawal at normal retirement age
    D. Withdrawal of employer profit sharing contributions
    E. Withdrawal of employer contributions from a money purchase plan

9. All the following statements regarding the general standard for hardship withdrawals are **TRUE, EXCEPT**:

    A. The general standard has two parts, the events test and the needs test.
    B. A participant must have an immediate and heavy financial need to be granted the withdrawal.
    C. Purchase of an automobile to commute to work may be considered a hardship event.
    D. The amount of the need can include estimated taxes and penalties.
    E. Resources of the participant's adult children must also be considered in determining whether to make the hardship distribution.

10. All of the following are types of plans that allow in-service withdrawals, **EXCEPT**:

    A. Employee stock ownership plans
    B. Stock bonus plans
    C. Target benefit plans
    D. Profit sharing plans
    E. 401(k) plans

11. All of the following payments are considered safe harbor hardship withdrawal events, **EXCEPT**:

    A. Payment to prevent eviction of the participant from the participant's principal residence
    B. Payment of tuition for the participant's child's doctorate program
    C. Payment of medical expenses for the participant's spouse
    D. Payment of expenditures necessary to acquire a second home
    E. Payment of room and board for college expenses of the participant

§10.12 Answers

1. **True.** The 10% additional income tax on early distributions applies to distribution made before age 59½. §10.07 [B]

2. **True.** A hardship withdrawal is a distribution that is on account of an immediate and heavy financial need. §10.04 [A]

3. **True.** An alternate payee under a QDRO may not be the participant. §10.08 [A]

4. **False.** Hardship withdrawals are not eligible for rollover, therefore mandatory 20% withholding does not apply. §10.07 [B]

5. **True.** Even if the participant signs a statement indicating no other resources are available, a plan sponsor who knows otherwise should deny the hardship request. §10.05 [B]

6. The correct answer is **A.** §10.03

   A. Correct. This statement is false because a participant may be eligible to withdraw after-tax employee contributions but non-vested matching contributions cannot be withdrawn.
   B. Incorrect. This statement is true because employer contributions must have been held in the plan at least two years to be eligible for in-service withdrawal.
   C. Incorrect. This statement is true because a 10% additional income tax does apply in addition to ordinary income tax that must be paid for in-service withdrawals prior to age 59½.
   D. Incorrect. This statement is true because a plan may require that a participant complete a fixed number of years of participation prior to receiving an in-service withdrawal.
   E. Incorrect. This statement is true because an ESOP may allow in-service withdrawals in order to satisfy the diversification requirements.

7. The correct answer is **D.** §10.04

A. Incorrect. This statement is true because the plan's hardship provisions must be defined.
B. Incorrect. This statement is true because the definition of hardship must be applied in a uniform manner.
C. Incorrect. This statement is true because the amount available must be determined in a uniform manner.
D. Correct. This statement is false because hardship withdrawals are a plan design option and not a requirement in 401(k) or any other retirement plan.
E. Incorrect. This statement is true because a hardship withdrawal may be available from employer contributions.

8. The correct answer is **E.** §10.03

A. Incorrect. This statement is true because after-tax employee contributions may be available for in-service withdrawal.
B. Incorrect. This statement is true because rollover contributions may be available for in-service withdrawal.
C. Incorrect. This statement is true because withdrawals at normal retirement age may be available even if the participant does not retire.
D. Incorrect. This statement is true because employer profit sharing contributions may be available for in-service withdrawal.
E. Correct. This statement is false because employer contributions from a money purchase plan are not available for in-service withdrawal.

9. The correct answer is **E.** §10.05

A. Incorrect. This statement is true because the general standard has two parts, the events test and the needs test.
B. Incorrect. This statement is true because a participant must have an immediate and heavy financial need to be granted the withdrawal.
C. Incorrect. This statement is true because the purchase of an automobile to commute to work may be considered a hardship event.
D. Incorrect. This statement is true because the amount of the need can include estimated taxes and penalties.
E. Correct. This statement is false because resources of the participant's adult children are not considered in determining whether to make the hardship distribution.

10. The correct answer is **C.** §10.03

    A. Incorrect. This statement is true because employee stock ownership plans may offer in-service withdrawals.
    B. Incorrect. This statement is true because stock bonus plans may offer in-service withdrawals.
    C. Correct. This statement is false because as a pension plan, target benefit plans may not offer in-service withdrawals.
    D. Incorrect. This statement is true because profit sharing plans may offer in-service withdrawals.
    E. Incorrect. This statement is true because 401(k) plans may offer in-service withdrawals.

11. The correct answer is **D.** §10.06

    A. Incorrect. This statement is true because payment to prevent eviction of the participant from the participant's principal residence is a safe harbor hardship withdrawal event.
    B. Incorrect. This statement is true because payment of tuition for the participant's child's doctorate program is a safe harbor hardship withdrawal event.
    C. Incorrect. This statement is true because payment of medical expenses for the participant's spouse is a safe harbor hardship withdrawal event.
    D. Correct. This statement is false because only payment of expenditures necessary to acquire a primary home is a safe harbor hardship withdrawal event.
    E. Incorrect. This statement is true because payment of room and board for college expenses of the participant is a safe harbor hardship withdrawal event.

Chapter 11: Participant Loans

§11.01 Learning Objectives

- List and describe the requirements for a qualified plan loan to prevent a prohibited transaction and avoid taxation.
- Identify the items that must be addressed in a loan policy.
- Calculate the maximum available loan amount based on a participant's account balance.
- Differentiate between a deemed distribution and a loan offset for loans in default.

§11.02 Introduction

A participant loan program under a qualified plan, in particular a 401(k) plan, is often viewed as a necessary plan feature, responding to participant demand and the desire to encourage the highest levels of participation possible despite the added costs. Participant loans are a practical alternative to taking out a loan from a bank, withdrawing money from retirement savings and suffering the accompanying tax consequences, or limiting one's elective deferrals for fear of "rainy day" demands. The ability to borrow funds from one's own account and repay the funds back with interest to that account can be genuinely appreciated by participants. When properly administered according to the Internal Revenue Code and ERISA, a participant loan allows access to one's retirement savings while still employed, without income taxes or penalties and with additional revenue to be paid to the participant's account in the form of reinvested loan interest.

Key to this process are the various qualified plan rules that govern participant loan programs. Since retirement plans should not be utilized as a personal savings account to draw upon at will prior to retirement, this chapter considers the necessary requirements surrounding participant loans, including the amounts that may be made available for borrowing, the terms of the loan including interest and repayment schedules, documentation and reporting, as well as taxable consequences should the loan not be repaid on schedule.

§11.03 Loan Availability

[A] In General

One of the fundamental requirements for any plan to be considered qualified for tax purposes is that it be established and maintained by the employer for the exclusive benefit of its employees or their beneficiaries. Consequently, the Internal Revenue Code and ERISA forbid certain transactions between the plan and persons or entities identified as parties-in-interest to the plan. These prohibited transactions include a loan or extension of credit from the plan to a party-in-interest.

Since an employee of the plan sponsor is a party-in-interest to the plan, the prohibited transaction rules stop a plan from extending a loan to any employee of its sponsor. However, a prohibited transaction exemption exists to allow loans between the plan and plan participants, with the stipulation that all regulations surrounding the prohibited transaction exemption for participant loans are met.

In addition to the prohibited transaction exemption rules, participant loan programs offered by qualified plans must address issues of taxation. Participant loans are considered taxable distributions from the plan unless they comply with applicable tax provisions under the Internal Revenue Code.

The coordination of these two sets of regulations to avoid current taxation on loan proceeds and prevent classification of a loan as a prohibited transaction results in a participant loan program that must meet the following requirements:

- Loans must be made available to participants on a reasonably equivalent basis;

- The loans must not be made available to HCEs in an amount greater than the amount available to NHCEs;
- The plan document must contain the terms of the loan program, or the employer must adopt a formal loan policy or procedure;
- All loans must bear a reasonable rate of interest; and
- Every loan must be adequately secured by either the participant's vested benefit or other collateral.

Effective January 1, 2002, sole proprietors, more than 5% shareholders of S corporations or partners owning more than a 10% interest in a partnership may receive loans from plans under the same circumstances as other plan participants. Prior to this date, these loans to shareholder-employees would have been prohibited transactions.

[B] Reasonably Equivalent Basis

Loans available on a reasonably equivalent basis to participants are loans offered without regard to age, religion, sex, race, color or national origin. Factors such as financial need may be considered if they are factors that are normally taken into consideration by lending institutions, such as banks, in similar circumstances. Also, the Internal Revenue Code and ERISA allow a plan to set a minimum loan amount of $1,000 without jeopardizing compliance with the availability requirement.

Under certain circumstances, participants who are not actively employed and thereby no longer parties-in-interest may be ineligible under the plan's loan program. Also, loans can be disallowed to directors and executive officers of the plan sponsor with regard to certain provisions of the Sarbanes-Oxley Act of 2002 (SOA '02).

Loans are still considered to be available on a reasonably equivalent basis in these particular instances. These exceptions are noted here to point out that every participant under the plan may not always be eligible for a loan.

§11.04 General Loan Provisions

[A] Loan Program or Written Loan Policy or Procedures

The DOL requires that the plan document contain the loan program provisions or include by reference the separate, written document that describes the plan's loan program. This separate, formal statement of the plan's policies surrounding participant loans is alternately called the plan's loan policy, loan program or loan procedure(s). Please refer to Appendix H for a sample loan policy.

The loan program must clearly describe the following items in a manner able to be understood by the average plan participant:

- The identity of the person or position administering the loan program (accomplished by providing someone's name or position title such as Human Resources Director);
- The application procedures;
- The basis on which loans are approved or denied;
- Limitations, if any, on the type, amount and number of loans allowed;
- The procedure for determining a reasonable rate of interest for the loan;
- The type of collateral that may be used to secure the loan; and
- The events that constitute loan default together with the steps that must be taken to preserve plan assets in the event of loan default.

[B] Reasonable Rate of Interest

The reasonable rate of interest requirement is satisfied if the rate charged for the participant loan is approximately the same rate charged for similar loans by persons or institutions in the business of lending money. The Internal Revenue Code and ERISA do not specifically contain a safe harbor method for determining a reasonable rate. Thus, a plan's loan policy typically ties the loan interest rate to an outside reference that reflects a current rate charged for similar loans by financial lending institutions in the community.

For example, a loan policy might base the interest rate on a sampling of rates from banking institutions and credit unions or set the rate at a certain percentage, such as one percent, above the prime rate. In this manner, each participant loan has an interest rate that approaches or reflects the rate the participant would have obtained had he or she borrowed funds from a commercial source outside the plan. Since rates fluctuate over time, one can expect to see differing interest rates utilized by the various participant loans under a qualified plan, each rate reflective of the then currently available commercial lending rate at the time the particular participant loan was obtained.

It should be noted that while participants are on military leave, under the Service Members Civil Relief Act of 2003 (SCRA) which amended the Soldiers and Sailors Civil Relief Act of 1940 (SSCRA), their pre-military service participant loans have a maximum interest rate of 6% unless a waiver of the SCRA interest limitation is obtained. Thus, an interest rate greater than 6% is reduced to 6% during the period of military service performed by the affected participant. The interest payments recommence at the higher rate upon the participant's return to active employment with the plan sponsor.

[C] Adequate Security

Participant loans must be more than just a promise of repayment. Adequate security is required, usually in the form of up to 50% of the participant's vested account balance valued at the time the loan is taken. Should the value of the participant's vested benefit later fall, such that the outstanding loan represents more than 50% of the value of the vested benefit, the loan is still considered adequately secured.

For ease of administration, most loan programs require that participants use only the collateral readily available from their vested account balance rather than accept outside collateral. In this manner, the plan avoids the following problems:

- Valuation of collateral; and
- Difficulty of collecting the collateral on defaulted loans.

Note that the DOL sets a limit of 50% of the participant's vested account balance or accrued benefit for use as collateral under a participant loan. This limit and the requirement of adequate security are coordinated with the loan amount limitation set forth below.

[D] Loan Amount Limits

The maximum nontaxable loan amount is the lesser of A or B:

A. $50,000, reduced by any excess of 1 minus 2:

1. The highest outstanding balance of loans during the one-year period ending on the day before the date on which the loan is made;

2. The outstanding balance of loans on the date on which the loan is made.

B. The greater of:

1. 50% of the participant's vested account balance or benefit; or

2. $10,000, if allowed by the plan.

The $10,000 amount is known as the de minimis loan amount. Use of this provision by a plan assumes additional collateral is secured, representing the difference between 50% of the participant's vested benefit and $10,000.

Example 11-1. Loan Amount Limit. Jay has a current vested account balance under his 401(k) plan of $125,000. He has not taken a loan from the plan before, but now wishes to borrow the maximum amount available. His plan's loan policy reflects the Internal Revenue Code's definition of the maximum nontaxable loan amount stated above.

Jay's maximum loan amount is calculated as the lesser of

A) $50,000, unreduced since this is Jay's first loan, or

B) $62,500 (50% of $125,000, which is greater than $10,000).

Therefore, Jay can apply for a $50,000 loan from the plan, secured by 40% of his vested account balance. No additional collateral is required because up to 50% of his vested account balance may be used as security for his participant loan.

Example 11-2. Additional Loan Amount. Ten months later, Jay again wishes to borrow the maximum amount. The plan allows for more than one loan at a time. His vested account balance is now $140,000, including a $47,000 outstanding loan balance.

Jay's maximum loan amount is the lesser of

A) $47,000, ($50,000 reduced by the excess of $50,000 - $47,000), or

B) $70,000 (50% of $140,000, which is greater than $10,000).

So the maximum amount Jay can borrow is $47,000. However, because Jay already has an outstanding loan of $47,000, he is at his maximum loan amount and cannot borrow additional funds from the plan.

[E] Term of Loan

To remain a nontaxable event, the repayment period of the loan may not exceed five years unless the loan is used to purchase the participant's principal residence. Home loans of this sort may have any reasonable repayment period and typically mirror the marketplace with repayment schedules of fifteen or thirty years. Also, there are generally three circumstances under which the original term of a loan may be extended: unpaid leaves of absence, loan refinancing and military service.

A plan may allow for a suspension of loan payments for a period of up to one year while a participant is on a leave of absence. There must be coordination between the term of the loan, the length of the leave and the number of payments made before the leave to achieve full relief under this allowable provision. At the end of the leave or one-year period, the interest accrued during the suspension of loan payments must be paid no later than the end of the maximum loan term allowed, that is, within five years of the original date of the loan.

As an illustration, if a participant takes out a loan with a three-year repayment schedule and after two years of payments goes on a leave of absence for six months, beginning upon his or her return that participant must resume loan payments and has a year to pay off the loan. The loan is paid off within three and one-half years from the date of the loan, well within the five-year maximum term.

If the term of the loan is between four and five years, the participant may not be able to achieve one full year of suspended loan payments. For example, if the term of the loan was four and one-half years, and after four years of payments the participant begins a year's leave of absence, the maximum loan term is reached at or before the end of the leave. The loan must be paid off by the end of the maximum loan term. For situations like these, if the plan allows, a participant might consider a loan refinancing.

In loan refinancing transactions, the original loan is replaced by a new loan that extends the repayment period to the maximum allowed, or increases the loan amount up to the maximum allowed, or accomplishes both an extension of the loan term and borrowing of additional funds. Since the Internal Revenue Code does not intend for refinancing to be a method of avoiding the maximum loan term, the refinancing rules explain how to take the replaced loan and its original period of repayment into consideration when calculating the maximum time period and amount for the replacement loan.

To meet the refinancing rules, the payments on the replacement loan must not be less than the principal and interest payments required to pay off the first loan within the original five-year term, plus the principal and interest payments required on the additional amount borrowed. (These rules are topics under advanced ASPPA courses.)

For those participants on military leave, loan payments may be suspended for the period of the military service, even if that period extends beyond one year. Upon return to employment with the plan sponsor, loan payments resume and must be completed no later than the maximum time period, five years, plus the period of military service. In this manner the loan may be repaid over a period longer than five years. To illustrate: a participant with a five-year loan who performs military service for three years has a total of eight years from the loan issue date to repay that loan.

[F] Loan Payments

The repayment terms of a participant loan must stipulate level amortized payments made at least once a quarter. Many employers prefer to require loan repayments through payroll withholding to reduce the likelihood of loan defaults and comply with the minimum quarterly repayment schedule. Where loan repays are taken by payroll deductions, the promissory note, if authorized by the plan's loan policy, can be written to accelerate repayment of the principal and interest on the plan loan when the participant is no longer on the payroll.

In other words, if the participant terminates employment for any reason including retirement, death, and disability, the remaining balance of the loan may become immediately due and payable. Typically, under these circumstances the participant has the option of paying off the loan using personal resources, or at the time the plan pays out the participant's benefits under the plan, the payment to the participant could be reduced by the amount of the outstanding loan.

Plans also can incorporate grace period provisions under their loan programs. During the grace period, often called the cure period, the participant can avoid a loan default and the resulting taxation by making up any missed payments. The loan regulations set the cure period maximum to be the last day of the calendar quarter following the calendar quarter in which the first missed payment was due. Of course, plans may set a shorter cure period or decide not to offer a cure period provision at all.

[G] Default of Loan

1. Deemed Distribution

Should the participant fail to make the required payments on a timely basis, the loan is in default, and the outstanding loan balance is considered to be a taxable distribution to the participant in the year of the default. The loan has become a **deemed distribution**, and is reported as such to the IRS by the plan and on applicable tax forms to the participant. When a loan is deemed distributed, it is not eligible for rollover treatment and no tax withholding applies since no cash is being distributed from the plan. The loan amount may generate additional taxes in the form of the 10% additional income tax on early distributions, if applicable, or further penalties if the loan default also is considered a prohibited transaction.

Although the defaulted outstanding loan balance is deemed to have been distributed to the participant, it remains as part of the participant's vested account balance under the plan until a distributable event such as termination of employment occurs. During this period, the defaulted loan is considered an outstanding loan, and therefore is included in any maximum loan amount calculations should the plan allow the participant to request another loan. While the loan remains as part of the vested account balance under the plan, the participant has the option to repay the defaulted loan, at which time the repayment is considered an after-tax repayment to the plan. If not repaid by the time the participant takes a total distribution from the plan, the outstanding loan balance is treated as a loan offset as described below.

2. Loan Offset

Upon a distributable event, the participant's vested benefit may be reduced by the amount of an outstanding or defaulted loan. Known as a **loan offset**, if not previously taxed as a deemed distribution, the loan offset amount becomes taxable to the participant at this time. Unlike deemed distributions, loan offset amounts can be rolled over to another qualified plan or IRA. This is accomplished by the participant depositing into the rollover IRA or qualified plan funds from personal savings in an amount equal to the loan offset amount.

Since loan offset amounts are rollover-eligible, if the participant also receives cash and chooses not to roll over the distribution, 20% mandatory withholding applies on the entire taxable distribution amount including any loan offset amount not previously taxed as a deemed distribution to the extent that there is sufficient cash to withhold.

For example, if a participant receives a termination distribution of $10,000 consisting of a $9,000 loan balance and $1,000 in cash, the entire amount of the cash is withheld for taxes since there is insufficient cash to support the full 20% withholding ($10,000 x 20% = $2,000). If the $10,000 distribution consisted instead of a $7,000 loan and $3,000 in cash, the participant would receive $1,000 in cash, and the plan would withhold for taxes the full 20% or $2,000.

As illustrated above, the consequences of a loan default are complicated and far-reaching. These consequences are explored in greater depth in advanced ASPPA courses.

[H] Spousal Consent

If a plan is subject to the QJSA and QPSA requirements, the participant's spouse needs to consent to the plan loan if the loan amount is greater than $5,000. The spousal consent must be in writing, and both the spousal consent and the participant's execution of the loan application and promissory note need to be witnessed by a plan representative or notary public. Note that a plan could choose to require spousal consent even if it is not subject to QJSA and QPSA requirements.

[I] Loan Documents—Paper or Electronic Format

The provisions under the Internal Revenue Code that prevent a participant loan from being an immediately taxable event or considered a prohibited transaction include a stipulation that the loan must be evidenced by a legally enforceable document containing the terms of the loan and including the amortized payment schedule. This document may be in paper or electronic format. If provided in electronic format, the following requirements arise:

- Confidentiality (the participant should be the only person able to request a loan);
- Confirmation of the loan, either paper or electronic, must be received by the participant within a reasonable period of time;

- Option of receiving a paper document including loan confirmation at no charge must be available to the participant;
- Reasonable access to the electronic system for loan requests must be provided;
- Sufficient opportunity to change or delete the loan request before the loan is finalized must be assured;
- Electronic medium language should be of sufficient clarity to be readily understood by the participant and no less clear than paper medium language; and
- Electronic signatures are allowable as long as the absence of a written signature still renders the document a legally enforceable agreement.

§11.05 Federal Truth in Lending Act

The Federal Truth in Lending Act applies to plans that during any calendar year have more than 25 loans in total or have at least five loans for the purchase of a principal residence. Sometimes referred to as Regulation Z after the Internal Revenue Code of Federal Regulations section containing these rules, if the Act applies, the plan trustee must provide additional paperwork that discloses to participants the amount financed, the finance charges if any, the annual percentage rate calculated in accordance with federal guidelines, and the security interest required to make the loan. These Regulation Z disclosures can be furnished to the participant in either paper or electronic format.

The following are two more examples of loan amount calculations. Please refer to Appendix I for a loan calculation worksheet.

§11.06 Loan Example I

Fred's Vested Account Balance is $200,000 as of September 30, 2006. Having received a loan on September 30, 2005 of $35,000, on September 30, 2006 Fred's outstanding loan balance is $25,000. As of September 30, 2006, Fred's maximum amount available for a new loan is $15,000.

