Employee Benefit Plans

Explanation No. **4**

Miscellaneous Provisions

The purpose of Form 5626, Worksheet Number 4 and this explanation is to identify major problems in various areas of a plan. However, there may be issues not mentioned in the worksheet that could affect the plan's qualification. A plan which generally is more generous than the statutory minimum requirement for qualification in any given area will not fail to qualify merely because it fails to adhere to specific language found in the statute if it can be otherwise demonstrated that the minimum statutory requirement is met.

Generally, a "Yes" answer to a question on the worksheet indicates a favorable conclusion while a "No" answer signals a problem concerning plan qualification. This rule may be altered by specific instructions for a given question. Please explain any "No" answer in the space provided on the worksheet.

The sections cited at the end of each paragraph of explanation are to the Internal Revenue Code and the Income Tax Regulations.

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The technical principles in this publication may be changed by future regulations or guidelines.

I. Merger and Termination Provisions

Line a. A qualified plan must contain an express provision that if it terminates, or partially terminates (or, in the case of a profit-sharing, stock bonus, or other plan described in section 412(h), there is a complete discontinuance of contributions), a participant's interest under the plan on the date of termination (or discontinuance) is nonforfeitable to the extent funded.
411(d)(3)

Line b. A qualified plan must provide that if it merges or consolidates with, or transfers assets or liabilities to, any other plan after September 2, 1974, each participant will (if the plan is terminated) receive a benefit immediately after the merger, etc., which is equal to or greater than the benefit the participant was entitled to immediately before the merger, etc., (if the plan had then terminated).
401(a)(12)

Lines c. and d. When an employer terminates an overfunded defined benefit plan, receives the excess assets, and then establishes a new defined benefit plan covering the active employees ("termination/reestablishment" transaction), the employer may not recover any surplus assets until it has fully vested all participants' accrued benefits and has made lump sum distributions or purchased guaranteed annuity contracts to protect accrued benefits. In this regard, section 411(d)(6) and Rev. Rul. 85-6 require that plans provide for satisfaction of contingent liabilities to participants who have elected certain optional forms of benefit payment. If guaranteed annuity contracts or lump sum distributions have not been made by the terminated plans, favorable determination letters for the terminated and replacement plans will contain the appropriate selective caveat(s).

An employer that terminates an over-funded defined benefit plan may maintain a replacement defined benefit plan covering the same group of employees. The prior plan and the replacement plan, in combination, may provide benefits for each participant equivalent to those to which the participant would have been entitled if the prior plan had continued without interruption. The new plan may grant past service credit for the period during which an employee was covered by the terminated plan (subject to the limitations of section 415). Where a new plan with credit for past service is established the future amortization period for the unfunded past service liability for the new plan under section 412 must be the lesser of 30 years or the weighted average future remaining working lifetime of all covered employees. The employer must request and obtain IRS approval for this change in funding method for the new plan. If approval has not been received, favorable determination letters for the terminated and replacement plans will contain the appropriate selective caveat(s).

An employer may not recover surplus assets in a transaction in which it splits an over-funded defined benefit plan into two defined benefit plans, terminates one of the plans and receives the excess assets ("spinoff/termination" transaction), unless the following conditions are satisfied:

(i) The benefits of all employees (including those employees covered by the ongoing plan) must be fully vested and nonforfeitable as of the date of termination.

(ii) All benefits accrued as of the date of termination for all employees (including those employees covered by the ongoing plan) must be provided for by the purchase of guaranteed annuity contracts.

(iii) In the case of the ongoing plan, the funding method for such plan must be changed on the date of termination by combining and offsetting amortization bases in accordance with Code section 412(b)(4). The amortization period for this base will be the lesser of the combined amortization period or the weighted average future remaining working lifetime of all covered employees. The employer must request and obtain IRS approval for this change in funding method. If, in the original plan guaranteed annuity contracts have not been purchased for all covered employees, a favorable determination letter may not be issued unless the employer has given written assurance that guaranteed annuity contracts will be purchased or lump sums paid for employees, (see note below). Further, any such favorable determination letter on the ongoing and terminated plan must contain the appropriate selective caveat(s). If the employer has not obtained IRS approval for any required change in funding method, any favorable determination letter on the ongoing and terminated plan must contain the appropriate selective caveat(s). These caveats are found in Exhibit 7.13.5-17 of IRM 7.13.5 and their use is explained in Exhibit 7.13.5-16 of IRM 7.13.5.

Note that the lump sum payments may not be made or annuity contracts distributed to the active participants under the ongoing plan unless such participants have attained normal retirement age. See also section 411(a)(11) requiring consent for certain "cash-outs".

In general, these requirements apply to termination/reestablishment and spinoff/termination cases where the termination and the reestablishment or the spinoff and termination occur within a five year period.
Implementation Guidelines, Treasury news release dated May 24, 1984
401(a)(2)
Rev. Rul. 85-6, 1985-1 C.B. 133

Line e. One of the requirements for plan qualification is that the plan be intended to be permanent. A plan may not satisfy the permanency test of the income tax regulations if, within 15 years of the termination of a defined benefit plan involving a reversion of assets, an employer has previously received a reversion of assets upon termination of a defined benefit plan which covered some or all of the same employees.
Implementation Guidelines, Treasury news release dated May 24, 1984
IRM 7.12.1.2.10

II. Benefits

Line a. A qualified pension, profit-sharing, or stock bonus plan may not permit the assignment or pledging of nonforfeitable plan benefits as security for loans. Under section 401(a)(13), a trust forming part of a stock bonus, pension, or profit-sharing plan will not be qualified unless the plan which the trust is a part of provides that the plan's benefits may not

be assigned or alienated. There are, however, exceptions to this general rule:

(1) A plan may provide that, after a benefit is in pay status, the participant receiving the benefit may make a voluntary and revocable assignment (not more than 10 percent of any benefit payment), if the assignment is not to defray plan administrative costs.

(2) A loan, made to a participant or beneficiary and secured by the participant's nonforfeitable benefit, will not be treated as an assignment or alienation if the loan is exempt from the excise tax on prohibited transactions imposed by Code section 4975. This exception applies only to loans from the plan and not to loans from third parties. A plan will not meet the requirements of section 401(a)(13) if it permits the assignment or pledging of nonforfeitable benefits as security for loans from a party other than the plan.

(3) If a "qualified domestic relations order" requires the distribution of all or part of a participant's benefits under a plan to an alternative payee, the payment of such benefits will not be treated as an assignment or alienation of benefits prohibited by section 401(a)(13). A "qualified domestic relations order" is a "domestic relations order," within the meaning of Code section 414(p)(1)(B), which (i) creates or recognizes the existence of an alternative payee's right to, or assigns to an alternate payee the right to receive all or a portion of the benefits payable to a participant under a plan; (ii) specifies the information required by section 414(p)(2); (iii) does not require a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan; (iv) does not require the plan to provide increased benefits (determined on the basis of actuarial value); and (v) does not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a qualified domestic relations order. An "alternate payee" is a spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant.

(4) A participant's benefits under a plan may be offset to satisfy the participant's liability to a plan due to the participant's conviction of a crime, certain civil judgments, and certain settlement agreements involving the participant and the Department of Labor or the Pension Benefit Guaranty Corporation. In certain circumstances the spouse must consent to this offset. See section 401(a)(13)(C).

401(a)(13)
414(p)

Line b. A qualified plan must provide that, unless a participant elects otherwise, payments of benefits will begin not later than the 60th day after the close of the plan year in which the latest of these events occur: (1) the participant reaches either the plan's normal retirement age or 65, whichever comes first; (2) the 10th anniversary of the year in which the participant started participation in the plan or, (3) the participant terminates service with the employer.