First Limitation

1. Enter participant's highest outstanding loan balance during the 12 months ending on the day before the date the loan is to be made:	$ 35,000
2. Enter participant's outstanding loan balance on the date the second loan is to be made (if there is no outstanding loan enter zero (-0-)):	$ 25,000
3. Subtract amount on line 2 from amount on line 1:	$ 10,000

4. Subtract amount on line 3 from $50,000: $ 40,000

Second Limitation

5. Enter current value of participant's vested account balance: $ 200,000

6. Multiply amount on line 5 by 50%): $ 100,000
   (This is the 50% of the vested account balance portion
   of the calculation)

7. Enter amount on line 6 or $10,000, if greater: $ 100,000
   (Use of $10,000 requires additional collateral)

Participant's Loan Limit

8. Enter lesser of line 4 or line 7: $ 40,000

9. Enter participant's outstanding loan balance on the date the loan is to be made [if there is no outstanding loan balance, enter zero (-0-); this is the same amount from line 2] $ 25,000

10. Subtract amount on line 9 from amount on line 8. This is the participant's loan limit: $ 15,000

§11.07 Loan Example II

Devon's Vested Account Balance is $75,000 as of June 30, 2006. Devon previously received a loan on June 30, 2004 of $35,000, which had an outstanding loan balance of $30,000 on June 30, 2005. On June 30, 2006 Devon's outstanding loan balance is $25,000. His maximum amount available for a new loan is $12,500 as of September 30, 2006.

First Limitation

1. Enter participant's highest outstanding loan balance during the 12 months ending on the day before the date the loan is to be made: $ 30,000

2. Enter participant's outstanding loan balance on the date the second loan is to be made (if there is no outstanding loan enter zero (-0-)): $ 25,000

3. Subtract amount on line 2 from amount on line 1: $ 5,000

4. Subtract amount on line 3 from $50,000: $ 45,000

Second Limitation

5.	Enter current value of participant's vested account balance:	$ 75,000
6.	Multiply amount on line 5 by 50%: (This is the 50% of the vested account balance portion of the calculation)	$ 37,500
7.	Enter amount on line 6 or $10,000, if greater: (Use of $10,000 requires additional collateral)	$ 37,500

Participant's Loan Limit

8.	Enter lesser of line 4 or line 7:	$ 37,500
9.	Enter participant's outstanding loan balance on the date the loan is to be made [if there is no outstanding loan balance, enter zero (-0-); this is the same amount from line 2]	$ 25,000
10.	Subtract amount on line 9 from amount on line 8. This is the participant's loan limit:	$ 12,500

§11.08 Key Terms

Deemed Distribution: Occurs when a loan is defaulted and the outstanding loan balance is considered to be a taxable distribution to the participant in the year of the default.

Loan Offset: Upon a distributable event, the participant's vested benefit may be reduced by the amount of an outstanding or defaulted loan.

§11.09 Review of Key Concepts

- A participant loan program must satisfy both ERISA and the Internal Revenue Code to avoid current taxation and to prevent the loan from being classified as a prohibited transaction.
- Participant loans must be available to all participants on a reasonably equivalent basis.
- Generally, participant loans are limited to the lesser of 50% of a participant's vested account balance or $50,000.
- The maximum loan term when the loan is issued may not exceed five years unless the loan is used to purchase the participant's primary residence.

- The interest rate charged for a participant loan must be similar to the interest rate charged by other lending institutions for similar loans.

- A plan is required to maintain a detailed written loan policy.

- Amortized loan repayments of both principal and interest must be made at least quarterly.

- A deemed distribution occurs when a loan is defaulted, and the outstanding loan balance is considered to be a taxable distribution to the participant in the year of the default.

- Upon a distributable event, a participant's vested benefit may be reduced by the amount of an outstanding or defaulted loan. This is known as a loan offset.

§11.10 Review Questions

[A] True or False

______ 1. A plan may set a minimum loan amount of $1,000.

______ 2. A plan may allow loans to HCEs only.

[B] Multiple Choice

3. All of the following statements regarding loan offsets and deemed distributions are **TRUE, EXCEPT:**

   A. Upon a plan distributable event, a participant's vested benefit may be reduced by the amount of an outstanding loan.
   B. If not previously taxed as a deemed distribution, a loan offset is eligible to be rolled over to another qualified plan.
   C. A defaulted loan is considered a distributable event, thus the loan can be distributed to the participant.
   D. If not previously taxed as a deemed distribution, and to the extent there is cash available to withhold, a loan offset is subject to mandatory 20% tax withholding.
   E. A deemed distribution may be subject to the 10% additional income tax on early distributions.

4. All of the following must clearly be described in a loan program, in a manner able to be understood by the average plan participant, **EXCEPT**:

   A. The method by which a participant may obtain an IRS determination letter for the plan.
   B. The basis on which loans are approved or denied.
   C. Limitations, if any, on the number of loans allowed.
   D. The type of collateral that may be used to secure the loan.
   E. The events that constitute a loan default.

5. Based on the following information, calculate the maximum loan amount that Participant C can take on December 31, 2006.

   - The plan allows two outstanding loans.
   - Participant C's vested balance as of December 31, 2006 is $60,000
   - Participant C has one other outstanding loan, whose balance was $10,000 on December 31, 2005.
   - The balance of Participant C's outstanding loan is $6,000 on December 31, 2006.

   A. $6,000
   B. $10,000
   C. $24,000
   D. $30,000
   E. $50,000

6. All of the following requirements must be met in a participant loan program in order to avoid current taxation or a prohibited transaction, **EXCEPT**:

   A. Loans must be made available to participants on a reasonably equivalent basis.
   B. Loans must not be made available to HCEs in an amount greater than the amount available to NHCEs.
   C. The plan document must contain the terms of the loan program, or the employer must adopt a formal loan policy or procedure.
   D. All loans must bear a reasonable rate of interest.
   E. Loans may not be secured by either the participant's vested benefit or other collateral.

§11.11 Answers

1. **True.** A plan may set a minimum loan amount of $1,000. §11.03 [B]

2. **False.** The loans must not be made available to HCEs in an amount greater than the amount available to NHCEs. §11.03 [A]

3. The correct answer is **C.** §11.04 [G]

   A. Incorrect. This statement is true because upon a plan distributable event, a participant's vested benefit may be reduced by the amount of an outstanding loan.
   B. Incorrect. This statement is true because if not previously taxed as a deemed distribution, a loan offset is eligible to be rolled over to another qualified plan.
   C. Correct. This statement is false because a defaulted loan is not considered a distributable event.
   D. Incorrect. This statement is true because if not previously taxed as a deemed distribution, and to the extent there is cash available to withhold, a loan offset is subject to mandatory 20% tax withholding.
   E. Incorrect. This statement is true because a deemed distribution may be subject to the 10% additional income tax on early distributions.

4. The correct answer is **A.** §11.04 [A]

   A. Correct. This statement is false because the determination letter for the plan need not be described in the loan program.
   B. Incorrect. This statement is true because the basis on which loans are approved or denied must be described in the loan program.
   C. Incorrect. This statement is true because limitations, if any, on the number of loans allowed must be described in the loan program.
   D. Incorrect. This statement is true because the type of collateral that may be used to secure the loan must be described in the loan program.
   E. Incorrect. This statement is true because the events that constitute a loan default must be described in the loan program.

5. The correct answer is **C.** §11.04 [D]

First Limitation

1. Enter participant's highest outstanding loan balance during the 12 months ending on the day before the date the loan is to be made: $10,000

2. Enter participant's outstanding loan balance on the date the second loan is to be made (if there is no outstanding loan enter zero (-0-)):	$ 6,000
3. Subtract amount on line 2 from amount on line 1:	$ 4,000
4. Subtract amount on line 3 from $50,000:	$46,000

Second Limitation

5. Enter current value of participant's vested account balance:	$60,000
6. Multiply amount on line 5 by 50%): (This is the 50% of the vested account balance portion of the calculation)	$30,000
7. Enter amount on line 6 or $10,000, if greater: (Use of $10,000 requires additional collateral)	$30,000

Participant's Loan Limit

8. Enter lesser of line 4 or line 7:	$30,000
9. Enter participant's outstanding loan balance on the date the loan is to be made [if there is no outstanding loan balance, enter zero (-0-); this is the same amount from line 2]	$ 6,000
10. Subtract amount on line 9 from amount on line 8. This is the participant's loan limit:	$24,000

6. The correct answer is **E.** §11.03 [A]

   A. Incorrect. This statement is true because loans must be made available to participants on a reasonably equivalent basis.
   B. Incorrect. This statement is true because loans must not be made available to HCEs in an amount greater than the amount available to NHCEs.
   C. Incorrect. This statement is true because the plan document must contain the terms of the loan program, or the employer must adopt a formal loan policy or procedure.
   D. Incorrect. This statement is true because all loans must bear a reasonable rate of interest.
   E. Correct. This statement is false because loans must be secured by either the participant's vested benefit or other collateral.

Chapter 12:
Distributions and Tax Rules

§12.01 Learning Objectives

- Define early, normal and late retirement age and be able to determine benefits of attaining such age.
- Determine a participant's normal retirement age given the plan definition of normal retirement age.
- Identify distributable events upon separation of service for reasons other than retirement.
- Differentiate between the required forms of distribution from a nonpension and pension plan.
- Define a qualified joint and survivor annuity (QJSA).
- Define a qualified pre-retirement survivor annuity (QPSA).
- Recognize the Internal Revenue Code's involuntary distribution rules and the additional options plans have for involuntary distributions.
- Identify who must take a required minimum distribution and when the first distribution must begin.

- Define eligible rollover distribution and list the type of withdrawals that are eligible rollovers.
- Explain excise taxes, additional income taxes and mandatory withholding applicable to plan distributions.

§12.02 Introduction

Over the length of a qualified plan's "financial" lifetime, contributions and earnings flow into the plan while distributions and withheld taxes flow out of the plan. One might say that the financial life of the plan begins with the deposit of the first dollar of contribution made on behalf of the first plan participant and ends when the last dollar is distributed to the last participant. Not surprisingly, this financial lifecycle is governed by regulations surrounding and supporting the tax advantages of qualified plan status. Just as there are strict guidelines regarding the acceptance, funding, and allocation of contributions and their affiliated earnings, so too are there myriad rules surrounding when and how a qualified plan may pay out retirement benefits or otherwise release monies to participants and their beneficiaries.

In general, participants receive distributions of benefits from a plan upon the occurrence of certain specified events, such as:

- Retirement;
- Disability;
- Death; and
- Other termination of employment.

There also may be opportunities to receive benefits from the plan while still employed, should the plan document so allow (discussed in Chapters 10 and 11).

In the realm of retirement plan distributions, the term "separation from service" is often used interchangeably with "termination of employment." When an employee resigns, retires, dies or experiences a loss of job due to a reduction in force or layoff, he or she has clearly undergone a separation from service; there has been termination of employment with the employer. At other times, particularly in situations where companies merge, acquire, or sell portions of themselves, an employee's termination status may not be so easily determined. This chapter furthers the discussion of employment termination events as opportunities for distribution of plan benefits and sets forth ground work for an understanding of termination status.

When an event triggers the ability to receive a payment of benefits, the plan's mechanisms for processing distributions as defined in the plan document come into play. These mechanisms are designed to comply with the Internal Revenue Code and ERISA regarding timing of payments, options for choosing the amount and frequency of payments, application of income tax withholding or excise taxes, notification, reporting and disclosure requirements.

This chapter serves as a general introduction to the events, method, and tax considerations of payment of benefits from qualified plans.

§12.03 Distributable Events

If one begins with the understanding that the purpose of a qualified plan is to provide a tax-advantaged vehicle for accumulation of retirement benefits, then it follows that there would be legal restrictions on the circumstances, other than retirement, under which a plan is permitted to distribute benefits to participants or their beneficiaries. Some of these circumstances are easily understood, such as the death of the participant. Other circumstances may be more complex, and therefore the plan document's distribution provisions should always be carefully read to understand which of the allowable permitted circumstances the plan utilizes. Often referred to as distributable events, the most common of these are:

- Retirement;
- Death;
- Disability;
- Separation from service;
- Termination or partial termination of the plan;
- Financial hardship;
- Attainment of age 59½ or a specified later age; and
- Qualified Domestic Relations Orders (QDROs).

[A] Distribution upon Retirement

Upon reaching normal retirement age, participants become fully vested in their account balances or accrued benefits and are eligible to begin receiving distributions of their retirement benefits. While the plan is allowed to determine its own normal retirement age as set forth in the plan document, with limited exceptions for specialized defined benefit plans the Internal Revenue Code and ERISA require that **normal retirement age** under a qualified plan cannot be greater than:

1) The time a participant attains age 65; or, if later,

2) The fifth anniversary of the participant's initial date of plan participation.

Example 12-1. Normal Retirement Age. Jennifer is a participant in a plan that designates age 60 as the normal retirement age. At her commencement of participation under the plan, Jennifer was 58. Under the terms of the plan, Jennifer may retire upon reaching age 60 and seek distribution of her benefits after two years of participation.

Example 12-2. Normal Retirement Age. Alternately, if Jennifer's plan used the maximum normal retirement age allowed under law, Jennifer could retire at age 65, since this date would be later than the fifth anniversary of her participation under the plan (age 63).

Of note: the fifth anniversary of a participant's initial date of plan participation is considered to be the first day of the plan year if the participant's actual entry date under the plan occurs during the plan year.

Most qualified plans permit a participant to begin taking distributions upon attainment of normal retirement age, whether or not he or she actually retires. This does not mean that the participant is always required to begin distribution, for plans may have provisions for late retirement as discussed below. The participant, prior to attaining normal retirement age, is typically given paper or electronic distribution information including descriptions of payment options between 30 and 90 days prior to the date distributions commence. If the plan allows, these forms may include an election to defer payment.

Retirement prior to the plan's normal retirement age may be available to a participant. Predominantly, eligibility provisions for early retirement include specific age and service requirements. Additionally, under pension plans, the participant must separate from service; receipt of early retirement benefits is not allowed while the participant remains employed by the plan sponsor. These requirements for early retirement must be contained within the plan document.

For example, a plan may set normal retirement age as attainment of age 65, and define early retirement age as attainment of age 55 with a minimum of 10 years of service. Under this example, any employee hired prior to age 45 could seek early retirement and distribution of benefits upon reaching age 55.

As previously indicated, a participant may decide not to separate from service upon attaining normal retirement age, deferring distribution while still employed if the plan so allows. This is referred to as late retirement because the participant elects to retire later than the plan's normal retirement age.

At other times a participant separates from service upon attaining normal retirement age but does not want to begin receiving distributions until a much later date. This is referred to as a delayed distribution because the participant elects to delay receiving his or her distribution.

<u>1. Amount of Distribution</u>

In defined contribution plans, the amount of the distribution is easily ascertained. For a participant who terminates employment at normal retirement age or older as specified in the plan document, the participant receives his or her account balance and becomes 100% vested in any employer contributions to his or her account.

If a participant terminates at early retirement age the participant receives the vested account balance at that time. The plan does not have to provide 100% vesting at early retirement age.

Participants in defined benefit plans also become fully vested upon reaching normal retirement age. However, in contrast to defined contribution plans, distributions from defined benefit plans are more complex because of the nature of the promised retirement benefit. The benefit under a defined benefit plan is always stated as an amount payable at normal retirement age, usually a monthly amount. But, the actual payment can differ depending upon whether the individual is retiring prior to reaching normal retirement age under early retirement, or had continued to work beyond normal retirement age, postponing payment of benefits until a subsequent late retirement date.

In either case, retiring early or late, the benefit payable at normal retirement age is adjusted or subsidized according to the terms of the plan to reflect the form of benefit payment and the participant's age at commencement of payments.

As a simplified example, consider a retirement benefit of $500 per month, with payments to begin upon attainment of normal retirement age 65 and continuing each month for the lifetime of the participant. Further, assume the participant was fully vested at age 50 and lives until age 90. If the participant retired early at age 60, the $500 monthly payment slated to begin at age 65 and continuing for 25 years until age 90 would have to be adjusted downward to an equivalent benefit, such that the monthly payments could begin five years earlier and continue for 30 years instead of 25 years.

Alternately, if the participant retired late at age 70, the $500 monthly payment would be adjusted upward to an equivalent benefit to be paid over 20 years instead of 25 years. Through these adjustments, the normal retirement benefit is converted into an equivalent benefit that reflects the participant's age at commencement of payments so that the plan would not be paying a greater or lesser benefit than what would have been paid had the participant retired at the normal retirement age.

Early retirement benefits under defined benefit plans also may include subsidized benefits. That is, the normal retirement benefit does not have to be actuarially reduced to reflect the earlier commencement of benefits. By subsidizing the early retirement benefit in this manner, or by providing 100% vesting at early retirement age, the plan sponsor demonstrates a willingness to absorb the additional costs associated with early retirement.

This could create an incentive for older, more highly-paid workers to retire, setting the stage for hiring younger or more affordable employees or for mitigating a pressure to downsize in less than a robust economy.

The example above used a life expectancy assumption of age 90. These types of assumptions are contained in the plan document for use in calculating benefits payable under defined benefit plans upon distributable events. As illustrated, distribution calculations under a defined benefit plan are markedly different from those of defined contribution plans and typically are performed by or under the guidance of an actuary. For this reason, terms such as actuarial adjustment and actuarial equivalent are often referred to when determining distribution calculations.

2. Timing of Distributions

In broad terms, most defined contribution plans offer distributions upon retirement or separation from service with as minimal a waiting period for processing as allowable by law and in keeping with the plan document's provisions for timing and methods of distribution. In today's daily valuation marketplace, immediate distributions to those terminating employment prior to retirement are commonplace, and the ability to receive a quick distribution should employment end is often an incentive for new employees to participate in the plan. Additionally, these distributions usually ease the burden of administering the plan.

Finding lost participants and beneficiaries as addresses become outdated or communication with the plan fails over the passage of time is so widespread a difficulty that specialized firms offer locator services, and the IRS and DOL have supplied rules and procedures for plan sponsors to follow in the search for missing participants. Consider that maintaining accounts for terminated employees and supplying them with required plan communications and financial information over an extended period of time may themselves become onerous and expensive tasks.

At the other end of the benefit spectrum from defined contribution plans are the defined benefit plans and the nature of their retirement benefits. Since the normal retirement benefit is a promised future benefit payable at normal retirement age rather than a current accumulation of funds in an individual account, it is often found that those who terminate employment prior to normal retirement age may be required to wait until normal retirement age before benefit payments begin. This allows the defined benefit plan to continue accumulating funds to pay benefits in the intervening years.

Absent a properly completed participant election to delay distributions, the Internal Revenue Code and ERISA state that commencement of benefits shall begin no later than the 60th day after the close of the plan year in which the latest of the following three events occurs:

- The participant attains the plan's normal retirement age or age 65, whichever is later;
- The 10th anniversary of the employee's participation in the plan is reached; and
- The participant terminates service with the employer.

[B] Distributions upon Disability

In addition to supplying benefits at retirement, many plans offer benefits to participants who become disabled and thereby are unable to continue working. The plan document defines what constitutes disability and disabled for plan purposes and what documentation is required to substantiate this status. Many plans apply a more liberal disability definition than the standard used for qualifying for Social Security disability benefits.

The consequences of disability as a distributable event in a defined contribution plan are fairly limited. Often the plan permits vesting to be accelerated to 100% of the existing account balances. Also, plans might set aside hours-worked prerequisites for a contribution or forfeiture allocation during the year of disability in order to increase the account balances prior to distribution. For example, a defined contribution plan might require 1,000 hours of service during the plan year in order to receive a contribution allocation unless a participant terminates service during the year for reasons of disability.

Even when separating from service because of a disability creates no additional benefits under the plan, a distribution from the plan for reason of disability may still provide some tax benefits. The distribution rules that apply to a participant upon separation from service apply to a disabled participant, but only if the plan's definition of disability equates to the Internal Revenue Code's definition as under the Social Security Act. If both definitions of disability are the same, the participant can avoid the 10% additional income tax on early distributions. Additionally, under very limited circumstances, the participant may be able to exclude disability payments from ordinary income.

More generous benefits are commonly available in a defined benefit plan. The usual form of disability benefit in a defined benefit plan is a monthly payment continuing until the earliest of:

- The date the participant reaches normal retirement age (at which time the normal retirement benefit begins);
- The time the disability ceases; or
- Death.

In some cases, in lieu of a stream of monthly payments beginning after disability or at normal retirement, the plan may allow the disabled participant to immediately receive a lump sum distribution representing the actuarially-determined current value of the participant's vested, accrued retirement benefit.

[C] Distributions upon Death

When a participant in a defined contribution nonpension plan (e.g. a 401(k) plan) dies, his or her account balance often becomes 100% vested under the terms of the plan. The death of the participant then causes the vested account balance to be distributed in a lump sum payment to those persons named or considered the participant's beneficiaries under the plan.

Spousal beneficiaries may rollover the lump sum payment to their own IRA or qualified retirement plan. Some plans also allow an allocation of contributions or forfeitures to the deceased participant's account for the plan year in which the participant dies, increasing account balances prior to distribution in recognition of the participant's service for that year.

A defined benefit plan provides a minimum death benefit for participants who die prior to reaching normal retirement. This minimum benefit, called a Qualified Pre-Retirement Survivor Annuity (QPSA), is described later in this chapter. Should the plan choose, additional benefits may be credited in the form of accelerated vesting to 100%, or accrual of benefits for the plan year.

When a retired participant who had been receiving benefit payments from the defined benefit plan dies, death occurs while the participant is in pay status. In this instance, the form of benefit payment that the participant chose at retirement determines whether any kind of death benefit or continuation of monthly payments is payable to a surviving spouse or other designated beneficiary.

The timing and method of distribution of death benefits are controlled by the plan document provisions. Generally, death benefits are available for payment as soon as reasonably possible, and in the case of surviving spousal beneficiaries often within 90 days or less. Upon receipt, death benefits become includable in gross income by the recipient, but the 10% additional income tax on early distributions does not apply. Spousal beneficiaries have the option of rolling over death benefits to another qualified plan or IRA, and as rollover-eligible distributions, 20% mandatory withholding rules apply.

If the plan allows, surviving spouses may be permitted to withdraw periodic payments from the plan or choose other distribution options. Additionally, beneficiary recipients must comply with required minimum distribution rules.

[D] Distributions upon Separation from Service

Separation from service as a result of a layoff or a resignation is a distributable event for a participant of a defined contribution plan. Because defined contribution benefits are portable, a distribution of a participant's vested account balance upon separation from service is available as soon as is administratively feasible. Sometimes a participant may need to wait until the last employer contribution is made to the account to receive his or her account balance. The employer contribution may be deposited any time up through the tax filing due date, with extension, following the year of separation. However, as discussed above, participants in a defined benefit plan who experience a layoff or who resign before retirement age generally are required to wait until normal retirement age (often 65) to receive the retirement benefit.

Separation from service does not occur if an employee continues to perform the same job despite changes in his or her employer resulting from a company-level transaction such as a merger or acquisition. In these situations, the term severance of employment is used to address employees who work each day at the same job, but one day go to sleep as employees of Company A and awake the next day as employees of Company B. They have experienced a severance of employment from Company A, but this may or may not mean they are eligible for a distribution from their former Company A's qualified plan.

The plan document, as well as the Internal Revenue Code and ERISA rules, determines whether distributions are allowed. More advanced ASPPA courses discuss severance of employment in greater detail. For purposes of this course, it is sufficient to understand that there are distinctions between separation from service and severance of employment, and it should not be assumed that they are interchangeable in meaning.

§12.04 Forms of Distribution

Essentially, there are only two basic forms for total distribution of benefits: a single payment or a series of installment payments. Types of installment payments vary based on the number, frequency, and time period over which payments are made, resulting in flexibility of payment option but also more complicated benefit calculations.

For example, payments might be monthly over the lifetime of the participant, or alternately monthly over the joint lifetimes of the participant and his or her beneficiary ending only upon the death of both individuals. Type of plan additionally plays a role: defined contribution plans almost uniformly offer the choice of a lump sum payment, while defined benefit plans are required to offer installment payment choices.

[A] Form of Distribution from Nonpension Plans

The typical form of distribution, or type of payment, in a profit sharing, stock bonus or 401(k) plan is a complete distribution of the entire vested account balance in a single payment, commonly known as a **lump sum distribution**. If no monies were transferred into the plans, as discussed below, these types of plans are permitted to restrict distribution to the form of a lump sum payment, offering the participant no other payment option. Participants entitled to receive a distribution from such a plan need only be provided with the following documents:

- A Special Tax Notice Regarding Plan Payments explaining taxation of distributions and withholding rules. Please refer to Appendix J for a sample.
- An Election for Direct Rollover of a Qualifying Distribution to transfer monies directly to another qualified plan; and
- A Withholding Election Form for income tax purposes.

Thus, in terms of administrative ease, lump sum distributions from individual account plans are relatively simple and efficiently accomplished, eliminating the necessity to keep track of the whereabouts of terminated former participants for installment payment purposes.

However, profit sharing, 401(k) or stock bonus plans may wish to offer installment payments or perhaps annuities, which are installment payments guaranteed to be paid over the course of the participant's lifetime or the joint lifetimes of the participant and a beneficiary. In the event a nonpension plan decides to include annuity payment options, additional election documentation must be provided in order for the participant to make an informed choice.

Under certain circumstances, a nonpension plan is required to offer annuity payment options. If any monies from a money purchase or target benefit plan, which are pension plans as discussed in the next section, have been transferred directly to a nonpension plan without any opportunity for the participant to elect distribution of these pension monies, then the annuity rules affiliated with these pension plans follow the transfer of these assets.

In these instances, the nonpension plan must provide annuity payment options with regard to the transferred pension plan assets. An example of this situation would be when an employer maintaining two plans, money purchase and profit sharing, decides to terminate the money purchase plan and transfer the assets into the profit sharing plan. Participants in the profit sharing plan would subsequently have prior money purchase plan individual accounts in addition to their regular profit sharing individual accounts. They would then be given annuity payment options regarding distribution of their prior money purchase plan monies.

[B] Form of Distribution from Pension Plans

Unlike nonpension plans, money purchase, target benefit and defined benefit plans must provide annuity options for distribution. The required form of distribution, or type of payment, under a pension plan is a joint and survivor (J&S) annuity for married participants. Under this J&S annuity, distribution of benefits is made in a series of payments over the joint lifetimes of the participant and spousal beneficiary, the annuitants, and continues in the event of the death of one of the annuitants with payments made to the survivor.

For unmarried participants, the required form of distribution is a single life annuity: distribution of benefits is made in a series of payments over a single life, that of the participant.

It should be noted that these annuities are the required form of distribution from pension plans in the absence of any elections by the participant to the contrary. A married participant may, with proper spousal consent, as applicable, select a different form of payment. For spousal consent to a distribution other than the joint and survivor annuity, the spouse completes a Waiver of Joint and Survivor Annuity Form. In fact, most participants in pension plans select a lump sum payment instead of an annuity, if the plan allows.

[C] Qualified Joint and Survivor Annuity (QJSA)

Of course not just any type of annuity meets the Internal Revenue Code and ERISA requirements for qualified plans. A **qualified joint and survivor annuity (QJSA)** provides for a series of periodic payments for the life of the participant, with a survivor annuity for the life of the participant's spouse. The amount of the survivor annuity may not be less than 50% and not more than 100% of the amount of the annuity payable during the period that the participant and spouse are both alive.

The dollar amount of the annuity payment is derived actuarially and is based on the normal retirement benefit under a defined benefit plan and the vested account balances under a money purchase or target benefit plan. (Remember also that certain nonpension plans are subject to QJSA rules as discussed above.)

An example of a QJSA is a 75% J&S annuity: upon the death of the participant, the surviving spouse receives 75% of the annuity payment amount made prior to the participant's death. Note that the plan may choose to require a participant to be married for at least one year before treating that participant as married for QJSA purposes.

Example 12-3. QJSA. Sam and Julie are married. Upon Sam's retirement, he and Julie elect to take a joint and 50% survivor annuity (the normal form of distribution) from his company's money purchase plan. While Sam is alive, each month he and Julie receive $1,000. If Sam dies before Julie, Julie is paid the survivor benefit of $500 each month ($1,000 x 50% = $500). If Sam survives Julie, he continues to receive $1,000 each month. Upon the deaths of both Sam and Julie, the annuity payments cease.

Participants entitled to receive QJSA distributions from a plan are provided therefore with annuity explanations, notices and waiver elections in addition to income tax, rollover and withholding information, including:

- A Special Tax Notice Regarding Plan Payments explaining taxation and withholding rules;
- An Election for Direct Rollover of Qualifying Distribution to transfer monies directly to another qualified plan;
- A Withholding Election Form for income tax purposes or a W-4P for the election of taxation on annuity payments;
- A Notice of Joint and Survivor Annuity Form explaining the J&S annuity;
- A Waiver of Joint and Survivor Annuity Form for spousal consent of a distribution form other than the J&S annuity; and
- An Explanation of Optional Forms, providing the relative values of the optional forms of distribution available for comparison of the choices and a discussion of the financial impact of electing an optional form if required by the regulations.

The content of these various forms has been legislated, and in many cases the IRS and DOL have provided sample language to assist plan sponsors in crafting forms that are clear and contain sufficient information to fulfill participant notice and consent requirements.

[D] Qualified Pre-Retirement Survivor Annuity (QPSA)

All plans subject to QJSA rules also need to comply with QPSA requirements. A **qualified pre-retirement survivor annuity (QPSA)** is a series of periodic payments for the life of the surviving spouse of a participant who has died before commencing payment of benefits. The participant's surviving spouse must be offered a QPSA unless the participant and spouse had previously waived the QPSA or elected an alternative form of distribution prior to the participant's death. Plans may choose to require that a participant be married for at least one year for these rules to apply.

The amount of the QPSA is the same amount that would have been made to the surviving spouse under the plan's QJSA. In general terms, the QJSA calculation and the subsequent QPSA calculation are performed as if the participant had retired one day prior to death. For money purchase and target benefit plans, in no event can the QPSA be calculated using an amount less than 50% or more than 100% of the participant's vested account balance. Of note: typically most money purchase and target benefit plans and many defined benefit plans provide QPSA benefits in excess of the 50% minimum and usually incorporate the entire account balance/accrued benefit.

Example 12-4. QPSA. Meghan is a participant in her company's money purchase plan and has an account balance of $300,000. The plan provides for a QPSA of 50% payable to the surviving spouse. She and James had been married for over one year at the time of her death. Meghan and James did not previously elect an alternative form of distribution. Under the QPSA rules, James receives an annuity for his lifetime based on at least $150,000 ($300,000 x 50%).

[E] Optional Forms of Payment

A participant in a qualified retirement plan may have other options available for receiving payments from the plan. The plan sponsor might wish to include an array of choices beyond those that are required by law so participants may select the best option to suit their individual needs. For example, a participant may want to take a lump sum distribution from a money purchase plan instead of a joint and survivor annuity because the participant feels confident that he or she can invest the monies to yield a larger retirement income than that provided by the annuity.

Other participants may prefer taking distributions in an annuity form to be assured that payments continue for the participant's life or the joint lifetimes of the participant and a beneficiary. To assist in the decision-making, participants are often advised to consult with their personal financial advisors prior to making an election.

Curtailing the number of optional forms of distribution under a plan is in part an administrative consideration. Balanced against a desire to offer multiple choices is a need to control the amount of literature and calculations that must be provided to participants regarding each option. Too many similar choices also may create confusion.

Given the enormity and far-reaching consequences of decisions regarding distribution options, the rules regarding disclosure of the relative values of optional forms of payment and income-tax ramifications of different distribution choices result in specific notification and informational forms which must accompany election forms. Consequently, in common practice, multiple types of J&S annuities or a large variety of installment payment time periods are not often found within one plan.

When present, in addition to the types of payment previously discussed, optional forms of distribution ordinarily include:

- Annuities with period certain payments: annuities that are guaranteed to be paid for the specified period. For example, a life and ten year certain annuity is a series of payments to the participant for his or her lifetime with guaranteed payments for ten years. Should the participant die after six years, the remaining four years of payments are paid to the participant's beneficiary. Contrast this with a life annuity that ceases when the participant dies, even if death occurs after only one payment.
- Installment payments: Payments made directly from a participant's account balance over a period not to exceed the participant's life expectancy at the time payments begin, or payments not to exceed the joint life expectancies of the participant and the participant's beneficiary. As an example, a plan might offer installment payments over five years.
- Other forms of payment: Additional distribution options may include in-kind distributions of employer securities, that is, a distribution of the actual shares rather than cash, or transfer of ownership from the plan to the participant of other assets specifically held for the participant's benefit such as insurance contracts.

§12.05 Involuntary and Required Minimum Distributions

[A] Involuntary Distributions

Sometimes called cash out distributions or force-outs, involuntary distributions represent an allowable method for handling small account balances under defined contribution plans or small vested accrued benefits under defined benefit plans. There are issues to consider regarding involuntary distributions, including the form of payment and the manner of payment.

The involuntary distribution rules provide a dollar amount under which all distributions may be made in a lump sum without spousal consent. Providing a lump sum is usually cheaper for the plan sponsor and easier for the participant.

Consider a terminated, married participant with a $2,000 account balance under a money purchase plan. The annuity rules attendant upon money purchase plans would require that the form of benefit payment be a joint and survivor annuity unless the participant elected otherwise with spousal consent. Perhaps the $2,000 account balance would translate to a $2 monthly payment to the participant, reducing to a 50% payment of $1 per month to the surviving spouse upon the death of the participant.

This annuity is too small for most insurance companies to be willing to pay it. In addition, rather than processing all the participant and spousal paperwork surrounding this annuity option for such a small annuity amount, the plan could incorporate the provision for forcing this small balance to be paid in a lump sum payment to the participant without requiring the consent of the participant or the spouse to this form of distribution. The participant would then need only income-tax, withholding and rollover documents. As long as the benefit to be paid is below the involuntary distribution limit under the plan, the Internal Revenue Code and ERISA, any QJSA or QPSA provisions that would otherwise apply may be set aside in favor of an immediate lump sum payment.

The plan document contains the involuntary distribution provision under the plan. The law allows involuntary distributions of account balances of $5,000 or less for defined contribution plans, and for defined benefit plans those vested accrued benefits whose current value is $5,000 or less. Plans may decide to set a lower threshold for involuntary distributions, such as $3,500, or forego entirely the ability to involuntarily distribute benefits.

The manner in which these involuntary distributions can be made also is simplified. Until March 28, 2005, the plan document identified whether the involuntary distribution was paid as a cash lump sum or whether it was rolled over to an IRA. Most plan documents were written to require distribution in cash.

Effective for involuntary distributions made on or after March 28, 2005, qualified retirement plans cannot cash out benefits worth more than $1,000 unless the participant affirmatively elects to receive cash. Without the participant's election, any involuntary distribution must be automatically rolled over to an IRA. The plan administrator establishes the IRA with a trustee unrelated to the employer on behalf of a participant and makes initial investment decisions for the IRA. Under the final rules, amounts under $1,000 also may be automatically rolled or may be cashed out, depending on the terms of the plan document.

Occasionally, the plan sponsor is unable to locate a participant who is entitled to a distribution. In order to find these people, the DOL provides four mandatory search methods that are used by all fiduciaries to attempt to locate a participant prior to the participant being classified as lost. Lost participants can have an IRA established for them without their consent or election. The mandatory methods required to be taken to declare someone lost are:

1. Mail the distribution packet via certified mail.
2. Check related plan records for any other address for the participant.
3. Check with the participant's beneficiary to attempt to locate the participant.
4. Make use of either the IRS or Social Security Administration's letter forwarding services to send the participant the required distribution forms (The IRS [www.irs.gov] and SSA [www.ssa.gov] have published guidelines.)

Once a participant has been declared lost, an IRA can be established for them. Each financial institution has created its own process for dealing with the establishment of lost participant IRAs.

Note: A lost participant's vested account balance or value of the vested accrued benefit should be transferred to an IRA as soon as administratively feasible after it has been determined that the participant is lost. The $5,000 limit described above does not apply for this type of involuntary distribution. In the event the plan does not incorporate the involuntary distribution rules, these lost participant rules automatically take affect upon plan termination allowing the plan to pay all participants, even those it can't find.

[B] Required Minimum Distributions

Distribution of retirement benefits cannot be postponed indefinitely. Qualified retirement plans are not meant to function as an estate-planning tool for accumulating wealth to bequeath to one's heirs. Consequently, all qualified retirement plans including IRAs must comply with minimum distribution rules. Generally speaking, once a participant becomes subject to minimum distribution rules, each calendar year he or she must receive at least a required minimum amount from the qualified plan.

To comply with the Internal Revenue Code, participants reaching age 70½ who are not 5% owners of the employer must begin receiving required minimum distributions (RMD) by the April 1st of the calendar year following the later of:

- The calendar year in which the participant attains age 70½; or
- The calendar year in which the participant retires.

Participants who are 5% owners may not postpone receipt of required minimum distributions until retirement. They must begin minimum distributions by April 1st of the calendar year following the year in which they attain age 70½.

For both 5% owners and non-5% owners the required minimum distributions for the second and subsequent years must be distributed by December 31.

Example 12-5. Required Minimum Distributions. Terry turns 70½ on August 2, 2006, and retires after a long career. Since Terry has become subject to required minimum distribution rules for the calendar year 2006, he must begin receiving required minimum distributions no later than April 1, 2007.

Since participants subject to minimum distribution rules must receive a distribution for each applicable calendar year, the initial required minimum distribution is due for the calendar year in which age 70½ is attained. Participants turning 70½ could choose to receive a distribution by December 31st. Alternately, if a participant elects to delay the initial required minimum distribution until April 1st of the calendar year following that in which he or she turned 70½, the result is receipt of two payments in one year: the delayed payment from the year the participant reached age 70½ and the minimum for the following year.

This can result in a higher tax burden for this individual in the year the two distributions occur. The decision to elect to defer the initial payment should be made after the participant consults a financial advisor.

Example 12-6. Delayed Required Minimum Distribution. Sophia turns 70½ on October 27, 2005, and continues employment. An officer and a 5% owner, Sophia decides to delay receipt of her first minimum distribution until April 1, 2006. Consequently, she receives two payments in 2006: the required minimum for calendar year 2005 by April 1, 2006 and the required minimum for 2006 by December 31, 2006.

The specialized calculations of the required minimum amount are covered in advanced ASPPA courses.

§12.06 Taxation

[A] In General

In broad terms, distributions from qualified plans become part of the gross income of the recipient for the year in which they are received. The specific tax consequences and any opportunities to defer taxation of a distribution depend on the reason for the distribution, the form of the distribution, and the identity of the person receiving the distribution. As examples, taxation issues differ for a required minimum distribution as compared to a retirement distribution; if there are after-tax employee contributions as part of the distributed amount or if the distribution contains shares of employer stock; and whether the recipient is the participant or a non-spousal beneficiary.

Certain distributions may be rolled over or transferred directly in whole or in part to another qualified plan or IRA, thus deferring or reducing taxation. For example, eligible rollover distributions include those to a participant who terminates employment, attains age 59½, retires or becomes disabled. Spousal beneficiaries receiving death benefits are additionally allowed rollovers, as are spouses or former spouses of participants who receive distributions from the plan as the result of a divorce. In contrast, required minimum distributions, corrective distributions resulting from maximum annual benefit failures, and death benefits paid to non-spousal beneficiaries are examples of distributions that cannot be rolled over. These remain subject to individual income tax rules.

Numerous tax advantages may exist for distributions that cannot be rolled over. Special income tax averaging methods might be available or long-term capital gains treatment. Distributions in the form of an annuity also carry some tax advantages. These rules are complicated, but can be financially beneficial to qualified participants and their spouses. (Further detailed discussion of taxation issues is contained in the advanced ASPPA courses.)

[B] Excise Taxes and Additional Income Taxes

Excise taxes and additional income taxes on distributions from qualified plans include:

- A 50% excise tax for failure to take required minimum distributions; and
- A 10% additional income tax on early distributions (received prior to age 59½ unless certain exceptions apply).

Failure to receive a required minimum distribution results in an excise tax payable by the participant of 50% of the amount that was not distributed by the applicable deadline. Note that payment of this excise tax is not a substitute for receipt of the required distribution. The required minimum distribution must still be made, and the 50% penalty paid in addition to any income taxes.

Usually, when a participant who has not attained age 59½ receives a distribution from a qualified retirement plan, the IRS imposes a 10% tax in addition to any ordinary income taxes. Some of the limited exceptions to this rule are distributions made upon death, disability or separation from service after attainment of age 55.

Further detailed discussion of taxation issues is contained in the advanced ASPPA courses.

[C] 20% Withholding Rules

The imposition of mandatory 20% federal income tax withholding on amounts distributed from a qualified plan depends on whether or not the distributed amount is eligible for rollover treatment. The Internal Revenue Code imposes mandatory 20% withholding for any taxable distribution over $200 that is eligible for rollover treatment but is paid directly to the participant. If the participant decides to roll over an eligible distribution directly from the distributing plan to an IRA or another qualified plan, the rollover is accomplished tax-free, and no withholding applies since taxation has been deferred.

If the distribution is not eligible for rollover treatment, no mandatory 20% withholding applies. Instead, the plan may choose to allow the participant to elect a withholding amount such as 10% or to elect no withholding at all. If the amount of the distribution is $200 or less, whether or not rollover-eligible, withholding is not required.

The Internal Revenue Code specifically excludes the following from the definition of eligible rollover distributions:

- Withdrawals due to financial hardship;
- Substantially equal periodic payments over the participant's life expectancy for a period of ten years or longer; and
- Required minimum distributions.

Example 12-7. Lump Sum Distribution. Cory terminates employment with a vested account balance of $20,000 that is eligible for rollover treatment. Cory elects to receive the $20,000 in a cash lump sum payment. Under the mandatory 20% withholding rules, the plan issues a check for $16,000 to Cory and makes a $4,000 federal income tax deposit to the IRS representing the taxes withheld from Cory's distribution. At the proper time, the plan issues a Form 1090-R to Cory for use in reporting the distribution and taxes withheld in conjunction with Cory's personal income tax filing.

Under the rollover rules, a participant has 60 days to roll over eligible funds. If the participant subsequently decides to roll over part or all of a distribution previously received to avoid any taxation, he or she may need to use personal savings to make up for the amounts deposited with the IRS as income taxes paid. The participant would then recover the withheld amounts when filing that year's personal tax return.

Example 12-8. Subsequent Rollover. Cory receives the $16,000 check from the plan on October 1. On October 31st, Cory decides to defer payment of all taxes associated with the distribution from the retirement plan. Withdrawing $4,000 from personal savings, Cory rolls over $20,000 into an IRA. Later, Cory claims credit for $4,000 in income tax payments and reports the $20,000 rollover as an exclusion from gross income.

In addition to any required federal income tax withholding, if a participant lives in a state that mandates state income tax withholding and elects or is required to have federal tax withheld, state income tax also is withheld. State tax also can be withheld for participants who live in a state that does not require state income tax to be withheld when the participant elects state withholding on the distribution request form.

Note that although the plan administrator may be required to withhold 20% of the distribution amount and send it to the IRS to be credited to the taxes of the recipients, the recipients may owe additional taxes on the distribution and be required to pay them when filing their income tax return for the year. Thus, an election of a lump sum distribution may be reduced by 20% Federal tax withholding and state taxes if required before the person receives the distribution check. In addition, if the person is in a higher tax bracket than 20% for the year of the distribution, more taxes are owed on the distribution when filing the current year's federal income tax return. The 10% additional income tax for those recipients under age 59 ½ also may be owed at that time. The person receiving the distribution may be able to use special tax rules to reduce the taxes owed. For instance, the entire distribution may be reported as ordinary income and might qualify for ten-year forward averaging.