Although a plan is not required to provide an election for further deferrals, it may permit a participant to ask that payment of any benefit begin at a date later than the dates described above. Then, the plan must require the participant to make an election by submitting to the plan administrator a written statement which describes the benefit and states the date on which payment is to begin. Distribution of a participant's benefit must, of course, comply with the requirements of section 401(a)(9). See Worksheet No. 9.

401(a)(14)
1.401(a)-(14)

Line c. A pension plan may not provide benefits before a participant terminates service, reaches normal retirement age, dies, or becomes disabled; profit-sharing and stock bonus plans may provide for payment before the normal retirement age or termination of service.

1.401-1(b)(1)(i) & (ii)

Line d. To be qualified, a plan (defined benefit and defined contribution) that provides for payment of any early retirement benefit when a stated period of service is completed and a stated age is reached must also provide that a participant who has met the service requirement (and is vested in it) will receive the benefit when the age requirement is satisfied. The benefit may be actuarially reduced, however, it may not be less than the reduced normal retirement benefit (the benefit to which the participant would have been entitled under the plan at normal retirement age, reduced by reasonable actuarial assumptions).

401(a)(14)
1.401(a)-14(c)

Line e. A qualified plan must give the distributee of an eligible rollover distribution the option of having the distribution paid in a direct rollover to an eligible retirement plan specified by the distributee. For this purpose, a distributee includes only the employee and the employee's surviving spouse (or the employee's spouse or former spouse, if designated as an alternate payee under a qualified domestic relations order).

For distributions made after December 31, 2001, an eligible rollover distribution is generally any distribution of all or any portion of the balance to the credit of the employee in the plan. However, an eligible rollover distribution does not include the portion of any distribution not includible in gross income (disregarding the exclusion for net unrealized appreciation), any distribution required by section 401(a)(9), or any distribution that is one of a series of substantially equal periodic payments over at least ten years or over the life or life expectancy of the employee or of the employee and a designated beneficiary, and hardship distributions. Certain other distributions, such as corrective distributions of excess contributions or excess deferrals under a qualified CODA, are not eligible rollover distributions.

Under section 643 of the Economic Growth and Tax Relief Reconciliation Act of 2001, an eligible rollover distribution also may include after-tax employee contributions which are not includible in gross income. However, such portion may only be transferred to an IRA or to a qualified plan under section 401(a) or a plan under section 403(b) that agrees to separately account for the transferred amounts including separately accounting for the portion of such distribution which is includible in gross income and the portion of such distribution which is so includible.

An eligible retirement plan is an IRA, a qualified plan, a 403(a) or 403(b) plan, or a 457(b) plan, that accepts the distributee's eligible rollover distribution.

A direct rollover means that the distribution is paid directly to the eligible retirement plan. This may be accomplished by any reasonable means of direct payment.

The plan administrator may prescribe any reasonable procedures for the distributee to elect a direct rollover. In addition, the plan may provide that a distributee will not be allowed to elect a direct rollover if the distributee's eligible rollover distributions for the year are reasonably expected to total less than $200.

The Service has provided sample language that plan sponsors may adopt to satisfy the direct rollover plan provision requirement and safe harbor notice language. These rules apply to distributions made after December 31, 2001, which expanded spousal rollovers and the definition of eligible retirement plan. Other more restrictive rules apply for distributions made before January 1, 2002.

401(a)(31)
402(c)(8)(B)
1.401(a)(31)-1
1.402(c)-2
Notice 2001-57
Notice 2002-3

Line f. Automatic rollover requirements apply to certain mandatory distributions under a plan. Pursuant to section 411(a)(11), if the present value of any nonforfeitable accrued benefit exceeds $5,000, a plan must provide that such benefit is not immediately distributable without the consent of the participant. Therefore, a plan may provide that amounts that do not exceed $5,000 may be immediately distributable without consent. Under section 401(a)(31)(B), when a distributee of any mandatory distribution that is an eligible rollover distribution does not elect to have the distribution transferred to an eligible retirement plan or to receive it directly, and the distribution exceeds $1,000, then the plan administrator must transfer the amount to an individual retirement plan and give the participant written notice. This rule applies to mandatory distributions made on or after March 28, 2005.

401(a)(31)(B)
Notice 2005-5
Notice 2005-95

III. General Qualification Issues

Line a. Under the trust instrument it must be impossible at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the year or after it) used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries. The statute provides a limited exception for certain contributions to multiemployer plans. In addition, Rev. Rul. 91-4 provides that the general prohibition against diversion does not preclude the return of a contribution an employer makes if (1) the contribution is made by reason of mistake of fact; (2) the contribution is conditioned on initial qualification of the plan, a determination letter application is filed by the due date of the return for the taxable year in which the plan was adopted or any prescribed later date (i.e., a later section 401(b) date), and the plan receives an adverse determination; or (3) the contribution is conditioned on its deductibility under section 404. The contribution's return must be made within one year of the mistaken payment of the contribution, denial of qualification, or disallowance of the deduction, as the case may be. Nondeductible contributions to a qualified defined benefit plan of less than $25,000 may be treated as disallowed and thus may be returned to the employer if the plan specifically allows the return of contributions determined by the Service to be nondeductible and the contribution is conditioned on deductibility.

401(a)(2)
1.401-2(b)(1)
Rev. Rul. 91-4, 1991-1 C.B. 57
Rev. Rul. 90-49, 1990-2 C.B. 620

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b. A plan shall not be qualified unless it provides that an employee's right to his or her normal retirement benefit is nonforfeitable on attainment of normal retirement age as defined in Code section 411(a)(8), that is, the earlier of normal retirement age under the plan or the later of age 65 or the 5th anniversary of participation commencement. If a plan defines normal retirement date as the first day of the month coincident with or following the date on which a participant reaches age 65, and provides that a participant's right to his or her normal retirement benefit is nonforfeitable at the normal retirement date a participant might not be fully vested at his or her normal retirement age as required by section 411(a).

411(a)
411(a)(8)
1.411(a)-7(b)

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c. A profit sharing plan must have a predetermined formula for allocating employer contributions that precludes employer discretion. One such method is to allocate contributions in proportion to compensation. The allocation formula may also take into account years of service, but this may be discriminatory.

401(a)(4)
1.401-1(b)(1)(ii)

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d. A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his or her employees over a period of years, usually for life, after retirement. A plan so designed will be considered a pension plan if employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, in the case of a money purchase plan, such contributions are fixed without being geared to profits. This requirement will be satisfied if the employer-provided benefit under the plan can be determined under an express formula stated in the plan that does not involve employer discretion. For example, the definitely determinable benefit requirement will not be satisfied unless the percentage of the survivor portion of the qualified joint and survivor annuity of a pension plan is not within the discretion of the plan sponsor.

Under a money purchase pension plan, however (but not under a defined benefit plan), forfeitures may be applied to increase the benefit any employee would otherwise receive under the plan.

401(a)(8)
1.401-1(b)(1)(i)
Rev. Rul. 74-385, 1974-2 C.B. 130

Line e. Defined benefit plans that provide for the payment of optional benefit forms that are the actuarial equivalent of the normal retirement benefit payable under the plan, like any other pension plan, must provide for the payment of definitely determinable benefits as required by section 1.401-1(b)(1)(i) of the regulations. See Rev. Rul. 69-427 which deals with the application of this rule to a plan that provides disability benefits and early retirement benefits. Whenever the amount of a benefit in a plan is to be determined by some procedure that requires the use of actuarial assumptions, (interest, mortality, etc.) the assumptions to be used must be specified within the plan in a manner which precludes employer discretion. Such assumptions may be fixed or variable as long as they do not involve employer discretion.