To assist participants in assessing the implications of rollovers and withholding, the plan administrator must provide written notice regarding income tax and withholding rules, generally called the Special Tax Notice Regarding Plan Payments after the IRS' sample language. Please refer to Appendix J for a sample. In fulfillment of disclosure and consent requirements for qualified plans, this written notice is given to the participant within a reasonable time before a distribution is made to allow the participant sufficient time to consider these taxation issues. The following information must be provided:

- Availability of the direct rollover;
- Income tax withholding rules, including the 20% mandatory withholding rules;
- Information about the 60 day rollover rule; and
- Any other special tax rules that may apply.

§12.07 Key Terms

Lump Sum Distribution: A complete distribution of the entire vested account balance in a single payment.

Normal Retirement Age: Cannot be greater than 1) the time a participant attains age 65, or if later 2) the fifth anniversary of the participant's initial date of plan participation.

Qualified Joint and Survivor Annuity: Provides for a series of periodic payments for the life of the participant with a survivor annuity for the life of the participant's spouse.

Qualified Pre-Retirement Survivor Annuity: A series of periodic payments for the life of the surviving spouse of a participant who has died before commencing payment of benefits.

§12.08 Review of Key Concepts

- Distributions from qualified plans are generally not permitted until the occurrence of a distributable event, such as:

  Retirement;
  Separation from service;
  Death; and
  Disability.

- Normal retirement and early retirement are events defined in a plan that allow a participant to receive plan distributions.

- Upon reaching normal retirement age, participants must become fully vested in their account balances or accrued benefits.

- Normal retirement age cannot be greater than 1) the time a participant attains age 65, or if later 2) the fifth anniversary of the participant's initial date of plan participation.

- The plan document specifies whether or not a plan allows for accelerated 100% vesting upon early retirement, death or disability.

- Lump sum distributions are the normal form of payment in most profit sharing, 401(k) and stock bonus plans.

- The normal form of payment in a money purchase, target benefit or defined benefit plan typically is a QJSA for married participants and a single life annuity for unmarried participants. Participants can elect out of the normal form with spousal consent.

- A qualified joint and survivor annuity (QJSA) provides for a series of periodic payments for the life of the participant with a survivor annuity for the life of the participant's spouse.

- A qualified pre-retirement survivor annuity (QPSA) is a series of periodic payments for the life of the surviving spouse of a participant who has died before commencing payment of benefits.

- A plan <u>may</u> allow involuntary distributions of account balances or accrued benefits whose current value is $5,000 or less.

- Effective for involuntary distributions made on or after March 28, 2005, qualified retirement plans cannot cash out benefits worth more than $1,000 unless the participant affirmatively elects to receive cash. Without the participant's election, any involuntary distribution must be automatically rolled over to an IRA.

- A plan must begin distributions to participants reaching age 70½ who are not 5% owners by April 1st of the calendar year following the later of 1) the calendar year in which the participant attains age 70½ or 2) the calendar year in which the participant retires.

- Participants who are 5% owners cannot postpone receipt of required minimum distributions past April 1st of the calendar year following the year in which they attain age 70½.

- Distributions from qualified plans are ordinarily included in the gross income of the recipient for the year in which they are received. Taxation can be deferred by rolling the distribution into an IRA or other qualified plan as long as the distribution is eligible for rollover treatment.

- The Internal Revenue Code imposes mandatory 20% federal income tax withholding for any taxable distribution over $200 that is eligible for rollover treatment but is paid to the participant.

§12.09 Review Questions

[A] True or False

______ 1. A typical form of distribution in a profit sharing plan is a lump sum distribution.

______ 2. Late retirement is when someone terminates employment upon attaining normal retirement age but does not start receiving distributions until a much later date.

______ 3. A plan may set the involuntary distribution threshold at $2,500.

______ 4. Absent any election by the participant, the normal form of distribution in a pension plan is an annuity.

______ 5. A failure to take a required minimum distribution results in a 50% excise tax to the plan sponsor.

[B] Multiple Choice

6. All of the following are eligible rollover distributions, **EXCEPT**:

   A. A distribution to a participant who terminated employment
   B. A distribution to a participant who is age 59½
   C. A distribution to a participant who retired
   D. A distribution to a participant who is disabled
   E. A distribution to a participant, age 40, due to financial hardship

7. All of the following statements regarding a QJSA are **TRUE, EXCEPT**:

   A. A QJSA is a series of payments over the joint lifetimes of the participant and the participant's spouse and continues in the event of the death of one of them.
   B. A QJSA is a single life annuity for an unmarried participant.
   C. The amount of the survivor annuity must not be less than 50% of the amount payable to the participant.
   D. All married participants are required to receive their distribution in the form of a QJSA.
   E. A notice must be provided explaining what is a QJSA.

8. Based on the following information, determine the latest date the participant must begin receiving a required minimum distribution (RMD):

- The participant's date of birth is September 1, 1936.
- The participant is a 50% owner.
- The participant is still actively employed.

A. September 1, 2006
B. March 1, 2007
C. April 1, 2007
D. December 31, 2007
E. April 1, 2008

9. All of the following statements regarding required minimum distribution (RMDs) are **TRUE, EXCEPT**:

A. A terminated participant turning 70½ may choose to receive a required minimum distribution by December 31 in the year the participant becomes 70½.
B. A required minimum distribution is made one time and when made no further distributions need to occur.
C. Participants reaching age 70½ and retiring can postpone receiving their first required minimum distribution until April 1st of the calendar year following the year they reach age 70½.
D. Participants who are 5% owners may not postpone receipt of required minimum distributions until retirement.
E. Active participants age 70½, who are not 5% owners, can postpone receiving required minimum distributions.

10. Based on the following information, determine when Participant A will reach normal retirement age:

- The plan uses the maximum normal retirement age allowed under the Internal Revenue Code and ERISA
- Participant A's date of birth is July 1, 1940.
- Participant A's date of hire was June 1, 2001.
- Participant A's date of plan participation was July 1, 2001.
- The plan year end is June 30.

A. January 1, 2005
B. July 1, 2005
C. January 1, 2006
D. July 1, 2006
E. June 1, 2011

11. All of the following statements regarding QPSAs are **TRUE, EXCEPT**:

    A. The plan may require the spouse to have been married to the participant for six months to be eligible for the benefit.
    B. The distribution to the spouse must be offered in the form of a QPSA unless the participant and spouse had elected a different form prior to the participant's death.
    C. It is a series of periodic payments for the life of the surviving spouse of a participant who died before payment of benefits began.
    D. In a money purchase plan the benefit must be equal to at least 50% of the participant's vested account balance.
    E. The QPSA is determined as if the participant had retired one day prior to the date of death.

12. All of the following are distributable events for the participant, **EXCEPT**:

    A. Retirement
    B. Disability
    C. Death
    D. QDRO
    E. Termination of service

§12.10 Answers

1. **True.** A typical form of distribution in a profit sharing plan is a lump sum distribution. §12.04 [A]

2. **False.** Delayed distribution is when someone terminates employment upon attaining normal retirement age but does not start receiving distributions until a much later date. §12.03 [A]

3. **True.** Involuntary distributions are available for amounts of $5,000 or less, depending on the plan document. §12.05 [A]

4. **True.** Pension plans are required to pay distributions in the form of an annuity unless the participants (and spouse, if applicable) elect a different form. §12.04 [B]

5. **False.** The failure to take a required minimum distribution may result in a 50% excise tax to the participant, not the plan sponsor. §12.06 [B]

6. The correct answer is **E.** §12.06 [A]

   A. Incorrect. This statement is true because a distribution to a participant who terminated employment is an eligible rollover distribution.
   B. Incorrect. This statement is true because a distribution to a participant who is age 59½ is an eligible rollover distribution.
   C. Incorrect. This statement is true because a distribution to a participant who retired is an eligible rollover distribution.
   D. Incorrect. This statement is true because a distribution to a participant who is disabled is an eligible rollover distribution.
   E. Correct. This statement is false because hardship distributions are not eligible for rollover.

7. The correct answer is **D.** §12.04 [C]

   A. Incorrect. This statement is true because a QJSA is a series of payments over the joint lifetimes of the participant and the participant's spouse and continues in the event of the death of one of them.
   B. Incorrect. This statement is true because a QJSA is a single life annuity for an unmarried participant.
   C. Incorrect. This statement is true because the amount of the survivor annuity must not be less than 50% of the amount payable to the participant.
   D. Correct. This statement is false because participants may elect a a different form of payment.
   E. Incorrect. This statement is true because a notice must be provided explaining what is a QJSA.

8. The correct answer is **E.** A 5% owner is required to take minimum distributions no later than April 1st of the calendar year following the year in which he or she attains age 70½. This participant was born September 1, 1936 and attains age 70½ on March 1, 2007. Therefore, required minimum distributions must begin no later than April 1, 2008. §12.05 [B]

9. The correct answer is **B.** §12.05 [B]

   A. Incorrect. This statement is true because a terminated participant turning 70½ may choose to receive a required minimum distribution by December 31 in the year the participant becomes 70½.
   B. Correct. This statement is false because once begun, a required minimum distribution is due each year.
   C. Incorrect. This statement is true because participants reaching age 70½ and retiring can postpone receiving their first required minimum distribution until April 1st of the calendar year following the year they reach age 70½.
   D. Incorrect. This statement is true because participants who are 5% owners may not postpone receipt of required minimum distributions until retirement.
   E. Incorrect. This statement is true because active participants age 70½, who are not 5% owners, can postpone receiving required minimum distributions.

10. The correct answer is **D.** The maximum normal retirement age under the plan cannot be greater than 1) the time a participant attains age 65, or if later 2) the fifth anniversary of the participant's initial date of plan participation. Participant A attains age 65 on July 1, 2005. Participant A has five years of participation on July 1, 2006. Therefore, the maximum normal retirement age for Participant A is July 1, 2006. §12.03 [A]

11. The correct answer is **A.** §12.04 [D]

    A. Correct. This statement is false because the plan may require the spouse to have been married to the participant for at least one year to be eligible for the benefit.
    B. Incorrect. This statement is true because the distribution to the spouse must be offered in the form of a QPSA unless the participant and spouse had elected a different form prior to the participant's death.
    C. Incorrect. This statement is true because a QPSA is a series of periodic payments for the life of the surviving spouse of a participant who died before payment of benefits began.
    D. Incorrect. This statement is true because in a money purchase plan the QPSA benefit must be equal to at least 50% of the participant's vested account balance.
    E. Incorrect. This statement is true because the QPSA is determined as if the participant had retired one day prior to the date of death.

12. The correct answer is **D.** §12.02

    A. Incorrect. This statement is true because retirement may be a distributable event for the participant.
    B. Incorrect. This statement is true because disability may be a distributable event for the participant.
    C. Incorrect. This statement is true because death of the participant may be a distributable event.
    D. Correct. This statement is false because while a QDRO may be a distributable event for the alternate payee, it is not for the participant.
    E. Incorrect. This statement is true because termination of service may be a distributable event for the participant.

Chapter 13: Updating Plans and Error Corrections

§13.01 Learning Objectives

- List examples of events that require changes in plan documents.
- Explain when an employer is required to furnish a summary plan description (SPD) or a summary of material modifications (SMM).
- Describe the IRS programs available to qualified plans for correction of plan defects.
- Describe the DOL programs available to qualified plans for correction of plan defects.

§13.02 Introduction

From time to time, qualified plans need to be amended as laws governing retirement plans are issued or updated by Congress. At other times, employer considerations might instigate an amendment: perhaps the evolving needs of the plan sponsor would be best served by use of a different allocation method and adoption of a loan program, or a change in the corporate structure of the employer necessitates alternate provisions to incorporate an expanded employee population. Alternately, under less optimal circumstances, a faulty plan provision, flawed language or operational non-compliance may lead a plan sponsor to create a clarifying amendment as well as an application for IRS approval of the corrective action.

Throughout the amendment process, whatever the driving event behind the amendment, the overriding goal must be the maintenance of qualified status and the preservation of the related tax advantages for plan sponsor and participants. This chapter begins further study of the plan amendment process and procedures for corrective actions by considering:

- Law changes;
- Elective plan modifications;
- Communication of plan modifications to plan participants; and
- IRS/DOL correction programs.

§13.03 Law Changes

Upon the enactment of ERISA in 1974 and that Act's complete overhaul of existing pension law, Congress established fundamental rules for qualified plans and their plan sponsors whose effect continues to the present day. ERISA signaled the government's acknowledgement of the importance of pension law and also a commitment toward maintaining national attention on retirement issues. As a result, with ERISA Congress began a continuing process of pension legislation culminating in new laws every two to three years.

Once the law is amended, the IRS interprets the legislation and issues guidance through regulations, procedures, notices, rulings, announcements, model amendments and other assistance. In addition, the IRS may periodically update its previous guidance. As an example, when there are significant and far-reaching pension law changes, the IRS issues model language for inclusion in plan documents. This language is generally referred to as the **List of Required Modifications or (LRM)**. Similarly, the DOL functions as another source of guidance and public information, in particular with regard to participant issues.

Within the context of pension legislation, the federal courts also exert influence by ruling on ERISA through their decisions in actual court cases. Broadly speaking, the impact of court cases on any individual plan sponsor is small since court matters are most often a resolution between two parties. However, when an ERISA-related decision is that of an appeals court or the Supreme Court of the United States, the pertinent ruling may cause all qualified plan documents to be amended.

Thus, law changes requiring plan amendments or document restatements include not only direct legislative changes mandated by Congress but also interpretative changes mandated by the IRS, the DOL and the federal courts.

Legislatively mandated revisions to a plan take place on two levels: in form and in operation.

[A] Form

The plan document is amended formally to incorporate the legislative changes in the plan. The timeliness of such amendments is determined based on the **remedial amendment period (RAP)** that is prescribed by the IRS. When there are substantive new legal requirements, the RAP usually extends for several years beyond the effective date of the legislation. This allows the scope of the new law to be understood fully and gives sufficient time for conforming language to be developed and reviewed by attorneys and other retirement plan service providers, or for model language and other guidance to be offered by the IRS.

For example, the RAP affiliated with EGTRRA, which was adopted in June 2001, extended to the last day of the plan year that began in 2005. Sponsors of calendar year plans, then, had until December 31, 2005, to amend their plan documents for EGTRRA requirements. In effect, during the RAP a plan document is amended retroactively so that its provisions duly reference the effective date of the applicable legislation, which as illustrated can be many years in the past.

[B] Operation

Additionally, the plan must be in operational compliance with the new laws as required by Congress. Given the length of time represented by the RAP, the operational changes to a plan are often required years before the plan document is formally amended to include the actual language of the change or plan modification. In other words, a remedial amendment period extending into the future does not mean a plan may ignore effective legislation until the plan document has been updated. During the RAP, a plan needs to be in operational compliance with all applicable legislation. (Note the suggested use of an operational log during a RAP to document operational compliance.)

§13.04 Elective Changes to Plan Features

Elective changes to the plan document represent the plan sponsor’s ability to tailor its qualified plan to fit that sponsor’s intended purpose for maintaining a qualified plan as part of an overall employee benefit program. As the sponsoring organization adjusts its qualified plan goals over the course of time, the plan can be similarly adjusted to suit its sponsor’s evolution. As long as the desired adjustment does not conflict with ERISA and the Internal Revenue Code and is allowable under those strictures, the plan may be redesigned at the will of the employer.

Aside from the legislative admonition to stay within the guidelines surrounding qualified plans during a plan redesign in order to maintain tax-advantaged status for all concerned parties, there are a few administrative and non-discrimination governing principles that the plan sponsor should review during the amendment process.

[A] Written Procedure

The plan document must contain a written procedure for amending the plan and identify that person who has been granted legal authority to amend the plan. According to the Supreme Court, this plan document provision might simply state that the Company has the authority and is permitted to amend the plan document.

Bear in mind that a formal amendment to the plan document, signed and executed in a timely fashion, fulfills a plan's written amendment procedure as set forth in the plan document. A corporate resolution by the plan sponsor to amend its qualified plan would not have the same legal status as a formal amendment and should therefore be followed by an executed plan amendment to accomplish the desired revision to the governing plan document.

[B] Anti-Cutback

An amendment cannot eliminate benefits or rights that have already been accrued by participants (known as the anti-cutback rule). For example, if the plan sponsor wishes to amend the plan's vesting schedule to require increased service before attainment of full vesting, the new vesting schedule cannot lower a participant's pre-amendment vested percentage.

In general, future benefits such as the ability to have a participant loan or the pre-amendment higher benefit formula may be eliminated or lowered, but past benefits already earned must be preserved and maintained. Consideration of these anti-cutback provisions is critical. If, for example, a plan states that participants need to perform 1000 hours of service during a plan year to be eligible to receive an employer contribution allocation at the end of the plan year, the employer contribution may not be eliminated by an amendment during the plan year if any participants have performed 1000 hours of service before the date of the amendment.

[C] Determination Letter

A determination of the effect the proposed amendment exerts on the plan's current IRS determination letter or opinion letter should occur. If the amendment changes the provisions and form of the plan document such that the plan may no longer rely on its current approval letter, the plan sponsor may wish to apply for a new determination from the IRS, as explained in the next section of this chapter.

[D] Administrative Process

The effect of the amendment on the administrative processes supporting the plan should be carefully assessed. For example, addition of a 401(k) elective deferral provision to an existing profit sharing plan necessitates at a minimum a host of new participant election forms, communication material, updates to the format of participant statements, new responsibilities for internal human resources personnel and expanded accounting and recordkeeping. All service-providers to the qualified plan, in particular the retirement plan administration firm, accountant, actuary and attorney must be suitably geared up so that the plan can be operated according to the terms of the newly-revised plan document.

§13.05 Submitting Amendments for a New Determination Letter

A plan can be amended to comply with qualification requirements or it can be amended to modify terms that do not relate to qualification issues. After considering the extent and breadth of a plan amendment, and especially if that breadth takes the amendment beyond available model language, the employer may want to be assured that significant changes do not adversely affect the qualified status of the plan. For this reason, obtaining an updated favorable determination letter generally provides the plan sponsor with a certain peace of mind that the post-amendment plan document still complies with the law.

Bear in mind that a favorable determination letter does not guarantee that the plan has achieved qualified status: the plan must adhere to qualified plan rules in operation. But receipt of a favorable determination letter can at a minimum assure the plan sponsor that the document that governs the plan's operation and to which all operational questions defer is qualified in form.

The type of qualified plan document also can influence the plan sponsor's decision on whether or not to submit the newly-revised plan document to the IRS. If a prototype plan document is used and the employer is simply choosing a different plan provision from those available in the master or prototype arrangement, the plan remains covered under the opinion letter issued by the IRS to the prototype's sponsoring organization. Of course, plan sponsors using prototype documents are able to apply for an individual letter of determination if desired. When a plan sponsor wishes to deviate from the allowable language or options under a master or prototype plan, that deviation, however minute, renders the plan off-prototype and turns it into an individually designed plan.

Under those circumstances, as with all individually designed plans, the plan sponsor is well-advised to submit the plan document to the IRS to garner an official opinion concerning qualified status. Given that timely filing for a determination letter can have an effect on extensions of remedial amendment periods or allow an opportunity for dialogue between the IRS and the plan sponsor in order to resolve any document qualification issues, applying for a determination letter may well be worth the filing fee.

§13.06 Communication of Amendments to Participants

The plan is not considered amended unless the amendment has been timely communicated to affected plan participants and beneficiaries. Under the disclosure rules of Title 1 of ERISA, participants and beneficiaries are entitled to receive information that accurately explains the terms of the plan. To further this effort, ERISA prescribes two different forms of communication that an employer must at a minimum provide to these interested parties, as applicable:

[A] Summary Plan Description (SPD)

The SPD is the primary means of explaining plan provisions and the rights of participants and beneficiaries under the plan. It must be up-to-date as a stand-alone document or in conjunction with subsequent SMMs. The SPD was discussed in detail in Chapter 5.

[B] Summary of Material Modifications (SMM)

A summary of material modifications notifies participants of minor plan changes that are not sufficient in scope to require a new SPD. Since the SMM functions as a modification of the SPD, the SMM also must be a plain language explanation of the changes to the SPD, written in a manner that the average employee easily understands. The SMM must include:

- Plan name;
- Plan number;
- Plan sponsor name and tax identification number;
- Effective date of the change or modification; and
- The wording of the applicable SPD sections after the plan amendment or other change.

The SMM must be distributed to participants within 210 days after the close of the plan year in which the change was adopted. Where the SMM's reported changes do not affect the rights of the retired or terminated participants and beneficiaries receiving benefits under the plan, the SMM is not required to be furnished to these individuals.

Within 90 days after becoming participants, new participants under a plan must receive an SPD with any applicable SMMs subsequently issued that modify the SPD's provisions. Of course, when the latest SPD contains language that incorporates previous SMMs, only the SPD is provided. As discussed in Chapter 5, SPDs must be updated at least once every ten years, or at least once every five years if SMMs have been issued regarding changes to the SPD. Updated SPDs are distributed no later than 210 days after the end of the plan year in which they were updated.

SPDs and SMMs were at one time required to be filed with the DOL. Although this filing requirement was eliminated by TRA '97, the DOL may request copies of the SPD or SMM to be furnished within 30 days. If the requested documents are not furnished, the DOL may assess a penalty of up to $110 per day with a maximum of $1,100 per incident. Participants may ask the DOL to obtain a copy of the SPD or SMM if the disclosure deadlines set forth above have passed. Alternately, if the plan fails to distribute SPDs or SMMs by the requisite deadline, a participant can make a formal request to the plan administrator. Failure to comply with the participant's request within 30 days also could result in a penalty of $110 per day under ERISA.

§13.07 Operational Changes That Modify Plan Administration Procedures

As previously noted above, when Congress passes pension legislation, the effective date for the new laws is often immediate or soon after the legislation is passed. However, the remedial amendment period for conforming plan documents to these new laws often requires updated plan documents to be drafted and signed several years later. During this interim period, the plan administrator must operate the plan in good faith compliance with the law changes. Indeed, the applicable extension of time for updating plan documents as offered by the RAP is conditioned on good faith compliance by plan sponsors. This concept is of such importance that often sample good faith amendments are issued by the IRS for plan sponsor use.

But the notion of Congressional legislation as the sole driver of plan language changes or that legislative actions exclusively affect just the plan document is a short-sighted notion at best. Many times law changes require plan administration that differs significantly from what was previously required. For example, when the Unemployment Compensation Amendments Act of 1992 (UCA '92) was enacted into law, both rollover rules and the distribution notice requirements were revised and extended. To explain the ability to roll over distributions and the applicable mandatory 20% withholding requirements (addressed in Chapter 12), employers had to construct administrative procedures to provide terminated employees with these required disclosures and to accommodate the timing of notification rules and proper opportunity for terminated participants to consider their decisions.

Alternately, IRS or DOL procedural guidance and not a pension law change can require a plan sponsor and plan administrator to amend the plan and provide disclosures that give the participant information about the new procedures and operation of the plan.

§13.08 Government Audits and Correctional Programs Offered by the IRS and DOL

The emphasis on achieving and maintaining qualified plan status is to avoid the potentially dire consequence of losing qualification and surrendering tax-advantaged status. Disqualification can happen prospectively or retroactively, if the disqualifying defect occurred in the past, with the following results for years of disqualification:

- The employer's contribution deductions may be disallowed to the extent participants are not vested;
- Earnings on plan assets may become currently taxable to the trust;
- Participants may have to include vested benefits in their gross income; and
- Tax-free rollovers of distributions may be disallowed.

As one might imagine, plan disqualification is the unhappy outcome of an audit by the IRS or DOL, who share information. Both government agencies routinely audit a number of plans, chosen either at random or under a directed process. The IRS' directed process is based on the yearly Form 5500 filings with the DOL: answers to certain questions on the form can serve as audit flags. For example, a "yes" response to the question concerning failure on the part of the employer to remit to the plan in a timely manner any elective deferrals and participant loan payments would likely merit governmental scrutiny.

The DOL's directed selection process generally concerns plans that have been brought to the DOL's attention for known or suspected violations of ERISA. Perhaps participants have consulted the DOL as their advocate and requested a review of their employer's plan, or perhaps a news organization reports employee concerns surrounding the validity of a particular plan and its sponsor.

Whatever the audit trigger, if a retirement plan has been properly created and administered, an audit results in no changes for the plan sponsor or the participants. However, if the plan has been incorrectly administered, if the plan documents are not up-to-date or if the plan fiduciaries have improperly handled plan assets the consequences of a government audit can be significant.

It should not be assumed that the automatic and sole conclusion to an IRS or DOL audit where issues have been discovered is plan disqualification. Both agencies approach disqualification carefully, with an understanding of the potential impact plan disqualification would have on participants. More often, if the plan has failures *in form* (the plan document, SPD or the administration forms) or *in operation* (the plan is being operated in violation of the law or not in accordance with the terms of the plan document) the IRS notifies the plan sponsor of the failures and requires the plan sponsor to take corrective action. Similarly, the DOL works with the plan sponsor to correct defects, assessing penalties as applicable such as late filing fees associated with delinquent Form 5500s.

In general terms, all parties recognize that it is not usually in the best interests of the plan sponsor and participants for a plan to be disqualified. Mistakes of all kinds can and do happen for a variety of reasons. Rather than taking a chance with audit roulette: gambling that one's plan is never chosen for audit, or if chosen the audit does not uncover known defects, or if defects are found the IRS or DOL representative goes easy on the sanctions, both the IRS and the DOL have established correction programs for use by plan sponsors to voluntarily repair plan defects. Under the programs, correction fees are relatively low to encourage use of the programs and to support plan sponsors in their ongoing efforts to establish and continually operate their plans in accordance with qualified plan rules.

There is no statute of limitations on disqualification. It is true that the tax effects of disqualification are applicable only to years not closed by the statute of limitations. However, a plan is still disqualified even if the events causing such disqualification occurred during a year closed by the statute of limitations. The statute of limitations generally is three years from the date the Form 5500 is filed.

[A] IRS Voluntary Correction Programs

The IRS' **Employee Plans Compliance Resolution System (EPCRS)** is the present culmination of a series of correction programs, the first one created in 1990, which were combined into one comprehensive correction program in 1999. EPCRS allows for voluntary correction of certain plan qualification failures such as:

- Ineligible employer defects, where an employer is not eligible to sponsor the particular type of plan in use;
- Plan document failures, where the plan document itself is incomplete, does not reflect current legislation as required, or is otherwise in violation of qualified plan rules;
- Demographic issues, where the plan has failed minimum coverage requirements, minimum participation requirements for defined benefit plans or nondiscrimination requirements; and
- Operational defects, where the qualification failure arises because the plan was not operated according to the terms of its plan document.

EPCRS encompasses the following:

- Self-Correction Program (SCP);
- Voluntary Correction Program with Service Approval (VCP), and;
- Audit Closing Agreement Program (Audit CAP).

There are correction principles and rules of general applicability under the EPCRS. First, broadly speaking, failures are not considered corrected until full correction is made to all participants and beneficiaries for all affected taxable years. The correction method should be reasonable, appropriate and consistently applied to return the plan to the position it would have been in had the defects not occurred. Additionally, there are principles governing situations where allocations of contributions or distributions from the plan are utilized as corrective measures.

EPCRS includes examples of acceptable correction methods to certain operational violations which are deemed to be reasonable and appropriate. If correcting an operational for which an acceptable correction method is included in EPCRS, that correction method should be utilized.

1. Self-Correction Program (SCP)

The **Self-Correction Program (SCP)** allows a plan sponsor that has established compliance practices and procedures the ability to self-correct insignificant operational failures at any time without contacting the IRS and without payment of any fee or sanction. The failure must have happened due to misapplication of the administrative procedures or because the practice or procedure was somehow inadequate. The plan sponsor should fix the failure using the general correction principles of the EPCRS program, document the steps taken to demonstrate compliance with SCP in the event of any future audit, and as necessary make any changes to administrative procedures such that the error does not happen again.

The factors used in determining whether or not operational failures are insignificant are:

- The number of failures that occurred during the period being examined;
- The percentage of plan assets and contributions involved in the failure;
- The number of years the failure occurred;
- The number of participants affected relative to the total number of participants;
- Whether correction was made within a reasonable time after discovery; and
- The reason for the failure.

No single factor is sufficient to determine insignificance: rather all factors influence the decision. In the case of the plan with more than one operational failure in a single year, or operational failures that occur in more than one year, the operational failures are eligible for correction only if all the operational failures are insignificant in the aggregate.

The SCP program also allows the plan sponsor to fix operational failures that are significant without payment of any sanction or fee as long as:

- The plan received a favorable determination letter or is covered by an opinion letter issued by the IRS to the prototype's sponsoring organization; and

- The correction is either completed or substantially completed by the last day of the second plan year following the year of failure; that is within a two-year correction period. For example, a failure during a plan's 2006 calendar year should be fixed by December 31, 2008.

Significant operational failures are operational failures that do not meet the insignificant criteria. Also of note: the correction period for any significant operational failure that occurs for any plan year is deemed to end on the first date the plan sponsor receives written or verbal notification from the IRS or DOL that the plan is under examination for that plan year. Thus, correction under the SCP cannot be completed after notice that the IRS or DOL is auditing the plan year at issue. This is a significant issue since improvements in procedures have expedited the IRS and DOL initial review of Forms 5500. In many cases, the IRS or DOL is issuing audit notification letters prior to the expiration of the two-year correction period under SCP. Thus, once errors are identified, plan sponsors should not use the end of the two-year correction period as a reliable deadline.

The SCP is not available to address the following failures:

- Egregious failures, those that exhibit flagrant disregard of qualified plan rules;
- Plan document failures;
- Demographic failures;
- Ineligible employer failures;
- Failures that are corrected by a plan amendment which conforms the terms of the plan document to the plan's prior operation, with limited exceptions; and
- Failures involving misuse of plan assets.

2. Voluntary Correction Program (VCP)

The **Voluntary Correction Program (VCP)** requires IRS approval and payment of a fixed fee based on the number of participants but can be employed to correct demographic failures, egregious failures, plan document failures and those operational defects that do not meet the SCP eligibility. A plan does not need to have obtained previously a favorable determination letter in order to use the VCP program. The VCP fee is as low as $750 (for plans with less than 20 participants) and as much as $25,000 (for plans with more than 10,000 participants).

The application for approval may be made at any time prior to a plan audit. There are special procedures and documentation required for filing. Upon completion of the process, the IRS issues a compliance statement for approved correction methods. Within the compliance statement, the IRS identifies the failures, explains the terms of correction, sets forth the time period for implementing correction and importantly includes a representation that the IRS does not disqualify the plan due to the failures indicated. In a number of cases, the IRS follows-up after issuance of the compliance statement to ensure correction was completed.

Effective in 2002, the program permits eligible organizations to correct operational failures and receive a compliance statement. For example, a retirement plan administration firm having discovered an error in its software used in performing nondiscrimination tests ascertains that all of its clients for whom testing was performed have incorrect tests, demographic failures. The retirement plan administration firm, as a third party administrator eligible organization, could voluntarily submit for correction on all of its clients' plans under the VCP. Upon completion of the terms of the ensuing IRS' compliance statement, the clients' plans would be deemed corrected. Eligible organizations include insurance companies and third party administrative firms.

3. Anonymous Submission under VCP

Any VCP submission may be made as an anonymous submission (often referred to as "John Doe" submissions). When submitting an application, all information is included except the information identifying the plan and the plan sponsor. However, if the plan becomes under examination before the plan and plan sponsor are identified the plan becomes ineligible for VCP.

4. Audit Closing Agreement Program (Audit CAP)

The **Audit Closing Agreement Program (Audit CAP)** is nonvoluntary, unlike the other IRS programs, and is used when a plan sponsor is under examination or in the determination letter review process and qualification defects are discovered. Within the program, the plan sponsor and the IRS negotiate an appropriate settlement, typically resulting in larger sanctions than under the VCP. However, the clear advantage of Audit CAP is that the plan maintains its qualified status and avoids the tax consequences of plan disqualification. Given that the cost of an Audit CAP settlement is normally a fraction of the cost that would result if the plan were disqualified, the program sanctions represent a justifiable expense in light of the financial alternatives. Note that Audit CAP, like VCP and SCP, may not be used when there has been misuse of plan assets.

[B] DOL Voluntary Correction Programs

The Employee Benefits Security Administration (EBSA) of the DOL may impose monetary penalties for failure to file required reports or take civil or criminal action against the plan or plan fiduciaries for failures if discovered under audit. In addition to reporting and disclosure compliance, one of the key areas of DOL oversight is fiduciary conduct and responsibility, in particular with regard to the plan's financial dealings. Although the DOL's voluntary correction programs are less comprehensive than that of the IRS, they are nonetheless worthwhile as methods for avoiding potential civil liability under ERISA.

The DOL programs encompasses the following:

- The Delinquent Filer Voluntary Compliance (DFVC) Program; and
- The Voluntary Fiduciary Correction (VFC) Program.

1. Delinquent Filer Voluntary Compliance (DFVC) Program

The **Delinquent Filer Voluntary Compliance Program (DFVC)** provides an opportunity for plan administrators to bring their plans into compliance with reporting and disclosure rules by filing any and all previously delinquent Form 5500s. Under this program, the EBSA is authorized to waive all or a portion of the civil penalties and sanctions that may be assessed. These sanctions are normally substantial. As an example, a penalty of up to $1,100 per day for each day a plan administrator fails to file the Form 5500, a penalty of up to $1,000 for not filing an actuarial statement for defined benefit plans, and a penalty of up to $1 per day with a maximum of $5,000 for each terminated participant having vested benefits remaining in the plan who is required to be reported in the Form 5500 filing. In addition, willful violation of ERISA reporting rules or making knowingly false or concealing statements could lead to fines and imprisonment. Also, although the DFVC program does not cover late filing penalties for the IRS and PBGC, both agencies have agreed to provide a measure of penalty relief for compliance with the DFVC rules. With that in mind, the benefits of the DFVC program are clearly apparent.

To utilize the DFVC and obtain penalty relief, a plan administrator first files the delinquent Form 5500 including all required schedules and attachments as it is normally filed, which may be electronically, submitting it to the EBSA at the appropriate address listed in the Form 5500 instructions. A paper copy of the Form 5500 without accompanying schedules is then submitted with the applicable DFVC penalty amount paid by the plan administrator, not from plan assets, to the DFVC Program under the EBSA.

The applicable penalty amount is based on the number of the plan's participants and is subject to a per-plan cap to facilitate filing of all of a plan's delinquent returns under the DFVC program:

1. For small plan filers the penalty is $10 per day for each day the return is late with a maximum penalty of $750 per late return. If more than one year's late return is being submitted, the per-plan cap is $1,500.

2. For large plan filers the penalty is $10 per day for each day the return is late with a maximum penalty of $2,000 per late return. Multiple late form filings for large plan filers are subject to a $4,000 per plan limit.

<u>2. Voluntary Fiduciary Correction (VFC) Program</u>

The **Voluntary Fiduciary Correction Program (VFC)** represents an opportunity for correction of fifteen specific financial transactions involving fiduciary liability. Under this program, plan fiduciaries and other plan officials may avoid the assessment of civil penalties and other actions under ERISA by following the stated procedures for fixing the specific violations, calculating and restoring plan assets or any lost plan benefits to participants and beneficiaries and submitting an application to the DOL with documented evidence of the corrections.

The following are the listed financial violations allowable for correction under the VFC program:

- Delinquent participant contributions to pension plans;
- Delinquent participant contributions to insured welfare plans;
- Delinquent participant contributions to welfare plan trusts;
- Fair market interest rate loans with parties-in-interest;
- Below market interest rate loans with parties-in-interest;
- Below market interest rate loans with non parties-in-interest;
- Below market interest rate loans due to delay in perfecting security interest;
- Purchase of assets by plans from parties-in-interest;
- Sale of assets by plans to parties-in-interest;
- Sale and leaseback of property to sponsoring employers;
- Purchase of assets from non parties-in-interest at other than fair market value;
- Sale of assets to non parties-in-interest at other than fair market value;
- Benefit payments based on improper valuation of plan assets;
- Payment of duplicate, excessive or unnecessary compensation; and
- Payment of dual compensation to plan fiduciaries.

The IRS and DOL correction programs are discussed in greater detail in more advanced ASPPA courses.

§13.09 Key Terms

Audit Closing Agreement Program (Audit CAP): A special program by which a plan sponsor may correct a plan qualification error discovered during an IRS audit.

Delinquent Filer Voluntary Compliance (DFVC) Program: An EBSA/DOL program by which a plan sponsor which has not met certain filing requirements may file their delinquent returns.

Employee Plans Compliance Resolution System (EPCRS): A comprehensive IRS correction program that allows plan sponsors to correct plan defects voluntarily.

List of Required Modifications (LRM): Model language issued by the IRS when there are significant law changes affecting qualified retirement plans.

Remedial Amendment Period (RAP): The period of time during which a plan may be amended retroactively to conform the terms of the plan to legal requirements.

Self-Correction Program (SCP): A special program a plan sponsor can use to self-correct insignificant errors found in administering a retirement plan.

Summary of Material Modifications (SMM): A detailed summary to notify participants of minor plan changes to the plan document.

Summary Plan Description (SPD): A detailed, but easily understood, summary describing a qualified plan's provisions that must be provided to participants and beneficiaries.

Voluntary Correction Program (VCP): A program designed to handle the more common and less flagrant plan defects submitted to the IRS for review upon payment of a user fee.

Voluntary Fiduciary Correction (VFC) Program: An EBSA program designed for plan fiduciaries to identify and correct certain fiduciary failures.

§13.10 Review of Key Concepts

- When there are significant law changes, the plan document generally needs to be formally amended to incorporate those changes.

- Operational changes to a plan are often required years before the plan document is amended formally to comply with new legislation.

- An amendment cannot eliminate benefits that have already been accrued by participants. This principle is known as the anti-cutback rule.

- Receipt of a favorable determination letter can at a minimum assure the plan sponsor that the plan document is qualified in form.

- When a plan sponsor adopts an amendment, a Summary of Material Modifications (SMM) must be provided to the participants and beneficiaries.

- Disqualification of a plan can happen prospectively or retroactively, resulting in negative tax consequences for both participants and the plan sponsor.

- The IRS has developed a comprehensive program known as the Employee Plans Compliance Resolution System (EPCRS), incorporating all of the Service's correction programs available to plan sponsors.

- The DOL has two voluntary correction programs. These programs are less comprehensive than those maintained by the IRS, but are worthwhile as methods for avoiding potential liability for certain failures under ERISA.

§13.11 Review Questions

[A] True or False

______ 1. An SMM must be distributed to a participant within 210 days after the close of the plan year in which the change was adopted.

______ 2. A plan is required to be submitted to the IRS for a determination letter when an amendment is made to the plan document.

[B] Multiple Choice

3. All of the following statements regarding the DOL voluntary correction programs are **TRUE, EXCEPT**:

   A. Delinquent Form 5500s may be filed under the DOL programs with all or a portion of the penalties being waived.
   B. Delinquent Form 1099-Rs may be filed.
   C. Delinquent participant contributions may be corrected.
   D. Sale of assets by plans to parties-in-interest may be corrected.
   E. Loans issued to parties-in-interest at below market rates may be corrected.

4. All of the following statements regarding IRS programs available for correction of plan defects are **TRUE, EXCEPT**:

   A. SCP is available to correct insignificant operational failures at any time.
   B. SCP is available to correct failures involving misuse of plan assets.
   C. VCP can be used to correct plan document failures.
   D. VCP can be used to correct demographic failures.
   E. Audit CAP is used to correct qualification defects discovered by the IRS when auditing the plan.

5. All of the following events may cause a plan document to be amended, **EXCEPT**:

   A. A change in the IRS determination letter process
   B. A new IRS regulation that interprets a law
   C. The plan sponsor changes its qualified plan goals
   D. A law change that affects the plan
   E. A faulty plan provision

§13.12 Answers

1. **True.** An SMM must be distributed to a participant within 210 days after the close of the plan year in which the change was adopted. §13.06 [B]

2. **False.** A plan is never required to be submitted to the IRS for a determination letter. §13.04 [C]

3. The correct answer is **B.** §13.08 [B]

   A. Incorrect. This statement is true because delinquent Form 5500s may be filed under the DOL programs with all or a portion of the penalties being waived.
   B. Correct. This statement is false because the DOL correction programs do not currently address delinquent Form 1099-Rs.
   C. Incorrect. This statement is true because delinquent participant contributions may be corrected using DOL programs.
   D. Incorrect. This statement is true because sale of assets by plans to parties-in-interest may be corrected using DOL programs.
   E. Incorrect. This statement is true because loans issued to parties-in-interest at below market rates may be corrected using DOL programs.

4. The correct answer is **B.** §13.08 [A]

   A. Incorrect. This statement is true because SCP is available to correct insignificant operational failures at any time.
   B. Correct. This statement is false because SCP is not available to correct failures involving misuse of plan assets.
   C. Incorrect. This statement is true because VCP can be used to correct plan document failures.
   D. Incorrect. This statement is true because VCP can be used to correct demographic failures.
   E. Incorrect. This statement is true because Audit CAP is used to correct qualification defects discovered by the IRS when auditing the plan.

5. The correct answer is **A.** §13.03

    A. Correct. This statement is false because a change in the IRS determination letter process does not necessarily require a plan to be amended.
    B. Incorrect. This statement is true because a new IRS regulation that interprets a law may cause a plan to be amended.
    C. Incorrect. This statement is true because if the plan sponsor changes its qualified plan goals it may necessitate a plan amendment.
    D. Incorrect. This statement is true because a law change that affects the plan may necessitate a plan amendment.
    E. Incorrect. This statement is true because a faulty plan provision may cause a plan to be amended.

Chapter 14:
Record Retention

§14.01 Learning Objectives

- Discuss what plan records need to be kept, as well as how long these records need to be kept.
- Discuss what employee data records need to be kept as well as how long they need to be kept.
- Describe how the safe harbor electronic document record retention is satisfied.

§14.02 Introduction

To support and validate the reporting and disclosure functions inherent in qualified plan administration, plan sponsors, plan administrators, and retirement plan administration firms as service providers incorporate into their operating procedures a full and complete methodology for retaining critical plan documents, participant information, financial, and other plan data. In this manner, these records can be accessed as verification, justification, and historical documentation of the plan's compliance with applicable qualified plan regulations for internal and potentially external governmental audit purposes. As such, proper record retention, which is determining what records to keep and for how long, is essential to the administration of a qualified retirement plan.

This chapter outlines the DOL and PBGC regulations with respect to record retention, specifically examining:

- What records need to be kept;
- How long records should be kept;
- How records should be archived; and
- How plan records need to be maintained in an electronic environment.

§14.03 Proper Record Retention

ERISA has set forth specific requirements with respect to record retention, outlining the task of retaining records that support the information included in participant benefit reports or in governmental filings such as the Form 5500. Conforming to these requirements can cause significant challenges to plan sponsors and retirement plan administration firms.

The Federal Guide to Record Retention Requirements is over 150 pages long and contains far more information than the qualified plan record retention guidelines under ERISA. In addition, many states have established their own record retention requirements. Although employers may already be addressing the general issue of record retention as part of running a business, all qualified plan sponsors must begin with a complete understanding of ERISA's record retention requirements since these are applicable as part of federal law.