401(a)(25)
1.401-1(b)(1)(i)
Rev. Rul. 69-427, 1969-2 C.B. 87
Rev. Rul. 79-90,1979-1 C.B. 155

Line f. Under Rev. Rul. 74-307, preretirement death benefits under a pension plan of any type will be considered incidental if either (1) less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary life insurance policies on the participant's life even if the total death benefit consists of both the face amount of the policies and the amount credited to the participant's account at the time of death, or (2) the total death benefit before normal retirement date does not exceed the greater of (a) the proceeds of ordinary life insurance policies providing a death benefit of 100 times the anticipated monthly normal retirement benefit, or (b) the sum of (i) the reserve under the ordinary life insurance policies plus (ii) the participant's account in the auxiliary fund.

Rev. Rul. 74-307 is directly applicable to defined contribution pension plans (i.e., money purchase pension plans), but can not be directly applied to defined benefit plans. The reason for this is that there are no participants' accounts in a defined benefit plan. Also, employer contributions are not allocable to individual participants' accounts, but are made to fund the benefits of the plan as whole. However, the general principle of Rev. Rul. 74-307, that death benefits will be considered incidental if less than a stated percentage of employer contributions made on behalf of each participant are used to purchase life insurance, can apply to defined benefit plans.

To apply the "50 percent" rule of Rev. Rul. 74-307 to defined benefit plans, an amount representing the "employer contribution for a participant" must be computed. This amount is the "theoretical contribution" which is the contribution that would be made on behalf of the participant, using the individual level premium funding method from the age at which participation commenced to normal retirement age, to fund the participant's entire retirement benefit without regard to preretirement ancillary benefits. The theoretical contribution is computed based upon reasonable actuarial assumptions (i.e., interest rate, mortality) that must be stated in the plan.

The "amount credited to the participant's account at the time of death" for this purpose is the theoretical individual level premium reserve that is computed using the theoretical contribution. The theoretical individual level premium reserve is the reserve that would be available at time of death if for each year of plan participation a contribution had been made on behalf of the participant in an amount equal to the theoretical contribution.

In applying Rev. Rul. 74-307 to defined benefit plans the maximum premiums for ordinary life insurance may be no more than 66 (33 if term and/or universal life insurance) percent of the theoretical contribution. The death benefit payable may not exceed the face amount of the insurance policies plus the theoretical individual level premium reserve less the cash value of the insurance policies.

In addition to incidental death benefits under the above application of Rev. Rul. 74-307, preretirement death benefits under a defined benefit plan will also be considered incidental if: (1) the cost of the death benefit for any individual does not exceed 25 percent of the total cost of the individual's benefit, (2) the death benefit is not greater than 100 times a participant's anticipated monthly annuity, (3) the death benefit is equal to the present value of the participant's accrued benefit, or (4) a surviving spouse's annuity benefit is a stated percentage of the deceased participant's accrued benefit or a stated percentage of the anticipated normal retirement benefit where the stated percentage is within the guidelines set forth in Rev. Rul. 70-611, as modified by Rev. Rul. 85-15.

In the case of a defined contribution plan that provides for the use of trust funds to purchase and pay premiums on ordinary life insurance contracts, the death benefit, which can include the participant's account balance, is deemed to be incidental if: (1) the aggregate life insurance premiums that have been paid with funds which have not been accumulated for at least 2 years for each participant are less than one-half of the aggregate of the contributions allocated to the credit of the participant at any particular time, and (2) the plan requires the trustee to convert the entire value of the life insurance contract at or before retirement into cash, or to provide periodic income so that no portion of such value may be used to continue life insurance protection beyond retirement, or to distribute the contract to the participant.

The same general 25 percent incidental benefit rule that applies for defined benefit plans also applies for defined contribution plans. Any lump sum death benefit provided by life insurance contracts under a defined contribution plan is deemed to be incidental if the premiums on the contracts purchased on behalf of a participant do not exceed 25 percent of the employer contributions allocated to the participant's account. Further, if the plan meets the rules ordinarily applicable to defined benefit plans, it will meet the incidental death benefit rule.

The rules discussed above relate to whether death benefits under defined benefit or defined contribution plans are incidental within the meaning of section 1.401-1(b)(1) of the regulations. Section 401(a)(11) of the Code, however, requires certain plans to provide automatic survivor benefits to the surviving spouse of a vested participant who dies before retirement. With an exception for plans described in section 401(a)(11)(C), a "qualified preretirement survivor annuity," as defined in section 417(c), is required to be provided by any defined benefit plan or any money purchase pension plan. A profit-sharing or stock bonus plan must also provide the qualified preretirement survivor annuity unless the plan satisfies certain requirements in section 401(a)(11)(B)(iii).

As explained in Rev. Rul. 85-15, the qualified preretirement survivor annuity is a preretirement death benefit that must be taken into account in determining whether death benefits under a plan are incidental within the meaning of section 1.401-1(b)(1) of the regulations. A plan under which the only preretirement death benefit is a qualified preretirement survivor annuity will satisfy the incidental death benefit requirement of section 1,401-1(b)(1) of the regulations.

If a plan provides any preretirement death benefit (i.e., a lump sum death benefit) in addition to the qualified preretirement survivor annuity, such benefits considered together will be deemed incidental so long as the value of the qualified preretirement survivor annuity and the additional death benefit do not exceed the maximum death benefit allowable under one of the rules discussed above relating to incidental death benefits under a defined benefit plan or defined contribution plan, whichever the case may be. In order to satisfy the incidental death benefit rule, a plan may be required to offset the value of the qualified preretirement survivor annuity against the additional death benefit, and only the excess, if any, of the additional benefit over the value of the qualified preretirement survivor annuity would be provided along with the qualified preretirement survivor annuity.

If under a pension plan, lump sum death benefits are to be offset by the value of the qualified preretirement survivor annuity to satisfy the incidental death benefit requirement of section 1.401-1(b)(1) of the regulations, the plan must specify the actuarial assumptions necessary, including the assumptions for determining the lump sum value of the survivor annuity, in order to make the benefits definitely determinable as required by section 401(a)(25) and Rev. Rul. 79-90.

Besides the preretirement incidental requirement described in the preceding paragraphs, a plan must also satisfy the minimum distribution incidental benefit (MDIB) requirement. See Worksheet No. 9 regarding the MDIB requirement.

401(a)(11)
401(a)(25)
1.401-1(b)(1)(i) & (ii)
Rev. Rul. 60-83, 1960-1 C.B 157
Rev. Rul. 60-84, 1960-1 C.B. 159
Rev. Rul. 66-143, 1966-1 C.B. 79
Rev. Rul. 68-31, 1968-1 C.B. 151
Rev. Rul. 70-611, 1970-2 C.B. 89
Rev. Rul. 74-307, 1974-2 C.B. 126
Rev. Rul. 79-90, 1979-1 C.B. 155
Rev. Rul. 85-15, 1985-1 C.B. 132

Line g. A pension or annuity plan may provide for the payment of sickness, accident, hospitalization, and medical expenses of retired employees and their spouses and dependents provided certain conditions are met.

First, a separate account (a “section 401(h) account”) must be established and maintained for the retiree medical benefits under the plan. (For any key employee, a separate account must also be maintained for the benefits payable to that employee (or spouse or dependents) and, generally, medical benefits payable to that employee (or spouse or dependents) may come only from that separate account.) Second, the employer’s contributions to the 401(h) account must be reasonable and ascertainable. Third, it must be impossible for the corpus or income of the 401(h) account to be used for or diverted to a purpose other than providing the retiree medical benefits prior to the satisfaction of all liabilities under the plan to provide such benefits. Fourth, the terms of the plan must provide that, upon the satisfaction of all liabilities under the plan to provide the retiree medical benefits, all amounts remaining in the 401(h) account must be returned to the employer.