A retirement plan, by its very nature, generates large amounts of paper documentation. Some documents must be retained for the life of the plan, while others may be disposed of after a few years. A document retention system that periodically allows responsible parties to review, update, preserve, and dispose of documents in a rational and organized fashion fosters good administration and enables the plan to comply with ERISA. Service providers and plan sponsors alike should proceed under a familiarity with record retention requirements toward developing and following a written record retention policy that addresses both paper documents and electronic transactions.

The burden of record retention falls on the plan administrator, which is usually the employer. If a service provider such as a retirement plan administration firm has assumed the job of document retention under the terms of its service agreement, it is important to note that the ultimate legal responsibility still remains with the plan administrator. While the plan sponsor may have legal recourse to the extent a service provider failed to keep adequate records as promised, the DOL's Employee Benefits Security Administration (EBSA) would sanction the plan administrator and not the service provider. Thus, to the extent the retirement plan administration firm does not deliver reports with sufficient supporting documentation to comply with record retention guidelines, the plan administrator should take steps to obtain the supporting documentation, preferably at the time the work is performed and any reporting to government agencies is accomplished. In this manner, the plan sponsor avoids the costs of backtracking to recreate the required records.

§14.04 What Records to Keep?

The topic of proper record retention can be divided into three general areas:

1. What records need to be kept?
2. How long should records be kept?
3. How should records be archived?

The short answer to these three questions is that all plan-related materials ought to be maintained for no less than six years in a manner in which the records can be readily retrieved.

[A] What Records Should Be Kept?

Plan records for retention by a plan sponsor and plan administrator include the following:

- The full and complete plan document, properly dated and signed, along with any corporate action taken to adopt the plan and all subsequently executed plan amendments and plan restatements. It is crucial that all historical documentation clarifying the operation of the plan from its inception be identified and preserved. Dates and signatures on all documents must be easily visible and present to indicate that these were the adopted legal instruments forming the written plan. Where draft documents were prepared as part of the design process, and the plan sponsor wishes to maintain these draft versions, they should be visibly identified as draft rather than final documents. Aside from historical value and their current application as the blueprint under which the plan operates, plan documents form an audit trail and also must be available for disclosure purposes to plan participants and government agencies. For example, where a plan does not have a copy of the most recent determination letter or has never applied for a determination letter, upon application for determination, the IRS requires copies of all plan amendments as part of the application submission.
- Additionally, maintaining a log of operational compliance is a useful tool that becomes especially important during any remedial amendment period, a period of time provided after the passage of legislation for the plan document to be amended or restated to reflect that new legislation. For example, during the GUST remedial amendment period, plan sponsors were permitted to take advantage of certain changes in the law operationally without formally amending the plan document, provided that the plan when ultimately amended reflected the operation of the plan

during the remedial amendment period. The operational compliance log should include what law changes were implemented by the plan and at what point in time the change in administration became effective. This log is eventually reflected in the restated document. With the average restatement period lasting over ten years the need for formal records with respect to operational compliance cannot be overlooked;

- Copies of all corporate actions and administrative committee actions relating to the plan.
- Copies of all communications to employees, including SPDs, SMMs, and anything else describing the plan that is provided or available to participants or beneficiaries. For example, a plan's employee communication pieces may comprise video or slide presentations and explanatory emails.
- A copy of the most recent determination letter or opinion letter from the IRS, or the form to request that determination letter if one is pending.
- All financial reports, including trustees' reports, journals, bank statements, brokerage account statements, ledgers, certified audits, investment analyses, balance sheets, and income and expense statements.
- Copies of Form 5500 and all schedules and attachments.
- Payroll records used to determine eligibility and contributions, including details supporting any exclusion from participation. (It is critical that sponsors keep complete census data, not just data on those who are eligible.)
- Hours of service and vesting determinations.
- Plan distribution records and withholding deposits, including Form 1099-Rs.
- Corporate income tax returns to reconcile deductions.
- Evidence of the plan's fidelity bond.
- Documentation supporting the trust's ownership of the plan's assets.
- Copies of all documents relating to plan loans, withdrawals, and distributions, including copies of spousal consents.
- Copies of nondiscrimination and coverage test results.
- Any other plan-related materials, such as claims against the plan.

Although not legally required, it is often desirable to retain some of this information, such as the complete plan document and certain participant data, for even longer periods of time, as discussed later in this chapter.

[B] Other Records That Should Be Kept

In addition to the documentation required to support government filings, the DOL generally requires records to be maintained by employers with respect to each employee. This data must be sufficient to determine the benefits due, or which may become due, to the employee under a qualified retirement plan.

Records of such data typically comprise:

- The employee's name and address;
- An employee number or other identifying code;
- The employee's marital status and the names of his or her spouse and dependents;
- The employee's birth date;
- The employee's date of hire (including all rehire dates);
- The date employment terminated including all termination dates following rehire dates, and the reason for termination if available (such as death or disability);
- Social Security number for tax reporting purposes;
- Current and historical beneficiary elections;
- Compensation history, including all components required to administer the plan (e.g., if benefits are determined only on base compensation excluding bonuses, overtime, or other taxable income, both base compensation and all taxable compensation should be kept.);
- History of deferral elections to 401(k) plans;
- Investment options chosen;
- All financial transactions, including transfers, loans and withdrawals;
- Copies of all employee correspondence;
- Distribution information, including all forms provided to the participant and any elections made; and
- Status as officer and company ownership (considering applicable family attribution of ownership rules).

It is important to keep records with respect to all employees, not just those eligible to participate in the plan. If it becomes necessary to prove to the IRS or to an employee making a claim for benefits that the individual was not eligible to participate, the plan administrator is required to furnish the specific terms of the plan document as it existed at the time in question as well as detailed payroll records.

Similarly, in the case of a 401(k) plan, all participants should complete beneficiary designation forms, not just those who make elective deferrals. If in the future a nondeferring participant receives an allocation, such as a forfeiture, top-heavy or nonelective contribution, a beneficiary designation is already on file in plan records.

[C] Records That Should Be Kept for Defined Benefit Plans

In addition to the DOL requirements above for defined contribution plans, the PBGC policies relating to record retention are in effect for defined benefit plans covered by the PBGC. For these plans, the plan administrator must be able to produce sufficient records to validate the premium payments it makes to the agency.

Records that the plan sponsor should retain for a potential PBGC premium audit include:

- The employee census data used to determine participation in the plan;
- Information relating to employees for whom premiums were not paid; and
- Documentation of any instances wherein the plan's current assets were determined to be less than required, called underfunded.

According to the PBGC regulations, records must be retained at the plan's principal place of business for six years after the date the premiums were due. Plan sponsors ought to coordinate with the plan's actuary or retirement plan administration firm to ensure the full retention of appropriate records.

[D] Records That Should Be Kept to Comply with ERISA §404(c)

ERISA §404(c) compliance includes a requirement that participants with the ability to direct investment of their retirement plan assets be given access to investment information regarding their fund choices. While much of this information is in the form of fund descriptions, prospectuses, or other literature issued directly from the investment companies involved, the plan sponsor also should have on hand copies of investment prospectuses and other education or informational communication materials that are being delivered to the plan participants. In this manner, the plan administrator may demonstrate its intention to meet the disclosure requirements for ERISA §404(c) protection from fiduciary liability.

§14.05 How Long Should Records Be Kept?

In general, documents should be kept for six years after the date of the government filing to which they relate. However, certain records should be kept for the life of the plan, and arguably throughout the existence of the plan sponsor. It is not an unheard of occurrence for questions to arise years after a plan has been terminated and assets distributed.

Records to keep indefinitely include:

- All plan documents;
- All documentation relating to a participant's benefit eligibility or amount of benefits paid; and
- All records pertaining to an employee's salary history and hours worked.

The longer the paper trail, the easier it is for the plan to respond to an inquiry from a government agency or a request for information from a plan participant. If records are lost, stolen, or destroyed before the expiration of the applicable retention period, the plan administrator is required to recreate the records, unless to do so would result in excessive or unreasonable costs. For other disclosure of participant benefits, the DOL can require the plan administrator to reconstruct the records, which could be very time consuming or in some instances impossible.

§14.06 How Should These Records Be Archived?

It is recommended that records be kept in a manner in which the records can be readily retrieved. Consequently, as part of emergency preparedness or system failsafe security, records are often maintained by both the plan sponsor and a service provider such as the retirement plan administration firm.

According to DOL regulations, electronic media may be utilized for purposes of complying with the record retention requirements if the following safe harbor stipulations are met:

- The recordkeeping system has reasonable controls to ensure the accuracy of the records;
- The recordkeeping system is capable of indexing, retaining, preserving, retrieving, and reproducing the electronic records;
- The electronic records can be readily converted into legible paper copies; and
- The electronic recordkeeping system is not subject to restrictions that would limit access to the records, such as reduced hours of access or requiring participants to sign on at a particular site in order to access the records.

According to the regulations, the plan administrator shall establish adequate record management practices and audits. Adequate record management practices and audits may include:

- Labeling of records;
- Providing a secure storage environment;
- Creating back-up electronic copies;
- Selecting an off-site storage location;
- Observing a quality assurance program; and
- Retaining paper copies of records that cannot be clearly, accurately, or completely transferred to an electronic recordkeeping system.

Most original paper records may be disposed after they are transferred to an electronic recordkeeping system provided the recordkeeping system complies with the above requirements. However, it is important to note that the original may not be discarded if:

- It has legal significance;
- There is inherent value in its original form (e.g., notarized documents, insurance contracts, stock certificates, and documents executed under seal);
- The record cannot be clearly, accurately or completely transferred to an electronic recordkeeping system; or
- The record is not legible and readable when reproduced in paper form.

For reasons of confidentiality, employers may find it necessary to keep some of these materials, such as participant transactions, separately from the plan's general records.

§14.07 Failure to Comply with Record Retention Regulations

The consequences of a failure to comply with the rules surrounding document retention manifest themselves in an inability to respond to participant or governmental requests for information in a timely manner. Lack of response or late response due to the need for record reconstruction can result in ERISA penalties assessed by the DOL and lawsuits pressed by participants. For example, failure to respond to a participant request for information within 30 days creates a $110 per day penalty, and failure to file a Form 5500 incurs a DOL penalty of $1,100 per day. With ERISA litigation increasing in light of the recent high profile corporate bankruptcies and mutual fund scandals, accurate maintenance of all essential plan records becomes more important than ever.

§14.08 Planning Ahead to Comply with Record Retention Regulations

Administering a retirement plan, especially a daily-valued 401(k) plan, can require fast paced efforts on the part of the plan sponsor and its paid professionals. Due to technological advancements, many transactions do not take place on paper, which is an added challenge to the recordkeeping requirements. No matter how quickly transactions are occurring, plan sponsors must periodically slow down and consistently archive plan records and transactions. Many plan sponsors develop checklists based on the required historical information that must be retained and subject themselves to periodic review of their record retention ongoing procedures. An annual self-audit, during which time all relevant materials are organized and archived, can help ensure that the plan is running properly and that all necessary records and documentation are being preserved. Within the context of these self-audits, the year's activities are spot-checked and any plan defect corrected in a timely fashion.

When a report is prepared or a benefit is paid, the plan administrator should ascertain there are adequate records to support the allocation, compliance test, or benefit payment. It is much easier and cost effective to gather the supporting documentation at the time the work is done. Years later if and when the plan's operation or calculations are challenged, there may have been staff changes or storage issues that make obtaining the data a complex and expensive endeavor. In those situations, an efficient retrieval of full, substantiating records proves invaluable and more than justifies the plan administrator's previous preparation and ongoing review of documentation procedures.

§14.09 Record Retention Guidelines

The following is a list of administrative matters that should be documented and archived each year.

Employer
- Controlled group information
- Affiliated service group information
- Attribution of ownership rules applied
- Type of entity
- Mergers and acquisitions or other changes
- Contribution data

Employees
- Leased employees
- Independent contractors
- Key employees
- HCEs
- Contribution data

Plan Document
- Signed and dated
- Determination letter
- Action adopting the plan
- Updated for all current rules
- Current copies of the SPD and any SMMs

Administration
- Schedule of allocations
- Schedule of eligibility
- Form 5500 for the prior year as well as supporting documentation with respect to the filing
- Coverage
- Nondiscrimination

- Annual additions
- Top-heavy
- ADP and ACP
- Schedules of years of service for vesting purposes
- Any report demonstrating compliance with various qualified plan rules
- QDRO administrative procedures
- Any notices to participants such as those regarding investment blackout periods, applications to the IRS, minimum funding requirements or safe harbor 401(k) status

Investments

- Written investment policy
- List of all plan assets
- SAR
- ERISA §404(c) compliance
- Loans
- Current investment elections
- Trust reports

Fiduciary

- List of current and recent plan fiduciaries

Administrative Forms

- Enrollment forms
- Beneficiary designation forms

§14.10 Review of Key Concepts

- ERISA has set forth specific record retention requirements for qualified plans.

- The burden of record retention falls on the plan administrator, which is usually the employer.

- The DOL usually requires records to be maintained by employers with respect to each employee in sufficient detail to determine the benefits due, or which may become due to the employee under a qualified retirement plan.

- The PBGC has specific regulations that relate to record retention of defined benefit plans. The plan administrator must retain sufficient records to validate the premium payments it makes to the agency.

- The plan sponsor also should keep copies of investment education and informational materials that are being delivered to the plan participants, including prospectuses. In this manner, these communications and disclosures are available to support ERISA §404(c) compliance.

- In general, documents should be kept for six years after the date of the government filing to which they relate. However, certain records should be kept for the life of the plan and/or plan sponsor.

- Failure to provide materials to plan participants in a timely manner can result in ERISA penalties and/or lawsuits.

§14.11 Review Questions

[A] True or False

______ 1. Documentation relating to the determination of benefits paid to a participant should be kept indefinitely.

______ 2. All records pertaining to an employee's salary history should be kept six years.

[B] Multiple Choice

3. All of the following plan records should be retained by the plan sponsor, **EXCEPT**:

   A. Full and complete properly executed plan document
   B. Form 5500
   C. Letters of appreciation to participants for jobs well done
   D. Form 1099-R
   E. Fidelity bond

4. All of the following statements regarding utilizing electronic media for record retention are **TRUE, EXCEPT**:

   A. The recordkeeping system must have reasonable controls to ensure accuracy.
   B. The recordkeeping system must be convertible to paper copies.
   C. The recordkeeping system must be capable of retrieving the information.
   D. The recordkeeping system must be capable of indexing.
   E. The recordkeeping system must be kept in a secure room monitored by video cameras.

§14.12 Answers

1. **True.** Documentation relating to the determination of benefits paid to a participant should be kept indefinitely. §14.05

2. **False.** Records pertaining to an employee's salary history should be kept indefinitely. §14.05

3. The correct answer is **C.** §14.04 [A]

   A. Incorrect. This statement is true because a full and complete properly executed plan document should be retained by the plan sponsor.
   B. Incorrect. This statement is true because Form 5500s should be retained by the plan sponsor.
   C. Correct. This statement is false because letters of appreciation to participants for jobs well done need not be retained for qualified plan purposes.
   D. Incorrect. This statement is true because Form 1099-Rs should be retained by the plan sponsor.
   E. Incorrect. This statement is true because information regarding the plan's fidelity bond should be retained by the plan sponsor.

4. The correct answer is **E.** §14.06

   A. Incorrect. This statement is true because the recordkeeping system must have reasonable controls to ensure accuracy.
   B. Incorrect. This statement is true because the recordkeeping system must be convertible to paper copies.
   C. Incorrect. This statement is true because the recordkeeping system must be capable of retrieving the information.
   D. Incorrect. This statement is true because the recordkeeping system must be capable of indexing.
   E. Correct. This statement is false because there is no requirement that the recordkeeping system be kept in a secure room monitored by video cameras.

Chapter 15:
ASPPA Code of Professional Conduct

§15.01 Learning Objectives

- Recognize the action required of an ASPPA member in situations requiring ethical standards.

§15.02 Introduction

This chapter contains the ASPPA Code of Professional Conduct by which ASPPA members must abide in all of their professional undertakings. This code serves the public interest.

§15.03 ASPPA Code of Professional Conduct

The reliance of the public, the business community and pension plan participants and beneficiaries upon the quality of advice and services provided by actuaries and other benefits professionals imposes upon them a duty to maintain the highest level of technical competence and integrity. To this end, a member of ASPPA shall:

- Maintain independence of thought and action,
- Observe the highest standards of practice, and
- Uphold the dignity and honor of the profession.

This Code of Professional Conduct (Code) identifies the professional and ethical standards by which all benefits professionals must abide and thereby serve the public interest.

1. COMPLIANCE

An ASPPA member shall be knowledgeable about this Code of Professional Conduct, keep current with Code revisions, and abide by its provisions.

Laws and regulations may impose binding obligations on a benefits professional. Where the requirements of law or regulation conflict with this Code, the requirements of law or regulation take precedence.

2. PROFESSIONAL INTEGRITY

An ASPPA member shall perform professional services with honesty, integrity, skill, and care. A member has an obligation to observe standards of professional conduct in the course of providing advice, recommendations, and other services performed for a principal. For purposes of this Code, the term "principal" means any present or prospective client or employer.

A member who pleads guilty to or is found guilty of any misdemeanor related to financial matters or any felony shall be presumed to have contravened this Code and shall be subject to ASPPA's counseling and disciplinary procedures.
A member's relationship with a third party shall not be used to obtain illegal or improper treatment from such third party on behalf of a principal.

3. QUALIFICATION STANDARDS

An ASPPA member shall render opinions or advice, or perform professional services only when qualified to do so based on education, training or experience.

4. DISCLOSURE

An ASPPA member shall make full and timely disclosure to a principal of all sources of compensation or other material consideration that the member or the member's firm may receive in relation to an assignment for such principal.

A member who is not financially and organizationally independent concerning any matter related to the performance of professional services shall disclose to the principal any pertinent relationship that is not apparent.

5. CONFLICTS OF INTEREST

An ASPPA member shall not perform professional services involving an actual or potential conflict of interest unless:

(a) The member's ability to act fairly is unimpaired;
(b) There has been full disclosure of the conflict to the principal(s); and
(c) All principals have expressly agreed to the performance of the services by the member.

If the member is aware of any significant conflict between the interests of a principal and the interests of another party, the member should advise the principal of the conflict and also should include appropriate qualifications or disclosures in any related communication.

6. CONTROL OF WORK PRODUCT

An ASPPA member shall not perform professional services when the member has reason to believe that they may be used to mislead or to violate or evade the law.

Material prepared by a member could be used by another party to influence the actions of a third party. The member should recognize the risks of misquotation, misinterpretation or other misuse of such material and should take reasonable steps to ensure that the material is clear and presented fairly and that the sources of the material are clearly identified.

7. CONFIDENTIALITY

An ASPPA member shall not disclose to another party any confidential information obtained through a professional assignment performed for a principal unless authorized to do so by the principal or required to do so by law.

“Confidential information” refers to information not in the public domain of which the member becomes aware during the course of rendering professional services to a principal. It may include information of a proprietary nature, information that is legally restricted from circulation, or information which the member has reason to believe that the principal would not wish to be divulged.

8. COURTESY AND COOPERATION

An ASPPA member shall perform professional services with courtesy and shall cooperate with others in the principal’s interest.

Differences of opinion among benefits professionals may arise. Discussion of such differences, whether directly between benefits professionals or in observations made to a client by one benefits professional on the work of another, should be conducted objectively and with courtesy.

A member in the course of an engagement or employment may encounter a situation such that the best interest of the principal would be served by the member’s setting out a differing opinion to one expressed by another benefits professional, together with an explanation of the factors which lend support to the differing opinion. Nothing in this Code should be construed as preventing the member from expressing such differing opinion to the principal.

A principal has an indisputable right to choose a professional advisor. A member may provide service to any principal who requests it even though such principal is being or has been served by another benefits professional in the same matter.
If a member is invited to advise a principal for whom the member knows, or has

reasonable grounds to believe, that another benefits professional is already acting in a professional capacity with respect to the same matter or has recently so acted, it would normally be prudent to consult the other benefits professional both to prepare adequately for the assignment and to make an informed judgment whether there are circumstances as to potential violations of this Code which might affect acceptance of the assignment. The prospective new or additional benefits professional should request the principal's consent to such consultation.

9. ADVERTISING

An ASPPA member shall not engage in any advertising or business solicitation activities with respect to professional services that the member knows or should know are false or misleading.

"Advertising" encompasses all communications by whatever medium, including oral communications, which may directly or indirectly influence any person or organization to decide whether there is a need for professional services or to select a specific person or firm to perform such services.

10. TITLES AND DESIGNATIONS

An ASPPA member shall make use of the membership titles and designations of ASPPA only where that use conforms to the practices authorized by ASPPA.

11. COLLATERAL OBLIGATIONS

An ASPPA member who is an actuary shall also abide by the Code of Professional Conduct for Actuaries.

A member or representative shall respond promptly in writing to any letter received from a person duly authorized by ASPPA to obtain information or assistance regarding possible violations of this Code.

§15.04 Review Questions

[A] True or False

______ 1. An ASPPA member shall not disclose to another party any confidential information obtained through a professional assignment unless authorized to do so.

______ 2. ASPPA members are prohibited from performing professional services involving an actual or potential conflict of interest.