Finally, the retiree medical benefits must be subordinate to the retirement benefits provided by the plan. This requirement will not be satisfied unless the plan provides that the aggregate actual contributions for retiree medical benefits, when added to the actual contributions for life insurance under the plan, are limited to 25 percent of the total actual contributions made to the plan (other than contributions to fund past service credits) after the later of the adoption or effective date of the section 401(h) arrangement.

401(h)

Line h. If a plan permits the transfer of assets in a defined benefit plan to a section 401(h) health benefit account, see section 16 and appendix of Rev. Proc. 2006-6, 2006-1 C.B. 204.

Line i. All defined contribution plans must provide for a valuation of investments held by the trust at least once a year, on a specified inventory date, in accordance with a method consistently followed and uniformly applied. The fair market value on the inventory date is to be used for this purpose, and the respective accounts of participants are to be adjusted in accordance with the valuation.

Rev. Rul. 80-155, 1980-1 C.B. 84

Line j. Certain corrective amendments that are made after the end of a plan year may be taken into account in determining whether a plan satisfies the minimum coverage or nondiscrimination requirements for such year. That is, the amendment may be treated as if it were adopted and effective as of the first day of the plan year even though it is in fact adopted after the end of the year. This rule applies in addition to the remedial amendment provisions described above.

If a corrective amendment to satisfy the minimum coverage or nondiscrimination requirements (other than an amendment permitted under the remedial amendment rules of section 401(b)) is being taken into account prior to its adoption, this line should be completed.

To satisfy the minimum coverage, nondiscrimination in amount, or nondiscriminatory plan amendment requirements (see Worksheet 5), a corrective amendment may retroactively increase accruals or allocations for employees who benefitted under the plan during the plan year being corrected or may provide accruals or allocations to employees who did not benefit during the plan year being corrected. To satisfy the nondiscriminatory current availability requirement that applies to benefits, rights, and features (see Worksheet 5), a corrective amendment may expand the availability of the benefit, right, or feature to employees to whom it was not previously available.

A corrective amendment may be taken into account prior to its adoption only if the following conditions are satisfied:

1. The amendment may not reduce any employee’s benefits determined under the plan prior to the amendment.

2. The amendment must generally be effective as if it had been adopted on the first day of the year being corrected that is, it must be treated as if in effect for the entire year. (An amendment to extend the availability of a benefit, right, or feature does not fail this requirement merely because it is not made effective prior to its adoption date.)

3. The amendment must be adopted and implemented on or before the 15th day of the 10th month after the close of the plan year being corrected. (This deadline is automatically extended by the filing of a determination letter request before the deadline. The extension is until the expiration of 91 days after disposition (e.g., issuance of a letter) of the request.)

4. The additional allocations or accruals for the plan year being corrected that result from the amendment must separately satisfy section 401(a)(4) for that year and must benefit a group of employees that separately satisfies section 410(b). (This requirement does not apply if the purpose of the amendment is to conform the plan to a nondiscrimination in amount safe harbor.) The employer may be asked to demonstrate that this requirement is satisfied.

Other conditions apply in the case of corrective amendments relating to the availability of benefits, rights, and features. Special rules also apply in the case of section 401(k) and section 401(m) plans. The specialist should refer to the regulations in these circumstances. The employer may be asked to demonstrate that these conditions and special rules are satisfied.

A nonsubstantive amendment may not be taken into account for purposes of the minimum coverage and nondiscrimination requirements. For example, an amendment will not be taken into account to the extent it affects nonvested, terminated employees who would not have received any economic benefit from the amendment had it been adopted in the year being corrected.

1.401(a)(4)-11(g)

Line k. For plan years beginning after December 31, 2002, section 408(q) provides that a defined contribution plan may allow employees to make voluntary employee contributions to a separate account or annuity established under the plan which, if that account or annuity meets the applicable requirements of section 408 (traditional IRA) or section 408A (Roth IRA), will be treated as an individual retirement plan (i.e. a “deemed IRA”). In general, the defined contribution plan and the “deemed IRA” are treated as separate entities with each entity subject to the rules generally applicable to it.

A plan with a deemed individual retirement annuity must satisfy the requirements of section 408(b). Similarly, a plan with a deemed individual retirement account must satisfy the requirements of section 408(a) except for the prohibition in section 408(a)(5) which is expressly excepted under 408(q). Accordingly, the assets of a deemed IRA may be commingled for investment purposes with the other assets of the plan. However, the plan must still restrict the commingling of deemed IRA assets with non-plan assets.

Deemed individual retirement accounts may be held in separate individual trusts, a single trust separate from a trust maintained by the defined contribution plan, or in a single trust that includes the defined contribution plan. If deemed IRAs are held in a single trust that includes the defined contribution plan, the plan must provide that the trustee shall maintain a separate account for each deemed IRA.

Deemed individual retirement annuities may be held under a single annuity contract or under separate annuity contracts. Where a single annuity contract is used, separate accounting for the interest of each participant is required. Also, the contract must be separate from any annuity contract of the plan.

As noted in Rev. Proc. 2003-13, plan language should address every applicable point in the IRA List of Required Modifications (LRMs) published on the Service’s web site at www.irs.gov/ep. Rev. Proc. 2003-13 also contains sample plan language to be used in conjunction with the IRA language. However, #5 of the sample plan amendment providing for separate trusts for deemed IRAs is no longer required. Section 1.408(q)-1(f) of the income tax regulations relating to deemed IRAs provides that a separate trust is not required in those cases in which the qualified employer plan maintains a trust, but only if separate accounting is maintained for each deemed IRA.

408(q)
408A
1.408(q)-1
Rev. Proc. 2003-13

IV. Compensation Limit

Line a. Section 401(a)(17) requires that a qualified plan must provide that the compensation taken into account for any employee in determining contributions or benefits for a plan year is limited to the annual compensation limit.

1.401(a)(17)-1(b)

The following applies to plan years beginning before January 1, 2002. For plan years beginning after December 31, 2001, see below:

The annual compensation limit for plan years beginning before January 1, 1994, is $200,000, adjusted, beginning on January 1, 1990, in the same manner as under section 415(d). The annual compensation limit for plan years beginning on or after January 1, 1994, is $150,000, adjusted, for changes in the cost of living as under section 415(d). However, the $150,000 amount will be adjusted only when the adjustment yields an increase in the annual compensation limit of at least $10,000, and adjustments will be made only in increments of $10,000. Adjustments in the annual compensation limit may not be taken into account prior to the plan year beginning in the calendar year for which the adjustment takes effect. For years beginning after December 31, 1994, the base period is the calendar quarter beginning October 1, 1993.

If compensation for a prior year is used in determining contributions or benefits for the plan year, the applicable compensation limit is the limit in effect for the prior year.

The annual compensation limit under section 401(a)(17) first applies in the first 1989 plan year. Thus, allocations or benefits accrued for plan years beginning before 1989 (the “statutory effective date”) are not subject to the annual compensation limit. Also, allocations or benefits accrued for plan years beginning on or after the statutory effective date

but before the 1994 plan year are not subject to the $150,000 limit. However, if an employer generally amends a plan to increase prior benefits for years before either the statutory or OBRA '93 effective date, the employer may not treat these benefits as accrued in the prior years (thereby avoiding either the $200,000 or the $150,000 limit).

Allocations for plan years beginning before the statutory effective date, even if based on compensation in excess of $200,000, do not limit allocations in later years. However, if compensation for a year beginning prior to the statutory effective date is used in determining contributions or benefits for the 1989 plan year or a later plan year beginning before January 1, 1994, then the compensation limit for that prior year is $200,000. Similarly, allocations for plan years beginning before January 1, 1994 (the "OBRA '93 effective date"), even if based on compensation in excess of $150,000, do not limit allocations in later years. However, if compensation for a year beginning prior to the OBRA '93 effective date is used in determining contributions or benefits for the 1994 plan year or a later plan year, then the compensation limit for that prior year is $150,000.

1.401(a)(17)-1(a) & (b)

For purposes of section 401(a)(17), a plan may determine the compensation that is used in computing contributions for the plan year on the basis of compensation for that plan year. A plan may also determine compensation on the basis of a 12 consecutive month period, or periods, ending within the plan year. In this case, the applicable limit that applies to compensation for such periods is the limit in effect for the calendar year in which each 12 month period begins.

1.401(a)(17)-1(b)(3)(ii)

If the plan determines compensation on a period of time less than 12 months, or in the case of a plan year of less than 12 months, then the otherwise applicable limit is proportionately reduced for the number of months fewer than 12. Proration is not required merely because accruals or allocations are based on compensation for that portion of the plan year during which the employee is a participant. Proration is also not required for employees covered under the plan for less than a full plan year provided their allocations are based on compensation for a period of at least twelve months.

1.401(a)(17)-1(b)(3)(iii)

In the case of a plan maintained by more than one employer, the annual compensation limit applies separately with respect to the compensation of an employee from each employer maintaining the plan.

1.401(a)(17)-1(b)(4)

For years beginning before January 1, 1997, the family aggregation rules of section 414(q), as modified by section 401(a)(17) apply with respect to the requirement that the plan must limit the amount of contributions taken into account in determining contributions. That is, the plan must treat the following family unit as a single employee with one compensation to which the annual compensation limit under the plan applies: an employee who is either a 5% owner or is both a highly compensated employee and one of the ten most highly compensated employees, such employee's spouse, and any lineal descendants of such employee who have not attained age 19 before the close of the year. If the compensation for the family unit exceeds the annual compensation limit, then the plan must specify how the limit will be allocated among the members of the family unit. However, if the plan provides for permitted disparity under section 401(i), this proration is not to be applied for purposes of determining the portion of each individual's compensation that is below the integration level.

These aggregation rules have been repealed effective for years beginning after December 31, 1996. If compensation for any year beginning before January 1, 1997 is used in determining allocations or benefits (or in testing for nondiscrimination) in a plan year beginning after December 31, 1996, the compensation limit under section 401(a)(17) for that prior year is also determined without regard to family aggregation. Thus, for example, in applying the compensation limit for 1997 in a defined benefit plan that bases its benefit on the highest 3 year average compensation, the family aggregation rules will be disregarded in determining the compensation limit for 1995 and 1996.

401(a)(17)
414(q)(6)(C)

For any plan year beginning after December 31, 2001, the annual compensation of each participant taken into account in determining allocations shall not exceed $200,000, as adjusted for cost-of-living increases in accordance with section 401(a)(17)(B) of the Code. Section 401(a)(17)(B) provides that the $200,000 amount shall be adjusted annually for increases in the cost of living at the same time and same manner as adjustments under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2001, and any increase which is not a multiple of $5,000 shall be rounded to the next lowest multiple of $5,000. The Commissioner generally publishes cost-of-living adjustments under section 401(a)(17)(B) and other sections in October of each year, applicable in the following year. Annual compensation means compensation during the plan year or such other consecutive 12-month period over which compensation is otherwise determined under the plan. The cost-of-living adjustment in effect for a calendar year applies to annual compensation for the determination period that begins with or within such calendar year.

Line b. A defined benefit plan must determine the accrued benefit of each section 401(a)(17) employee by applying the fresh-start rules described in section 1.401(a)(4)-13(c) (and, if applicable 1.401(a)(4)-13(d)) of the regulations and Worksheet #5A. Refer to Worksheet #5 and the accompanying explanation for a general discussion of the fresh-start rules under section 1.401(a)(4)-13(c) and (d) of the regulations.

Generally, an employee with an accrued benefit as of the last day of the 1988 plan year determined under a formula that took into account the employee's compensation in excess of $200.000 is a section 401(a)(17) employee. (This benefit, frozen as of the last day of the 1988 plan year, is referred to as the "section 401(a)(17) frozen accrued benefit.")

Likewise, an employee with an accrued benefit as of the last day of the 1993 plan year determined under a formula that took into account the employee's compensation in excess of $150,000 is generally a section 401(a)(17) employee. (This benefit, frozen as of the last day of the 1993 plan year, is referred to as the "OBRA '93 frozen accrued benefit.")

However, in either case, if the plan makes a fresh start using the formula with wear-away described in Worksheet 5 and the benefit determined by applying the current formula to total service (taking into account the annual compensation

limit) exceeds the frozen (or adjusted) accrued benefit, the employee will not be a section 401(a)(17) employee. If it is determined that there are no section 401(a)(17) employees in the plan, answer this line on the worksheet “N/A”.

The fresh-start date that must be used for transitioning into compliance with section 401(a)(17) (the “section 401(a)(17) fresh-start date”) must be a date that is not earlier than the last day of the 1988 plan year and, generally, not later than the last day of the 1993 plan year. For this purpose, the fresh-start rules must be applied using a benefit formula, after amendment to comply with the section 401(a)(17) $200,000 annual compensation limit and the final regulations, as the formula applicable to accruals in the post-fresh-start year. In addition the plan must apply the fresh-start rules to transition into compliance with the OBRA ’93 $150,000 annual compensation limit by using, generally, the last day of the 1993 plan year as the fresh-start date and using a benefit formula, after amendment to comply with the section 401(a)(17) $150,000 annual compensation limit and the final regulations, as the formula applicable to accruals in the post-fresh-start year.

Generally, the plan may adjust either the section 401(a)(17) frozen accrued benefit or the OBRA ’93 frozen accrued benefit, or both, for post-fresh-start date compensation increases, as described in section 1.401(a)(4)-13(d) of the regulations and Worksheet 5A. If the plan is amended to make a fresh-start for all employees, it may provide that there will be no adjustment to the pre-fresh-start date frozen accrued benefit, adjustment will be made to the frozen accrued benefits of non-section 401(a)(17) employees only, or adjustment will be made to the frozen accrued benefits of all employees in the plan.

If the plan is adjusting section 401(a)(17) employees’ accrued benefits, the adjustment is made in one of two ways. The frozen accrued benefit may be adjusted by multiplying it by the “old compensation fraction” as defined in section 1.401(a)(4)-13(d)(8)(i) of the regulations. In this case, the denominator is the employee’s compensation as of the fresh-start date, using the plan’s compensation formula (including the underlying definition and averaging period) as of that date and, in the case of an OBRA ’93 fresh-start date, reflecting the annual compensation limit that applied as of the fresh-start date. The numerator is the employee’s updated compensation, determined after applying the annual compensation limits to each year’s compensation used in the plan’s compensation formula. Alternatively, the plan may determine the employee’s adjusted accrued benefit by “plugging in” the employee’s updated compensation, determined after applying the annual compensation limits, in the formula used to determine the frozen accrued benefit. Thus, in either case there can be no adjustment until the updated compensation, determined after applying the annual compensation limit, exceeds the compensation used to determine the frozen accrued benefit.