§15.05 Answers

1. **True.** Confidential information may not be disclosed by an ASPPA member unless authorized to do so by the principal or required by law. §15.03

2. **False.** ASPPA members may perform services involving an actual or potential conflict of interest if 1) the member's ability to act fairly is unimpaired, 2) there has been full disclosure of the conflict to the principal(s) and 3) all principals have expressly agreed to the performance of services by the member. §15.03

10-Year COLA Summary

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Qualified Plan Limits										
401(k), 403(b) and SARSEP maximum deferral [402(g)]	$15,000	$14,000	$13,000	$12,000	$11,000	$10,500	$10,500	$10,000	$10,000	$9,500
457 maximum deferral	15,000	14,000	13,000	12,000	11,000	8,500	8,000	8,000	8,000	7,500
Catch-Up for 401(k), 403(b), SARSEP, and 457	5,000	4,000	3,000	2,000	1,000	–	–	–	–	–
SIMPLE election maximum deferral	10,000	10,000	9,000	8,000	7,000	6,500	6,000	6,000	6,000	6,000
Catch-Up for SIMPLE	2,500	2,000	1,500	1,000	500	–	–	–	–	–
DB – annual benefit	175,000	170,000	165,000	160,000	160,000	140,000	135,000	130,000	130,000	125,000
DC – annual contributions	44,000	42,000	41,000	40,000	40,000	35,000	30,000	30,000	30,000	30,000
Compensation Limits										
Maximum compensation	220,000	210,000	205,000	200,000	200,000	170,000	170,000	160,000	160,000	160,000
SEP annual compensation floor	450	450	450	450	450	450	450	400	400	400
Highly Compensated Employees										
Any employee compensation	100,000	95,000	90,000	90,000	90,000	85,000	85,000	80,000	80,000	80,000
Key Employees										
Officer compensation	140,000	135,000	130,000	130,000	130,000	70,000	67,500	65,000	65,000	62,500
10 largest owners	–	–	–	–	–	35,000	30,000	30,000	30,000	30,000
1% owner	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Covered Compensation Limits										
Social Security	94,200	90,000	87,900	87,000	84,900	80,400	76,200	72,600	68,400	65,400
Medicare	no limit	no limit	no limit	no limit	no limit	no limit	no limit	no limit	no limit	no limit

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10-Year COLA Summary (continued)

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Self-Employment Tax										
Self-employment rate	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%
Medicare rate	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%
Combined rate	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%	15.30%
Social Security Tax										
Social Security rate	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%
Medicare rate	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
Combined rate	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%
ESOP Distribution										
Normal dist. period (years)	5	5	5	5	5	5	5	5	5	5
Threshold account balance IRC 409(o)(1)(C)	885,000	850,000	830,000	810,000	800,000	780,000	755,000	735,000	725,000	710,000
One year extension threshold IRC 409(o)(1)(C)(ii)	175,000	170,000	165,000	160,000	160,000	155,000	150,000	145,000	145,000	140,000
Max. additional distribution periods allowable (years)	5	5	5	5	5	5	5	5	5	5
Maximum PBGC-Insured Annuity **ERISA Reg. 4022.23(c)**										
Age 65 / 100% Paid	3,971.59	3,801.14	3,698.86	3,664.77	3,579.55	3,392.05	3,221.59	3,051.44	2,880.68	2,761.36
Age 64 / 93%	3,639.58	3,535.06	3,439.94							
Age 63 / 86%	3,415.57	3,268.98	3,181.02							
Age 62 / 79%	3,137.56	3,002.90	2,922.10	2,895.17	2,827.85	2,679.72	2,545.06	2,410.40	2,275.74	2,181.47
Age 61 / 72%	2,859.54	2,736.82	2,663.18							
Age 60 / 65%	2,581.53	2,470.74	2,404.26	2,382.10	2,326.71	2,204.83	2,094.03	1,983.24	1,872.44	1,794.88
Age 59 / 61%	2,422.67	2,318.70	2,256.30							
Age 58 / 57%	2,263.81	2,166.65	2,108.35							
Age 57 / 53%	2,104.94	2,014.60	1,960.40							
Age 56 / 49%	1,946.08	1,862.56	1,812.44							
Age 55 / 45%	1,787.22	1,710.51	1,664.49	1,649.15	1,610.80	1,526.42	1,449.72	1,373.01	1,296.31	1,242.61

Appendix B:
Comparison of 401(k)s, SIMPLE 401(k)s and SIMPLE IRAs

	401(k)	SIMPLE 401(k)	SIMPLE IRA
Maximum Elective Deferral (2006):	$15,000	$10,000	$10,000
Maximum Catch-up Deferral (2006):	$5,000	$2,500	$2,500
Types of Allowable Contributions:	Elective Deferrals and catch-ups	Elective Deferrals And catch-ups	Elective Deferrals And catch-ups
	Employer Matching	**Either** Employer Matching (100% of first 3% of compensation deferred),	**Either** Employer Matching (100% of first 3% of compensation deferred),
	Employer Nonelective	**Or** Employer Nonelective (2% of compensation)	**Or** Employer Nonelective (2% of compensation)
	Employee After-Tax	Not Allowed	Not Allowed
Vesting	Any allowable schedule	100% immediate	100% immediate
Nondiscrimination Testing	Required	Not required	Not required
Top-heavy Rules	Apply	Do not apply	Do not apply
Loans	Allowed	Allowed	Not allowed
Form 5500	Required	Required	Not required

Appendix C:
Summary of Significant Legislation Affecting Retirement Plans

ERISA	Employee Retirement Income Security Act of 1974
ERTA	Economic Recovery Tax Act of 1981
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
DEFRA	Deficit Reduction Act of 1984
REA	Retirement Equity Act of 1984
COBRA	Consolidated Omnibus Budget Reconciliation Act
OBRA’86	Omnibus Budget Reconciliation Act of 1986
TRA’86	Tax Reform Act of 1986
OBRA’87	Omnibus Budget Reconciliation Act of 1987
TAMRA’88	Technical and Miscellaneous Revenue Act of 1988
OBRA’89	Omnibus Budget Reconciliation Act of 1989
OBRA’90	Omnibus Budget Reconciliation Act of 1990
UCA’92	Unemployment Compensation Amendments of 1992
FMLA	Family and Medical Leave Act of 1993
OBRA’93	Omnibus Budget Reconciliation Act of 1993
GATT or	Uruguay Round of the General Agreement on Tariffs and Trade
RPA’94	The Retirement Protection Act of 1994 was attached to the GATT bill.
USERRA	Uniformed Services Employment and Reemployment Rights Act of 1994
SBJPA	Small Business Job Protection Act of 1996
TRA’97	Taxpayer Relief Act of 1997
RRA‘98	IRS Restructuring and Reform Act of 1998

CRA'00	Community Renewal Tax Relief Act of 2000
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001
JCWAA	Job Creation and Worker Assistance Act of 2002
SOA'02	Sarbanes-Oxley Act of 2002
SCRA	Service Members Civil Relief Act of 2003
PFEA	Pension Funding Equity Act of 2004
PPA	Pension Protection Act of 2006

Appendix D:
A Guide to IRC Sections Affecting Retirement Plans

IRC §401(a) - Requirements for qualification

- (4) & (5) - General nondiscrimination rules
- (9) - Required distributions
- (10) - Top-heavy rules must be stated in plan document
- (11) - Requirement for a joint and survivor annuity and pre-retirement survivor annuity (QJSA and QPSA)
- (17) - Compensation limits
- (25) - Actuarial assumptions must be specified
- (26) - Minimum participation requirements
- (27) - Contributions to profit sharing plans need not be based on profits
- (28) - Employee Stock Ownership Plan (ESOP) requirements
- (31) - Optional direct transfer of eligible rollover distributions

IRC §401(b) - Retroactive changes in plan

IRS §401(c) - Rules relating to self-employed individuals and owner-employees

IRC §401(d) - Plans benefiting owner-employees

IRC §401(h) - Medical benefits for retirees

IRC §401(k) - Cash or salary deferral arrangements

IRC §401(l) - Integrating plan benefits with Social Security (Permitted Disparity)

IRC §401(m) - Nondiscrimination test for employer matching contributions and after-tax employee contributions

IRC §402(a) -Taxability of beneficiary of exempt trust

IRC §402(b) -Taxability of beneficiary of non-exempt trust

IRC §402(c) - Rules applicable to rollovers from exempt trusts

IRC §402(d)	- Tax on lump-sum distributions
IRC §402(f)	- Written explanation to recipients on distributions eligible for rollover treatment
IRC §402(g)	- Limit on elective deferrals
IRC §402(h)	- Rules for Simplified Employee Pensions (SEP)
IRC §403(a) and (b)	- Tax-sheltered annuity (TSA) rules
IRC §404	- Deduction of contribution rules
IRC §408	- Individual Retirement Accounts (IRA)
IRC §410(a)	- Minimum participation standards
IRC §410(b)	- Minimum coverage requirements
IRC §411(a)	- Vesting schedules
IRC §411(b)	- Accrued benefit requirements
IRC §411(d)(6)	- Anti-cutback rules
IRC §412	- Minimum funding standards
IRC §413	- Collectively-bargained plans
IRC §414(a)	- Service for predecessor employer
IRC §414(b)	- Employees of controlled group corporations
IRC §414(c)	- Employees under common control
IRC §414(d)	- Governmental plans
IRC §414(m)	- Affiliated service group
IRC §414(n)	- Employee leasing
IRC §414(p)	- Qualified Domestic Relations Order (QDRO)
IRC §414(q)	- Highly Compensated Employee (HCE)

IRC §414(r)	- Qualified Separate Lines of Business (QSLOB)
IRC §414(s)	- Definition of compensation
IRC §414(u)	- Veteran's Rights under Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)
IRC §414(v)	- Catch-up contributions for individuals age 50 or over
IRC §415(b)	- Defined benefit limitations
IRC §415(c)	- Defined contribution limitations
IRC §416(g)	- Top-heavy plan defined
IRC §416(l)	- Key Employee definition
IRC §417(a)	- Restrictions on cash-out payments
IRC §417(b)	- Other special rules and definitions regarding survivor annuities

Appendix E:
Annual Reporting Calendar

Item	Calendar Plan Year	Other Plan Year
Form 1099-R to participants (distribution reporting)	January 31	January 31
Form 945 with taxes due to IRS (withholding reporting)	January 31	January 31
Form 945 w/o taxes due to IRS (withholding reporting)	February 10	February 10
Form 1099-R to IRS (paper or diskette filing)	February 28	February 28
Form 4804	February 28	February 28
Form 1096 – Annual Summary Transmittal)	February 28	February 28
PBCG Form 1-ES to PBGC** (premium filing for 500+)	February 28	2 months > plan year beginning
Form 1099-R to IRS (electronic filing)	March 31	March 31
Schedule A insurance information due from insurer	April 30	4 months > plan year end
Form 5558 (extension for filing)	July 31	7 months > plan year end
Form 5500 and Schedules	July 31*	7 months > plan year end
PBGC Form 1 or Form 1-EZ**	October 15	9½ months > plan year beginning
SAR (w/o extension)	September 30	9 months > plan year end
SAR (with extension)	December 15	11½ months > plan year end

Form 5500 and Schedules (with extension)	October 15	9½ months > plan year end

* If the plan year-end and the fiscal year-end coincide, and there is a valid extension of time on the company's income tax return, then the deadline for the Form 5500 and related schedules is automatically extended to the due date for the corporate return without having to file a Form 5558 extension.

** Certain defined benefit plans only

Appendix F:
Special Event Reporting Summary

This summary is intended as a method of alerting the plan and its sponsor to various special situations, an "X" indicates the agency/parties that are to receive some type of notification of the event. It should be noted that while some items require immediate notification to the appropriate parties, other notifications are achieved through the annual reporting process.

Note – the PBGC column only applies to certain defined benefit plans.

	COMMUNICATE / REPORT / NOTICE TO:			
THE EVENT	**PARTICIPANT**	**DOL**	**IRS**	**PBGC**
1. Plan is adopted.	X		X*	
2. Employee becomes plan participant.	X			
3. Plan participant terminates with vested right.	X		X**	
4. Participant nears eligibility for early/normal retirement.	X			
5. Participant asks to examine or requests copies of documents or reports.	X			
6. Participant requests accrued and vested benefit.	X			
7. Claim for a benefit is submitted, denied, or resubmitted for review.	X			
8. Lump sum distribution of benefits is paid.	X		X	
9. Periodic payment of benefits is made.	X		X	
10. Plan is amended.	X		X*	
11. Change occurs in name or address of sponsor or administrator, employer identification number, plan number, plan name, plan year or trust year.	X	X	X	
12. Change occurs in plan's procedure for presenting a claim for benefits or appealing a denied claim.	X			
13. Prohibited transaction occurs between the plan and a disqualified person.		X	X	

THE EVENT	COMMUNICATE / REPORT / NOTICE TO:			
	PARTICIPANT	**DOL**	**IRS**	**PBGC**
14. Plan asset is merged, consolidated, divided or plan assets are transferred.			X	X
15. Plan is terminated or about to be terminated or IRS advises an event is a complete or partial termination.	X	X	X	X

*****Not required
** Only if paid

Appendix G:
Sample Hardship Provision Notice

COMPANY NAME
401(k) PROFIT SHARING PLAN

NOTICE OF HARDSHIP WITHDRAWALS

COMPANY NAME 401(k) PROFIT SHARING PLAN provides that the salary reduction amounts that have been contributed on your behalf by COMPANY NAME and any transfers from other qualified plans maintained in your participant rollover account may be withdrawn if you have an immediate and heavy financial need.

An immediate and heavy financial need can arise for one of the following reasons:

1. medical expenses which you, your spouse or dependents incur or are necessary for you, your spouse or dependents to obtain medical care. These must be expenses described in Section 213 of the Internal Revenue Code;

2. to purchase your principal residence;

3. to pay tuition, related educational fees, and room and board expenses for the next twelve (12) months of post-secondary education for you, your spouse, children or dependents;

4. to prevent your eviction from your principal residence or the foreclosure on your principal residence;

5. payment of funeral expenses; or

6. payment of expenses relating to the repair of damage to an employee's principal residence.

Also, in order to qualify for a withdrawal, you must have no other resources or savings to take care of the immediate and heavy financial need. Under special rules permitted by the IRS you will be considered not to have sufficient resources to meet the immediate and heavy financial need, but only if:

1. the hardship distribution we make to you is not in excess of the immediate and heavy financial need;

2. you have already obtained all distributions (other than a hardship distribution) and non-taxable loans available from any plan we maintain; and

3. you agree not to make salary reduction contributions for a 6-month period after you receive the hardship distribution.

If you wish to apply for a hardship distribution, you should fill out an application that the Administrator will provide. Return the application to the Administrator.

______________________________	______________________________
Administrator	Participant

Appendix H:
Sample Loan Policy

COMPANY NAME
401(k) PROFIT SHARING PLAN AND TRUST

PARTICIPANT LOAN PROGRAM

1. The Employer is authorized under the COMPANY NAME 401(k) PROFIT SHARING PLAN (the "Plan") to establish a loan program for loans to Participants and Beneficiaries (hereinafter individually referred to as "Borrower" or collectively referred to as "Borrowers") under the Plan. This document will explain the procedures that a Borrower must follow to apply for a loan from the Plan, as well as the requirements a Borrower must meet in order to be granted a loan. It will also explain other relevant aspects of the Plan's Loan Program. This document is prepared pursuant to relevant provisions of the Plan and is intended by this reference to be a part of the Plan. The Employer specifically reserves the right to amend these policies and procedures from time to time in accordance with the terms of the Plan and relevant provisions of law.

2. **Loan Administration.** The Plan Administrator administers the Loan Program. Any questions about the program and any requests for loan applications should be directed to the Human Resources Office.

3. **Who May Apply for a Loan?** Any Participant or Beneficiary who is a "party in interest" (as defined in section 3(18) of the Employee Retirement Income Security Act of 1974 (ERISA) who has a vested benefit resulting from Employee Deferrals or Rollovers may apply for a loan from the Plan.

4. **How to Apply for a Loan.** Loan applications may be obtained from the Human Resources Office. A Borrower who desires to borrow money from the Plan should complete a loan application and return it to the Human Resources Office for approval by the Plan Administrator. The Plan Administrator will generally approve or deny an application within 30 days. If the process in a particular case will take longer, the Plan Administrator will notify the Borrower in writing of the reason for the delay and the expected completion date of the application process. If the loan application is approved, the Borrower will be required to sign a promissory note.

5. **Basis for Loan Approval.** Generally, a loan application by an eligible individual that meets the requirements set forth in this document will be approved. However, in determining whether to approve a loan application, the Plan Administrator may consider, in a uniform and nondiscriminatory manner, any reasonable and legal factors which it deems relevant, including a Borrower's creditworthiness. If the Plan Administrator must deny an application, it will advise

the Borrower of the reasons for the denial in writing. No loan will be granted if any principal or interest payment, or both, on a prior loan, is in default.

6. **Limitations on Loans**.

a. The minimum loan amount shall be $1,000.

b. Loan amounts shall be in increments of $100.

c. A Borrower may only have one loan outstanding from the Plan at a time.

d. A Borrower may borrow funds from only his vested Before-Tax Account, Matching Account, and/or Rollover Account.

e. Each loan will be repaid in level periodic payments (on a payroll frequency basis, or at least quarterly if the Borrower is a Beneficiary) over a period not longer than 5 years. The amount of the loan, plus interest, will be amortized over the repayment period. This means that payments will be level throughout the repayment period, and each payment will include both principal and interest.

f. Payments on all loans (other than loans to Beneficiaries) will be made by automatic payroll deduction. The same amortized amount will be deducted every payroll period until the loan is repaid in full. If the Borrower is a Beneficiary, he or she must repay the principal and interest in equal amortized installments as required by the loan documentation (but not less frequently than quarterly) by submitting payment to the Plan Administrator (in care of the Human Resources Office). A Participant who is absent from service due to disability or a layoff must make loan payments by personal check at the same semi-monthly frequency as such payments would be made if the Participant were not absent from service.

g. The amount of the loan may not exceed the least of:

(i) $50,000, reduced by
(A) the highest outstanding balance of any loan from the Plan during the one year period ending on the day before the date the loan is made; minus
(B) the outstanding balance of any loan from the Plan on the date the loan is made; or
(ii) one half of the Borrower's vested balance in his Before-Tax Account, Matching Account, and Rollover Account.

7. **Collateral.** A Borrower's entire vested account balance shall serve as security for a loan from the Plan.

8. **Source and Application of Funds.** All loans under the Plan shall be made and considered assets of the Trust. All loans outstanding under the Plan shall be secured by the applicable portion of the Borrower's vested accounts under the Plan as designated by the Plan Administrator. The funds for the loan will be removed from the investments in the Borrower's Accounts on a pro-rata basis.

9. **Interest Rate.** The rate of interest charged on a loan from the Plan to a Borrower shall provide the Plan with a return commensurate with the prevailing interest rate charged on similar commercial loans by persons in the business of lending money. The rate of interest shall be determined on the last day of each calendar quarter, and all loans made by the Plan during the following quarter shall be subject to that rate. The interest rate will generally be the prime rate according to the Trustee as of such determination date, plus ***%. However, if the Plan Administrator has reason to believe that the rate is unreasonably high or low and not commensurate with rates charged by persons in the business of lending money under similar circumstances, the Plan Administrator will determine a reasonable rate of interest.

10. **Unpaid Absences.** This section applies only to Borrowers who are employees:

    a. The Plan Administrator may, in its sole discretion but in a manner that does not discriminate in favor of highly compensated employees, permit an employee who has a loan outstanding to suspend payments during an approved unpaid Leave of Absence. However, such suspension may not continue for longer than one year.

    b. If the Plan Administrator permits a Borrower's loan payments to be suspended during a Leave of Absence, the loan will not be considered in Default during the suspension period. The balance of principal and accumulated interest shall be determined as of the date on which the Borrower returns to work (or, if earlier, the end of the one-year period following the beginning of the Leave of Absence) (the "Post-Leave Balance"). The Post Leave Balance shall be re-amortized over the remaining repayment period under the loan as originally documented to determine the payment amounts that must be made by the Borrower for the remaining term of the loan, so that the loan is fully repaid within the original repayment period. If the original repayment period ended while the Borrower was on leave, the full Post-Leave Balance must be repaid within one month of the date on which the Borrower returns from the approved leave.

    c. If the Plan Administrator does not suspend payments, a Borrower who is on a Leave of Absence must continue to make payments when due (by submitting a check or money order payable to the Plan to the Trustee). As noted below under "Default Procedures," if such Borrower fails to make any such cash payment within thirty (30) days of the due date, the loan will be deemed to be in Default.

11. **<u>Default Procedures.</u>** Since most loans will be repaid through automatic payroll deduction, "default" -- failure to make timely repayment -- will generally not occur. However, to the extent that any loan is for any reason not repaid at any time during the course of a loan, each of the following shall be considered an event of default:

    a. Ninety (90) days after a Borrower terminates employment, except in the case of a disability or layoff;

    b. Ninety (90) days after the Borrower fails to make timely payment of principal and interest when due;

    c. If the Borrower makes any untrue representations or warranties in connection with obtaining the loan; or

    d. If the vested Account held as security under the Plan for the Borrower will, as a result of an impending distribution or withdrawal, be reduced to an amount less than the amount of all unpaid principal and accrued interest then outstanding under the loan.

12. **<u>Consequences of Default.</u>** There are two consequences when a Borrower defaults on a loan. First, the loan balance will be considered to be taxable income to the Borrower, and the Plan will issue a Form 1099-R at the end of the calendar year in which the default occurred. If the Borrower is under age 59-1/2, there may also be a 10% federal excise tax (and possibly a state excise tax) on the taxable amount.

    Second, depending on the circumstances, the loan may be "offset" against the Borrower's vested interest. If there is an offset, the loan is considered to be distributed to the Borrower, and the Borrower's vested interest is permanently reduced by the outstanding amount of the loan.

    Under the Plan, a Borrower can receive distributions of his or her benefit only on the occurrence of certain events (called "distributable events"). Distributable events are: death, disability, termination of employment, or attainment of age 59½. If a Borrower defaults on the loan after a distributable event has occurred, the loan will be immediately offset against the Borrower's vested interest, and will be considered to be distributed to the Borrower.

    However, if a default occurs before a distributable event, the loan will be considered to continue *even though it is taxable income to the Borrower*.