If the plan makes multiple fresh starts with respect to an employee, and the frozen accrued benefit consists of a sum of a frozen accrued benefit (or adjusted accrued benefit) as of a previous fresh-start date plus additional frozen accruals since the previous fresh-start date, the adjustment described above must be made separately to the previously frozen accrued benefit and the additional frozen accruals to the extent that these have been determined using different compensation formulas or compensation limits. For example, this could occur where an employee’s frozen accrued benefit as of the OBRA ’93 fresh-start date consists of the section 401(a)(17) frozen accrued benefit plus accruals between the statutory effective date and the OBRA ’93 effective date. In this case, the denominators in the adjustment fractions used to adjust the section 401(a)(17) frozen accrued benefit and the frozen accruals for years between the statutory effective date and the OBRA ’93 effective date will be different. In the former case, the denominator will not reflect any compensation limitation, while in the latter case the denominator will reflect the annual compensation limit as in effect under section 401(a)(17) in the years between the statutory effective date and the OBRA ’93 effective date.

A plan may be amended after either the section 401(a)(17) fresh-start date or the OBRA ’93 fresh-start date to provide a new optional form of benefit or to make an optional form of benefit available with respect to the applicable frozen accrued benefit, provided the optional form of benefit is not subsidized. If the plan adds an optional form of benefit with respect to an applicable frozen accrued benefit that is subsidized, the plan fails to satisfy section 401(a)(17).

1.401(a)(4)-13(c)
1.401(a)(4)-13(d)
1.401(a)(17)-1(e)

V. Amendments Relating to ESOPs

Line a. Regulation section 54.4975-11(a)(2) requires that in order to be an ESOP, the plan document must have language that specifically designates itself as an ESOP. The entire plan may be designated as an ESOP. However, Regulation §54.4975-11(a)(5) allows a plan to provide that only a portion of a qualified plan is an ESOP. For example, an ESOP could be a portion of a Profit Sharing Plan, or, an ESOP could be a portion of a Money Purchase Plan.

Section 4975(e)(7)(A) of the Code requires that an ESOP must also state that it is designed to invest primarily in qualifying employer securities.

54.4975-11(a)(2)
4975(e)(7)(A)
54.4975-11(b)

Line b. Regulation 54.4975-7(b)(4) provides that the proceeds of an exempt loan must only be used for: (i) the acquisition of qualifying employer securities, (ii) to repay such loan and/or, (iii) to repay a prior loan.

Reg. 54.4975-7(b)(4)

Line c. Regulations 54.4975-7(b)(5) provides that the exempt loan must be without recourse against the ESOP and that the only assets that may be given as collateral on such loan are qualifying employer securities of two classes, (i) those acquired with the proceeds of an exempt loan, and (ii) those that were used as collateral on a prior exempt loan and repaid with the proceeds of the current exempt loan.

Reg. 54.4975-7(b)(5)

Line d. Regulations 54.4975-7(b)(7) provides that the interest rate of the exempt loan must not be in excess of a reasonable rate of interest. The regulation further provides that all relevant factors will be considered in determining a reasonable rate of interest, including the amount and duration of the loan.

Regulation 54.4975-7(b)(13) provides that the exempt loan must be for a definite period of time and cannot be payable at the demand of any person, except in the case of default.

Reg. 54.4975-7(b)(7) & (13)

Line e. Regulation 54.4975-11(d)(4) Does the plan provide that if a portion of the account is forfeited, qualifying securities must be forfeited only after other assets.

Reg. 54.4975-11(d)(4)

Line f. Regulation §54.4975-11(c) requires that the terms of an ESOP must provide for the use of a suspense account to hold qualifying employer stock purchased by the ESOP trust through an exempt loan until its release and allocation to participants' accounts in the ESOP.

54.4975-11(c)

Line g. Regulation §54.4975-7(b)(8) provides that the plan must release employer security from the suspense account either under the "general rule" or the "special rule".

The "general rule' provides that for each plan year during the loan, the number of shares released must equal the number of shares held before the current year's release, multiplied by a fraction with the principal and interest paid for the year being the numerator and the denominator being the sum of this amount plus the principal and interest to be paid for all future years.

The "special rule" provides for the release of employer securities from the suspense account using the above fraction but based solely on payments of principal. This rule may only be used if the term of the loan is for 10 years or less (including renewal or extension periods) and the interest is one that would be determined under a standard amortization table.

The plan must state which method it intends on using to release stock from the suspense account. If the plan incorporates both methods, it should also have language to state that once a method is chosen it cannot be changed during the period of the exempt loan, except to the extent that the method as described in the general rule has been violated.

54.4975-7(b)(8).

Line h. If the employer has a class of securities that are required to be registered under Section 12 of the Securities and Exchange Act of 1934 (Section 12 of the Securities and Exchange Act of 1934 ("the Exchange Act") or a class of securities that would be required to be registered except for the exemption from registration provided by Section 12(g)(2)(H) of the Exchange Act, Code §409(e)(2) states that the ESOP must provide each participant with the right to direct the voting of securities allocated to their account on all corporate matters.

If the employer does not have registration type securities, Code §409(e)(3), requires that an ESOP allow the participants to vote the shares in their account, but only with regard to the following issues:

1. any corporate matter involving mergers, or consolidations,
2. the sale of all or substantially all of the corporation's assets,
3. re-capitalizations,
4. reclassifications,
5. liquidations, and
6. dissolutions,

It is the Service's position that applicable state law would govern with respect to the right to direct the plan to vote allocated shares, in the case of non-registration type securities. Therefore, state law must provide for shareholder voting on those corporate matters before voting rights are passed through to the participants. In addition, Code §409(e)(5) provides for a special 1 vote for each participant rule for non-registration type class securities. This special rule allows each participant 1 vote with the trustee voting the shares held by the plan in proportion to the votes received.

For either registration class or non- registration class of securities, the plan may provide that, if the plan trustee does not receive instructions on how to vote the particular shares, the trustee will vote those shares. See Revenue Ruling 95-57, 1995-57, 1995-2 C.B. 62.

In addition, it is not uncommon for plan provisions to not "pass through" voting rights on unallocated shares (shares still in the suspense account). The plan could provide for the trustee to vote these shares. The plan could also provide that unallocated shares as well as allocated shares are voted in proportion to the allocated shares for which directions have been received. The Department of Labor has held that the responsibility for the voting of unallocated shares should rest with the plan trustee. The plan trustee however, may follow plan provisions only to the extent permitted by ERISA §404(a)(1)(D) (i.e. insofar as plan provisions are consistent with Titles I and IV of ERISA).

409(e)(2) – (5)

Revenue Ruling 95-57

Line i. Since distributions from an ESOP may be made entirely in employer securities or in cash, or a combination of cash and securities, section 409(h)(1)(A) provides that the participant must be given the right to demand that their entire distribution be in the form of employer securities. If the employer securities are not readily tradable on an established market, the employee has the right to require that the employer repurchase the employer securities under a fair valuation formula. Code §409(h)(1)(B). However, benefits distributed from the portion of a plan that is not an ESOP is only subject to the requirements imposed under Code §401(a). For example, the Stock Bonus or Money Purchase portion of the plan could provide for a distribution of cash, while the ESOP portion would provide for a distribution of stock.

Code Section §409(h)(2)(B) provides that if the employer is an S corporation or if the employer's corporate charter (or bylaws) restricts ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan, the participant does not have to be given the right to demand a distribution in the form of employer securities. In either case, such plan may distribute employer securities subject to the requirement that such securities may be resold to the employer in conformance with section 409(h)(1)(B).

A right to demand a distribution in the form of employer securities does not have to be given if the securities were subject to the right of diversification and the participant had previously made an election to diversify. Code §409(h)(7) and Notice 88-56, Q&A-14.

409(h)(1)(A)

409(h)(1)(B)

409(h)(2)(B)

409(h)(7)

Line j. IRC section §409(h) and section §54.4975-7(b)(10) of the Regulations are designed to protect plan participant's from being "stuck" with employer stock where there is no market to sell the stock on an established market. An ESOP must provide therefore, that once participants receive a distribution of securities from the employer, they must be given the right to "Put" the securities back to the employer. The ESOP must require the employer to repurchase securities that are not "readily tradable on an established market" upon the participant's exercise of the put option (when distributed or if the stock is subject to a trading limitation when distributed). Also, this regulation requires that stock must be put at fair market value.

The ESOP must provide that the put option is exercisable during two periods. The first one is for at least 60 days following the date of distribution and the second one is for at least 60 days in the following plan year. Code §409(h)(4).

The plan must also provide that if the participant receives a total distribution which is required to be repurchased by the employer, the employer must make payments at least as rapid as substantially equal periodic payments (at least annually) over a period beginning not later than 30 days after exercise of the put option and not exceeding 5 years. The employer must also provide adequate security and pay reasonable interest on any unpaid amount. Code §409(h)(5).

If the exempt loan is repaid, or if the plan ceases to be an ESOP, the put option requirements must continue to exist with respect to distributions that were acquired with the exempt loan. Section 54.4975-11(a)(3)(ii) Also securities acquired by an ESOP with an exempt loan may not be subject to a preexisting put, call or other option, or buy-sell or similar arrangement while held by or distributed from the plan. Section 54.4975-7(b)(4). However, this provision does not override the put option requirement for securities that are not publicly traded (or, subject to a trading limitation).

409(h)(4)
409(h)(5)
54.4975-7(b)(10)
54.4975-11(a)(3)(ii)

Line k. Section 401(a)(28)(C) requires a plan to provide, with regard to activities carried on by a plan, that valuations of employer securities which are not readily tradeable on an established securities market are to be made by an independent appraiser. An "independent appraiser" is an appraiser who meets requirements similar to the requirements of the regulations under section 170(a)(1).

401(a)(28)(C)

Line l. Code section 401(a)(28)(B) provides that each qualified participant in a plan may elect, within 90 days after the close of each plan year in the qualified election period, to direct the plan with regard to the investment of at least 25 percent of the participant's plan account. The account balance subject to the diversification election is increased to 50 percent in the final year of the election period. Q&A-9 of Notice 88-56,1988-1 C.B. 540, provides that the portion of a qualified participant's account subject to the diversification election in all years of the qualified election period (other than the final year) is equal to (1) 25 percent of the number of shares of employer securities acquired by the plan after December 31, 1986, that have ever been allocated to a qualified participant's account, less (2) the number of shares of employer securities previously diversified pursuant to a diversification election made after December 31, 1986.

A "qualified participant" is any employee who has completed at least 10 years of participation in the plan and has attained age 55. The "qualified election period" is the 6 plan year period beginning with the later of (1) the first plan year in which the individual first becomes a qualified participant, or (2) the first plan year beginning after December 31, 1986.

There are three methods by which a plan can satisfy the diversification requirement. The first two are statutory and appear in section 401(a)(28)(B). First, the plan provides that the portion of the participant's account subject to the diversification election is distributed within 90 days after the period in which the election can be made. Second, the plan offers at least three investment options to each participant making the diversification election, and within 90 days after the election period ends, the plan invests the portion of the amount subject to the diversification election. Q&A-13 of Notice 88-56 provides a third method by which a plan can satisfy the diversification election. The plan offers a participant the option to direct the plan to transfer the portion of the account subject to the diversification election to another qualified defined contribution plan of the employer that offers at least three investment options. This transfer must be made no later than 90 days after the end of the election period.

401(a)(28)(B)
Notice 88-56, Q&A 13

Line m. Section 409(o) provides that an ESOP participant who is entitled to receive a distribution can elect to commence distributions sooner than the period described under sections 401(a)(14) and 401(a)(9). A participant can elect, with the consent of his or her spouse as required by section 401(a)(11) and 417, to commence the distribution of his or her account balance not later than one year after the close of the plan year (1) in which the participant separates from service by reason of normal retirement age, disability, or death, or (2) which is the 5th plan year following the plan year in which the participant otherwise separates from service, as long as the participant is not reemployed by the employer before this distribution is required to begin.

The election for accelerated distribution does not apply to any employer securities acquired with the proceeds of a loan to an ESOP until the close of the plan year in which the loan is repaid in full. Unless the participant elects otherwise, the distribution of the account balance must be in substantially equal periodic payments (made at least annually) over a period of not greater than five years. If the participant's account balance exceeds $800,000 (as adjusted for cost-of-living increases), the distribution period is increased, unless the participant elects otherwise, to five years plus one additional year (up to five additional years) for each $160,000 (or fraction thereof) by which the balance exceeds $800,000.

409(o)

Line n. Code §415(c)(6) & Regulation 1.415-6(g)(3) provide a special rule that may be used in determining annual additions made to an ESOP. The rule provides that if not more than one-third of the employer contributions to an ESOP for a plan year are allocated to the accounts of participants who are highly compensated employees (within the meaning of Code §414(q)), all forfeitures of leveraged stock and all employer contributions used to pay interest on a leveraged loan which

are charged against the participant's account are eliminated from the computation of annual additions

415(c)(6)
1.415-6(g)(3)

Line o. Section 409(n) was added by TRA '86. Prior to TRA '86, the prohibitions contained in section 409(n) appeared under the rules of section 1042. Section 409(n) states that a plan must provide that the assets of an ESOP attributable to employer securities acquired by the ESOP in a sale to which section 1042 applies (section 1042 securities) cannot accrue for the benefit of the persons specified in section 409(n). Also, the section 1042 securities acquired by the ESOP cannot be allocated directly or indirectly under any qualified plan of the employer.

Allocations of section 1042 securities cannot be made during the nonallocation period to any taxpayer who makes a section 1042 election, or to anyone who is related to the taxpayer within the meaning of section 267(b), unless the lineal descendant exception applies. This exception provides that an allocation of section 1042 shares to a relative of the taxpayer who made the section 1042 election is not prohibited if he or she is a lineal descendant of the taxpayer, and the amount allocated to all such lineal descendants during the nonallocation period does not exceed five percent of the employer securities held by the plan attributable to a sale under section 1042 by a person related to such descendants (within the meaning of section 267(c)(4)).

The nonallocation period is the period beginning when the securities are sold to the plan pursuant to section 1042, and ends on the later of 1) 10 years after the date of the sale, or 2) if the plan borrowed money to purchase the section 1042 securities, the date this indebtedness is repaid.

Allocations of section 1042 securities also cannot be made, at any time, to a person who owns, after the application of section 318(a), more than 25 percent of 1) any class of outstanding stock of the corporation which issued the employer securities or of any corporation which is a member of the same controlled group, or 2) the total value of any class of outstanding stock of such a corporation. Section 318(a) is applied to the "25 percent ownership of any class of stock" test without regard to the employee trust exception in section 318(a)(2)(B)(i). Therefore, stock owned by a qualified plan is attributed to a participant or beneficiary for purposes of (1) above.

A person is not treated as a 25 percent shareholder if he or she fails the limitation at any time in the one-year period ending on the date of the sale to the plan, or the date the securities are allocated to participants in the plan.

409(n)

Line p. Section 409(p) was enacted as part of EGTRRA effective for plan years after 12/31/04, but immediately effective for S corporation ESOPs established on or before 3/14/01. The intent of this law is to limit the tax deferrals provided by an S corporation ESOP to those situations where there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

Pursuant to section 409(p)(1) of the Code, an ESOP holding stock in an S corporation stock must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such stock may during a "nonallocation year", accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a) for the benefit of any "disqualified person". These assets accrued or allocated to the accounts of disqualified persons in a nonallocation years are "prohibited allocations". Note that there is a prohibited allocation to the extent that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a "disqualified person" during a nonallocation year. This includes all such assets allocated to the disqualified persons account in any previous year and held in the disqualified persons account in the nonallocation year. Section 1.409(p)-1T(b)(2).