    Once a distributable event occurs, the remaining unpaid balance on the loan, plus any accumulated but unpaid interest, will be offset against the Borrower's vested interest and will be considered to be distributed.

In addition to offsetting the loan, the Plan Administrator shall also have recourse to any and all other remedies permitted by law and by the Plan. Accordingly, a defaulting Borrower may be liable for all reasonable attorneys' fees, legal expenses and collection costs incurred in connection with exercising any rights and remedies. The Plan Administrator may delay enforcing any one or more of its rights and remedies without forfeiting such rights and remedies.

13. **Loans From Plans Merged into This Plan.** If the Borrower has a loan outstanding from another qualified retirement plan and that plan is merged into this Plan, such loan shall continue under the terms outlined in the promissory note and other documentation for such loan, even if such terms are contrary to this Loan Procedure.

14. **Effective Date.** The Effective Date of the Loan Procedures shall be ______________________.

PLAN ADMINISTRATOR FOR THE
COMPANY NAME
401(k) PROFIT SHARING PLAN AND TRUST

By: ____________________________________
Title: __________________________________
Date: __________________________________

Appendix I:
Loan Calculation Worksheet

First Limitation

1. Enter participant's highest outstanding loan balance during the 12 months ending on the day before the date the loan is to be made: $

2. Enter participant's outstanding loan balance on the date the second loan is to be made (if there is no outstanding loan enter zero (-0-)): $

3. Subtract amount on line 2 from amount on line 1: $

4. Subtract amount on line 3 from $50,000: $

Second Limitation

5. Enter current value of participant's vested account balance: $

6. Multiply amount on line 5 by 50%): $
   (This is the 50% of the vested account balance portion of the calculation)

7. Enter amount on line 6 or $10,000, if greater: $
   (Use of $10,000 requires additional collateral)

Participant's Loan Limit

8. Enter lesser of line 4 or line 7: $

9. Enter participant's outstanding loan balance on the date the loan is to be made [if there is no outstanding loan balance, enter zero (-0-); this is the same amount from line 2] $

10. Subtract amount on line 9 from amount on line 8. This is the participant's loan limit: $

Appendix J:
Special Tax Notice Regarding Plan Payments

This notice explains how you can continue to defer federal income tax on your retirement savings in your retirement plan (the "Plan") and contains important information you will need before you decide how to receive your Plan benefits.

This notice is provided to you by your Plan Administrator because all or part of the payment that you will soon receive from the Plan may be eligible for rollover by you or your Plan Administrator to a traditional IRA or an eligible employer plan. A rollover is a payment by you or the Plan Administrator of all or part of your benefit to another plan or IRA that allows you to continue to postpone taxation of that benefit until it is paid to you. Your payments cannot be rolled over to a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an education IRA). An "eligible employer plan" includes a plan qualified under section 401(a) of the Internal Revenue Code, including a 401(k) plan, profit sharing plan, defined benefit plan, stock bonus plan, and money purchase plan; a section 403(a) annuity plan; a section 403(b) tax-sheltered annuity; and an eligible section 457(b) plan maintained by a governmental employer (governmental 457 plan).

An eligible employer plan is not legally required to accept a rollover. Before you decide to roll over your payment to another employer plan, you should find out whether the plan accepts rollovers and, if so, the types of distributions it accepts as a rollover. You should also find out about any documents that are required to be completed before the receiving plan will accept a rollover. Even if a plan accepts rollovers, it might not accept rollovers of certain types of distributions, such as after-tax amounts. If this is the case, and your distribution includes after-tax amounts, you may wish instead to roll your distribution over to a traditional IRA or split your rollover amount between the employer plan in which you will participate and a traditional IRA. If an employer plan accepts your rollover, the plan may restrict subsequent distributions of the rollover amount or may require your spouse's consent for any subsequent distribution. A subsequent distribution from the plan that accepts your rollover may also be subject to different tax treatment than distributions from this Plan. Check with the administrator of the plan that is to receive your rollover prior to making the rollover.

If you have additional questions after reading this notice, you can contact your Plan Administrator at the phone number listed in your Summary Plan Description.

SUMMARY

There are two ways you may be able to receive a Plan payment that is eligible for rollover:

1. Certain payments can be made directly to a traditional IRA that you establish or to an eligible employer plan that will accept it and hold it for your benefit ("DIRECT ROLLOVER"); or

2. The payment can be PAID TO YOU.

If you choose a **DIRECT ROLLOVER:**

- Your payment will not be taxed in the current year and no income tax will be withheld.

- You choose whether your payment will be made directly to your traditional IRA or to an eligible employer plan that accepts your rollover. Your payment cannot be rolled over to a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account because these are not traditional IRAs.

- The taxable portion of your payment will be taxed later when you take it out of the traditional IRA or the eligible employer plan. Depending on the type of plan, the later distribution may be subject to different tax treatment than it would be if you received a taxable distribution from this Plan.

If you choose to have a Plan payment that is eligible for rollover **PAID TO YOU:**

- You will receive only 80% of the taxable amount of the payment, because the Plan Administrator is required to withhold 20% of that amount and send it to the IRS as income tax withholding to be credited against your taxes.

- The taxable amount of your payment will be taxed in the current year unless you roll it over. Under limited circumstances, you may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59½, you may have to pay an additional 10% tax.

- You can roll over all or part of the payment by paying it to your traditional IRA or to an eligible employer plan that accepts your rollover within 60 days after you receive the payment. The amount rolled over will not be taxed until you take it out of the traditional IRA or the eligible employer plan.

- If you want to roll over 100% of the payment to a traditional IRA or an eligible employer plan, you must find other money to replace the 20% of the taxable portion that was withheld. If you roll over only the 80% that you received, you will be taxed on the 20% that was withheld and that is not rolled over.

Your Right to Waive the 30-Day Notice Period

Generally, neither a direct rollover nor a payment can be made from the plan until at least 30 days after your receipt of this notice. Thus, after receiving this notice, you have at least 30 days to consider whether or not to have your withdrawal directly rolled over. If you do not wish to wait until this 30-day notice period ends before your election is processed, you may waive the notice period by making an affirmative election indicating whether or not you wish to make a direct rollover. Your withdrawal will then be processed in accordance with your election as soon as practical after it is received by the Plan Administrator.

MORE INFORMATION

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Payments from the Plan may be "eligible rollover distributions." This means that they can be rolled over to a traditional IRA or to an eligible employer that accepts rollovers. Payments from a plan cannot be rolled over to a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account. Your Plan Administrator should be able to tell you what portion of your payment is an eligible rollover distribution.

After-Tax Contributions. If you made after-tax contributions to the Plan, these contributions may be rolled into either a traditional IRA or to certain employer plans that accept rollovers of the after-tax contributions. The following rules apply:

a. Rollover into a Traditional IRA. You can roll over your after-tax contributions to a traditional IRA either directly or indirectly. Your Plan Administrator should be able to tell you how much of your payment is the taxable portion and how much is the after-tax portion.

   If you roll over after-tax contributions to a traditional IRA, it is your responsibility to keep track of, and report to the IRS on the applicable forms, the amount of these after-tax contributions. This will enable the nontaxable amount of any future distributions from the traditional IRA to be determined.

   Once you roll over your after-tax contributions to a traditional IRA, those amounts CANNOT later be rolled over to an employer plan.

b. Rollover into an Employer Plan. You can roll over after-tax contributions from an employer plan that is qualified under Code section 401(a) or a section 403(a) annuity plan to another such plan using a direct rollover if the other plan provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. You can also roll over after-tax contributions from a section 403(b) tax-sheltered annuity to another section 403(b) tax-sheltered annuity using a direct rollover if the other tax-sheltered annuity provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. You CANNOT roll over after-tax contributions to a governmental 457 plan. If you want to roll over your after-tax contributions to an employer plan that accepts these rollovers, you cannot have the after-tax contributions paid to you first. You must instruct the Plan Administrator of this Plan to make a direct rollover on your behalf. Also, you cannot first roll over after-tax contributions to a traditional IRA and then roll over that amount into an employer plan.

The following types of payments cannot be rolled over:

Payments Spread over Long Periods. You cannot roll over a payment if it is part of a series of equal (or almost equal) payments that are made at least once a year and that will last for:

- your lifetime (or a period measured by your life expectancy), or
- your lifetime and your beneficiary's lifetime (or a period measured by your joint life expectancies), or
- a period of 10 years or more.

Required Minimum Payments. Beginning in the year you reach age 70½ or retire, whichever is later, a certain portion of your payment cannot be rolled over if it is a "required minimum payment" that must be paid to you. Special rules apply if you own 5% or more of your employer.

Hardship Distributions. A hardship distribution cannot be rolled over.

ESOP Dividends. Cash dividends paid to you on employer stock held in an employee stock ownership plan cannot be rolled over.

Corrective Distributions. A distribution that is made to correct a failed nondiscrimination test or because legal limits on certain contributions were exceeded cannot be rolled over.

Loans Treated as Distributions. The amount of a plan loan that becomes a taxable deemed distribution because of a default cannot be rolled over. However, a loan offset amount is eligible for rollover, as discussed in Part II below. Ask the Plan Administrator of this Plan if distribution of your loan qualifies for rollover treatment.

The Plan Administrator of this Plan should be able to tell you if your payment includes amounts which cannot be rolled over.

II. DIRECT ROLLOVER

A **DIRECT ROLLOVER** is a direct payment of the amount of your Plan benefits to a traditional IRA or an eligible employer plan that will accept it. You can choose a direct rollover of all or any portion of your payment that is an eligible rollover distribution, as described in Part I above. You are not taxed on any taxable portion of your payment for which you choose a direct rollover until you later take it out of the traditional IRA or eligible employer plan. In addition, no income tax withholding is required for any taxable portion of your Plan benefits for which you choose a direct rollover. This Plan might not let you choose a direct rollover if your distributions for the year are less than $200.

Direct Rollover to a traditional IRA. You can open a traditional IRA to receive the direct rollover. If you choose to have your payment made directly to a traditional IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment made in a direct rollover to an IRA at that institution. If you are unsure of how to invest your money, you can temporarily establish an IRA to receive the payment. However, in choosing a traditional IRA, you may wish to consider whether the traditional IRA you choose will allow you to move all or a part of your payment to another traditional IRA at a later date, without penalties or other limitations. See IRS Publication 590, Individual Retirement Arrangements, for more information on traditional IRAs (including limits on how often you can roll over between IRAs).

Direct Rollover to a Plan. If you are employed by a new employer that has an eligible employer plan, and you want a direct rollover to that plan, ask the plan administrator of that plan whether it will accept your rollover. An eligible employer plan is not legally required to accept a rollover. Even if your new employer's plan does not accept a rollover, you can choose a direct rollover to a traditional IRA. If the employer plan accepts your rollover, the plan may provide restrictions on the circumstances under which you may later receive a distribution of the rollover amount or may require spousal consent to any subsequent distribution. Check with the plan administrator of that plan before making your decision.

Direct Rollover of a Series of Payments. If you receive a payment that can be rolled over to a traditional IRA or an eligible employer plan that will accept it, and it is paid in a series of payments for less than 10 years, your choice to make or not make a direct rollover for a payment will apply to all later payments in the series until you change your election. You are free to change your election for any later payment in the series.

Change in Tax Treatment Resulting from a Direct Rollover. The tax treatment of any payment from the eligible employer plan or traditional IRA receiving your direct rollover might be different than if you received your benefit in a taxable distribution directly from the Plan. For example, if you were born before January 1, 1936, you might be entitled to ten-year averaging or capital gain treatment, as explained below. However, if you have your benefit rolled over to a section 403(b) tax-sheltered annuity, a governmental 457 plan, or a traditional IRA in a direct rollover, your benefit will no longer be eligible for that special treatment. See the sections below entitled "Additional 10% Tax if You are under Age 59½ " and "Special Tax Treatment if You Were Born before January 1, 1936."

III. PAYMENT PAID TO YOU

If your payment can be rolled over (see Part I above) and the payment is made to you in cash, it is subject to 20% federal income tax withholding on the taxable portion (state tax withholding may also apply). The payment is taxed in the year you receive it unless, within 60 days, you roll it over to a traditional IRA or an eligible employer plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

Income Tax Withholding:

Mandatory Withholding. If any portion of your payment can be rolled over under Part I above and you do not elect to make a direct rollover, the Plan is required by law to withhold 20% of the taxable amount. This amount is sent to the IRS as federal income tax withholding. For example, if you can roll over a taxable payment of $10,000, only $8,000 will be paid to you because the Plan must withhold $2,000 as income tax. However, when you prepare your income tax return for the year, unless you make a rollover within 60 days (see "Sixty-Day Rollover Option" below), you must report the full $10,000 as a taxable payment from the Plan. You must report the $2,000 as tax withheld, and it will be credited against any income tax you owe for the year. There will be no income tax withholding if your payments for the year are less than $200.

Voluntary Withholding. If any portion of your payment is taxable but cannot be rolled over under Part I above, the mandatory withholding rules described above do not apply. In this case, you may elect not to have withholding apply to that portion. If you do nothing, an amount will be taken out of this portion of your payment for federal income tax withholding. To elect out of withholding, ask the Plan Administrator for the election form and related information.

60-Day Rollover Option. If you receive a payment that can be rolled over under Part I above, you can still decide to roll over all or part of it to a traditional IRA or an eligible employer plan that accepts rollovers. If you decide to roll over, you must contribute the amount of the payment you received to a traditional IRA or an eligible employer plan within 60 days after you receive the payment. The portion of your payment that is rolled over will not be taxed until you take it out of the eligible retirement plan.

You can roll over up to 100% of your payment that can be rolled over under Part I above, including an amount equal to the 20% of the taxable portion that was withheld. If you choose to roll over 100%, you must find other money within the 60-day period to contribute to the eligible retirement plan to replace the 20% that was withheld. On the other hand, if you roll over only the 80% of the taxable portion that you received, you will be taxed on the 20% that was withheld.

Example: The taxable portion of your payment that can be rolled over under Part I above is $10,000, and you choose to have it paid to you. You will receive $8,000, and $2,000 will be sent to the IRS as income tax withholding. Within 60 days after receiving the $8,000, you may roll over the entire $10,000 to a traditional IRA or an eligible employer plan. To do this, you roll over the $8,000 you received from the Plan, and you will have to find $2,000 from other sources (your savings, a loan, etc.). In this case, the entire $10,000 is not taxed until you take it out of the eligible retirement plan. If you roll over the entire $10,000, when you file your income tax return, you may get a refund of part or all of the $2,000 withheld.

If, on the other hand, you roll over only $8,000, the $2,000 you did not roll over is taxed in the year it was withheld. When you file your income tax return, you may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if you roll over the entire $10,000.)

Additional 10% Tax If You Are Under Age 59½. If you receive a payment before you reach age 59½, and you do not roll it over, then, in addition to the regular income tax, you may have to pay an extra tax equal to 10% of the taxable portion of the payment. The additional 10% tax does not apply to (1) payments that are paid after you separate from service with your employer during or after the year you reach age 55, (2) payments that are paid because you retire due to disability, (3) payments that are paid as equal (or almost equal) payments over your life or life expectancy (or your and your beneficiary's lives or life expectancies), (4) dividends paid with respect to stock by an employee stock ownership plan (ESOP) as described in Code section 404(k), (5) payments that are paid directly to the government to satisfy a federal tax levy, (6) payments that are paid to an alternate payee under a qualified domestic relations order, or (7) payments that do not exceed the amount of your deductible medical expenses. See IRS Form 5329 for more information on the additional 10% tax.

The additional 10% tax will not apply to distributions from a governmental 457 plan, except to the extent the distribution is attributable to an amount you rolled over to that plan (adjusted for investment returns) from another type of eligible retirement plan. Any amount rolled over from a governmental 457 plan to another type of eligible retirement plan will become subject to the additional 10% tax if it is distributed to you before you reach age 59½, unless one of the exceptions applies.

Special Tax Treatment If You Were Born before January 1, 1936. If you receive a payment from a plan qualified under section 401(a) or a section 403(a) annuity plan that can be rolled over under Part I and you do not roll it over to a traditional IRA or an eligible employer plan, the payment will be taxed in the year you receive it. However, if the payment qualifies as a "lump sum distribution," it may be eligible for special tax treatment. A lump sum distribution is a payment, within one year, of your entire balance under the Plan (and certain other similar plans of the employer) that is payable to you after you have reached age 59½ or because you have separated from service with your employer (or, in the case of a self-employed individual, after you have reached age 59½ or have become disabled). For a payment to qualify as a lump sum distribution, you must have been a participant in the Plan for at least five years before the year in which you received the distribution. The special tax treatment for lump sum distributions that may be available to you is described below.

Ten-Year Averaging. If you receive a lump sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using "10-year averaging" (using 1986 tax rates). Ten-year averaging often reduces the tax you owe.

Capital Gain Treatment. If you receive a lump sum distribution and you were born before January 1, 1936, and you were a participant in the Plan before 1974, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the Plan taxed as long-term capital gain at a rate of 20%.

There are other limits on the special tax treatment for lump sum distributions. For example, you can generally elect this special tax treatment only once in your lifetime, and the election applies to all lump sum distributions that you receive in that same year. You may not elect this special tax treatment if you rolled amounts into this Plan from a 403(b) tax-sheltered annuity contract, a governmental 457 plan, or from an IRA not originally attributable to a qualified employer plan. If you have previously rolled over a payment from this Plan (or certain other similar plans of the employer), you cannot use this special tax treatment for later payments from the Plan. If you roll over your payment to a traditional IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, you will not be able to use this special tax treatment for later payments from that IRA, plan, or annuity. Also, if you roll over only a portion of your payment to a traditional IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, this special tax treatment is not available for the rest of the payment. See IRS Form 4972 for additional information on lump sum distributions and how you elect the special tax treatment.

Employer Stock or Securities. There is a special rule for a payment from the Plan that includes employer stock (or other employer securities). To use this special rule, 1) the payment must qualify as a lump sum distribution, as described above, except that you do not need five years of plan participation, or 2) the employer stock included in the payment must be attributable to "after-tax" employee contributions, if any. Under this special rule, you may have the option of not paying tax on the "net unrealized appreciation" of the stock until you sell the stock. Net unrealized appreciation generally is the increase in the value of the employer stock while it was held by the Plan. For example, if employer stock was contributed to your Plan account when the stock was worth $1,000 but the stock was worth $1,200 when you received it, you would not have to pay tax on the $200 increase in value until you later sold the stock.

You may instead elect not to have the special rule apply to the net unrealized appreciation. In this case, your net unrealized appreciation will be taxed in the year you receive the stock, unless you roll over the stock. The stock can be rolled over to a traditional IRA or an eligible employer plan, either in a direct rollover or a rollover that you make yourself. Generally, you will no longer be able to use the special rule for net unrealized appreciation if you roll the stock over to a traditional IRA or another eligible employer plan.

If you receive only employer stock in a payment that can be rolled over, no amount will be withheld from the payment. If you receive cash or property other than employer stock, as well as employer stock, in a payment that can be rolled over, the 20% withholding amount will be based on the entire taxable amount paid to you (including the value of the employer stock determined by excluding the net unrealized appreciation). However, the amount withheld will be limited to the cash or property (excluding employer stock) paid to you.

If you receive employer stock in a payment that qualifies as a lump sum distribution, the special tax treatment for lump sum distributions described above (such as 10-year averaging) also may apply. See IRS Form 4972 for additional information on these rules.

Repayment of Plan Loans. If your employment ends and you have an outstanding loan from your Plan, your employer may reduce (or “offset”) your balance in the Plan by the amount of the loan you have not repaid. The amount of your loan offset is treated as a distribution to you at the time of the offset and will be taxed unless you roll over an amount equal to the amount of your loan offset to another qualified employer plan or traditional IRA within 60 days of the date of the offset. If the amount of your loan offset is the only amount you receive or are treated as having received, no amount will be withheld from it. If you receive other payments of cash or property from the Plan, the 20% withholding amount will be based on the entire amount paid to you, including the amount of the loan offset. The amount withheld will be limited to the amount of other cash or property paid to you (other than any employer securities). The amount of a defaulted plan loan that is a taxable deemed distribution cannot be rolled over.

IV. SURVIVING SPOUSES, ALTERNATE PAYEES AND OTHER BENEFICIARIES

In general, the rules summarized above that apply to payments to employees also apply to payments to surviving spouses of employees and to spouses or former spouses who are "alternate payees." You are an alternate payee if your interest in the Plan results from a "qualified domestic relations order," which is an order issued by a court, usually in connection with a divorce or legal separation.

If you are a surviving spouse or an alternate payee, you may choose to have a payment that can be rolled over, as described in Part I above, paid in a direct rollover to a traditional IRA or to an eligible employer plan or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to a traditional IRA or to an eligible employer plan. Thus, you have the same choices as the employee.

If you are a beneficiary other than a surviving spouse or alternate payee, you cannot choose a direct rollover, and you cannot roll over the payment yourself.

If you are a surviving spouse, an alternative payee, or another beneficiary, your payment is generally not subject to the additional 10% tax described in Part III above, even if you are younger than age 59½.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump sum distributions and the special rule for payments that include employer stock, as described in Part III above. If you receive a payment because of the employee's death, you may be able to treat the payment as a lump sum distribution if the employee met the appropriate age requirements, whether or not the employee had five years of participation in the Plan.

HOW TO OBTAIN ADDITIONAL INFORMATION

This notice summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described above are complex and contain many conditions and exceptions that are not included in this notice. Therefore, you may want to consult with the Plan Administrator or a professional tax advisor before you take a payment of your benefits from the Plan. Also, you can find more specific information on the tax treatment of payments from qualified employer plans in IRS Publication 575, Pension and Annuity Income, and IRS Publication 590, Individual Retirement Arrangements. These publications are available from your local IRS office, on the IRS's Internet Web Site at www.irs.gov, or by calling 1-800-TAX-FORMS.