Section 1.409(p)-1T(i)(2)(ii)(A) of the Temporary Regulations provides a transition rule whereby ESOP shares that are held for a disqualified person before the first plan year beginning on or after January 1, 2005 will not be treated as an impermissible accrual in 2005 if the shares are disposed of before July 1, 2005 (e.g., by distribution or transfer to a non-ESOP) and no amount is contributed for the benefit of the disqualified person under any plan of the employer intended to meet the requirements of section 401(a) (including the ESOP) during the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005.

Prohibited allocations are deemed to be distributed and includable in income tax. In addition, IRC 4979(A) imposes on the S corporation a 50% excise tax on the "prohibited allocations". That section also imposes a 50% excise tax on the value of the "synthetic equity" owned by "disqualified persons" during a nonallocation year, whether a prohibited allocation has occurred or not.

409(p)(1)
409(p)(2)
1.409(p)-1T(b)(1)
1.409(p)-1T(b)(2)(i)-(iv)

Line q. The definition of a "nonallocation year" is any ESOP plan year where, at any time during the year, "disqualified persons" own directly or through attribution, 50% of the number of outstanding shares of the S corporation. The determination of whether a nonallocation year has occurred takes into account all the shares of the S corporation whether held in the ESOP or not. Section 409(p)(5) provides that in the case of a person who owns synthetic equity, the shares of stock on which such synthetic equity is based on is treated as outstanding stock of the S corporation and deemed owned shares of that individual. Section 409(p)(3).

Under section 409(p)(4) a disqualified person is one who is either a member of a 20% shareholder group or is a 10% shareholder taking into account synthetic equity owned by the individual if such addition causes the individual to become disqualified.

A person is a member of a 20% shareholder group if the number of "deemed-owned shares" of the person and the person's family is at least 20% of the total S corporation shares held by the ESOP.

The term "deemed-owned shares", under section 409(p)(3)(C), is the sum of:

1) stock allocated to an account of an individual by the ESOP and

2) an individual's share of unallocated stock held by the ESOP. IRC section 409(p)(4)(C)(ii) provides that a

person's share of unallocated S corporation stock held by such plan is the amount of the unallocated stock which would be allocated to such person if the unallocated stock were allocated to all participants in the same proportions as the most recent stock allocation under the plan.

A person is a 10% shareholder if the person is not a member of a 20% shareholder group and the number of the person's "deemed-owned shares" is at least 10% of the total S corporation shares held by the ESOP.

The determination as to whether a participant is a 10% shareholder must also take into account that individual synthetic equity shares of the S corporation (see discussion of synthetic equity, below), if by doing so causes the person to be disqualified. Section 409(p)(5). In this regard synthetic equity issued by the S corporation to other individuals is not taken into consideration. The individuals total shares (deemed-owned and synthetic equity shares) are compared with the total number of deemed owned shares and the individual's synthetic equity shares. Section 1.409(p)-T(d)(1)

For purposes of determining ownership, the attribution rules of IRC section 318 apply, modified with the exception that the members of an individual's family shall include members of the family described in IRC section 409(p)(4)(D). See IRC section 409(p)(3)(B).

Family members will include the

(i) individual's spouse,

(ii) ancestors or lineal descendant of the individual or the individual's spouse,

(iii) brother or sister of the individual or the individual's spouse and any lineal descendant of the brother or sister, and

(iv) the spouse of any individual described in (ii) or (iii).

Section 409(p)(6)(C) defines synthetic equity as any stock option, warrant, restricted stock or similar right that gives the holder the right to acquire or receive stock of the S corporation. It also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value. Section 1.409(p)-1T(f)(2)(iv), synthetic equity is defined to include non-qualified deferred compensation. This includes any remuneration for services rendered to the S corporation to which IRC 404(a)(5) applies.

The number of synthetic equity shares attributed to a stock option is based on the number of shares that are subject to that option. For example, an option to purchase 10 shares of S Corporation stock becomes 10 shares of synthetic equity without regard to the option price. The number of synthetic equity shares based on shares of stock but for which payment is made in cash or other property (e.g., phantom stock units), the number of synthetic equity shares is equal to the number of shares having a fair market value equal to the cash or other property paid.

In the case of synthetic equity that is not determined by reference to shares (i.e., nonqualified deferred compensation), the person entitled to the synthetic equity is treated as owning the number of shares equal to the present value of the synthetic equity divided by the fair market value of a share of the S Corporation's stock as of the same date. Section 1.409(p)-1T of the regulations generally effective 1/1/05, provides the following special rules in regards to synthetic equity:

i. The number of synthetic equity shares based on nonqualified deferred compensation may be determined on the first day of the ESOP's plan year or any other reasonable determination date. Section 1.409(p)-1T(f)(4)(iii)(B)(1)

ii. An ESOP may provide that the number of synthetic equity shares treated as owned on a determination date may remain constant from that date until the date immediately preceding the third anniversary of the determination date. Section 1.409(p)-1T(f)(4)(iii)(B)(2).

iii. The number of shares otherwise determined is ratably reduced to the extent that S corporation shares are owned outside the ESOP. Section 1.409(p)-1T(f)(4)(iv)

409(p)(3)-(5)
409(p)(6)(C)
1.409(p)-1T(c)(1),(2)
1.409(p)-1T(d)(1)
1.409(p)-1T(d)(2)(i) – (iv)
1.409(p)-1T(e)
1.409(p)-1T(f)(1)
1.409(p)-1T(f)(2)(i), (ii) & (iv)
1.409(p)-1T(f)(4)(iii)(B)(1)
1.409(p)-1T(f)(4)(iii)(B)(2)
1.409(p)-1T(f)(4)(iv)

Line r. Section 404(k) was amended by EGTRRA to provide a deduction, in addition to the section 404(a) deductions, to a C corporation sponsor of an ESOP for dividends on "applicable employer securities" allocated to participant accounts which the participant elects to reinvest in employer securities. (See section 404(k)(2)(iii)). Notice 2002-2, 2002-1 C.B. 285, provides that this election must be between (a) either (i) the payment of dividends in cash to participants or (ii) the payment to the ESOP and distribution in cash to participants not later than 90 days after the close of the plan year in which the dividends are paid by the corporation. An ESOP may also offer participants a choice among both of the options described in (a) and the option described in (b).

Under section 404(k)(3), applicable employer securities means, with respect to any dividend, employer securities which are held on the record date for such dividend by an ESOP which is maintained by the corporation paying the dividend or any other corporation within the control group (as defined by section 409(l)(4)) of that corporation.

In addition to the election to reinvest dividends in employer securities, Section 404(k) also provides for employer deductions for dividends on employer securities allocated to participant accounts which are either paid directly to the participants or paid to the plan and distributed in cash to the participant not later than 90 days after the close of the plan year in which paid. (See sections 404(k)(2)(i)&(ii)).

Section 404(k) deductions are also allowed for dividends on allocated and unallocated applicable employer securities which are used to pay the exempt loan which was used to acquire the securities with respect to which the dividend is paid. (See, section 404(k)(2)(iv)). If the dividends used are on employer securities allocated to a participant's account, the plan must provide that employer securities with a fair market value not less than the amount of such dividend must be allocated to that participant's account in the year the dividend would otherwise have been allocated.

404(k)
Notice 2002-2