Section 410.—Minimum Participation Standards

26 CFR 1.410(b)–2: Minimum coverage requirements (after 1993).
(Also, § 401; § 1.401(a)(4)–1.)

Coverage; special rules; request for comments. This ruling describes the application of the special coverage rule for acquisitions and dispositions in section 410(b)(6)(C) of the Code in a situation involving a defined benefit plan and a profit-sharing plan that includes a qualified cash or deferred arrangement under section 401(k)(2). In addition, the ruling holds that a significant change in a plan or in the coverage of a plan during the transition period under section 410(b)(6)(C)(ii) curtails the period effective as of the date of the change and does not make the plan retroactively ineligible to apply section 410(b)(6)(C). Finally, the ruling also asks for comments as to other situations that may arise under section 410(b)(6)(C).

Rev. Rul. 2004–11

ISSUES

(1) Will the plans described below be treated as satisfying the requirements of § 1.401(a)(4)–1(b)(2) of the Income Tax Regulations, relating to nondiscriminatory contributions or benefits, and the requirements of §§ 401(k) and 401(m) of the Internal Revenue Code, as well as the requirements of § 410(b), by reason of the special rule in § 410(b)(6)(C) for certain acquisitions or dispositions?

(2) Does a significant change in a plan's coverage during the transition period under § 410(b)(6)(C)(ii) make a plan ineligible for the special rule in § 410(b)(6)(C), or merely curtail the transition period during which the special rule may be applied to the plan?

FACTS

Subsidiary S, which is part of X, a controlled group of corporations under § 414(b), sponsors a defined benefit pension plan and a profit-sharing plan for its employees. Both plans are qualified under § 401(a), and the plan year of each plan is the calendar year. Only employees of S are eligible to participate in the plans. The defined benefit plan would satisfy a nondiscrimination safe harbor under § 1.401(a)(4)–3(b) but for the fact that the plan provides a subsidized early retirement benefit that is not currently available to substantially all employees. For purposes of satisfying the nondiscrimination requirements of § 401(a)(4), the defined benefit plan is therefore restructured into two component plans, as permitted by § 1.401(a)(4)–9(c), one component consisting of all the accruals and other benefits, rights, and features provided to those employees to whom the subsidized early retirement benefit is currently available, and the other component consisting of all the accruals and other benefits, rights, and features provided to those employees to whom the subsidized early retirement benefit is not currently available. Each of the component plans separately satisfies a nondiscrimination safe harbor under § 1.401(a)(4)–3(b) and the other nondiscrimination requirements of § 401(a)(4) and also separately satisfies § 410(b) by satisfying the ratio percentage test of § 1.410(b)–2(b)(2). The profit-sharing plan includes only a qualified cash or deferred arrangement, as defined in § 401(k)(2), and matching contributions that are subject to the nondiscrimination requirements of § 401(m).

On June 22, 2004, all of the stock of S is sold to corporation Y. Immediately before the sale, the defined benefit plan maintained by S satisfies the minimum coverage requirements of § 410(b) by satisfying the ratio percentage test of § 1.410(b)–2(b)(2), and the qualified cash or deferred arrangement and the matching contribution portion of the profit-sharing plan each satisfy the ratio percentage test. For this purpose, neither plan is aggregated with any other plan, and X does not apply the coverage requirements of § 410(b) on the basis of separate lines of business under § 414(r). In addition, each of the component plans under the defined benefit plan satisfies the nondiscrimination requirements of § 401(a)(4) and the ratio percentage test of § 1.410(b)–2(b)(2) immediately before the sale.

S continues to maintain the profit-sharing plan without change after the sale. S also continues to maintain the defined benefit plan, but amends the plan to significantly change the benefit formula effective April 1, 2005.

LAW

Under § 401(a)(3), a plan is not qualified under section § 401(a) unless it satisfies the minimum coverage requirements of § 410(b) and § 1.410(b)–2. In order to satisfy § 410(b) and § 1.410(b)–2, the group of employees benefiting under a plan must not discriminate in favor of highly compensated employees (within the meaning of § 414(q)). In general, a plan satisfies § 410(b) for a plan year if the plan satisfies either the ratio percentage test in § 1.410(b)–2(b)(2) or the average benefit test in § 1.410(b)–2(b)(3) for the plan year. A plan satisfies the ratio percentage test for a plan year if, for the plan year, the plan benefits a percentage of nonhighly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan. A plan satisfies the average benefit test for a plan year if, for the plan year, the plan satisfies the nondiscriminatory classification test in § 410(b)(2)(A)(i) and § 1.410(b)–4 and the average benefit percentage test in § 410(b)(2)(A)(ii) and § 1.410(b)–5. In general, the average benefit percentage test requires the determination of each employee's employee benefit percentage, based on employer-provided contributions or benefits, under all of the employer's qualified plans.

Section 410(b)(6)(C) provides a special rule for applying the minimum coverage requirements in situations involving certain acquisitions or dispositions. Under § 410(b)(6)(C), if a person becomes, or ceases to be, a member of a group described in § 414(b), (c), (m), or (o), the requirements of § 410(b) are treated as having been met during the transition period with respect to any plan covering employees of such person or any other member of such group, provided two conditions are met. First, the plan must have satisfied the requirements of § 410(b) immediately before each such change in the members of a group. Second, the coverage under the plan must not significantly change during the transition period (other than by reason of the change in the members of a group) or the plan must meet such other requirements as the Secretary may prescribe. The transition period is defined in § 410(b)(6)(C)(ii) as the period beginning on the date of the change in members of a group and ending on the last day of the first plan year beginning after the date of such change.

For purposes of § 410(b)(6)(C), § 1.410 (b)–2(f) provides that the terms "acquisition" and "disposition" refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business. Section 1.410(b)–2(f) provides that a plan may be treated as satisfying § 410(b) during the transition period following an acquisition or disposition if the plan satisfies § 410(b) (without regard to § 410(b)(6)(C)) immediately before the acquisition or disposition and there is no significant change in the plan or in the coverage of the plan other than the acquisition or disposition.

Section 1.410(b)–7 provides the definition of plan that applies for purposes of § 410(b). In general, each single plan within the meaning of § 414(l) is a separate plan for purposes of § 410(b), but certain plans must be treated as comprising two or more separate plans, each of which is a single plan for purposes of § 410(b). Under § 1.410(b)–7(c), the portion of a plan that is a "section 401(k) plan" is treated as a separate plan for purposes of § 410(b). (A "section 401(k) plan" is a plan consisting solely of elective contributions described in §1.401(k)–1(g)(3) under a qualified cash or deferred arrangement described in § 1.401(k)–1(a)(4)(i).) Similarly, the portion of a plan that is a "section 401(m) plan" is treated as a separate plan for purposes of § 410(b). (A "section 401(m) plan" is a plan consisting solely of employee contributions described in §1.401(m)–1(f)(6) or matching contributions described in §1.401(m)–1(f)(12), or both.) Thus, in the case of a plan that includes elective contributions and employee or matching contributions, the plan must be disaggregated. The portion of the plan that is a section 401(k) plan and the portion of the plan that is a section 401(m) plan must separately satisfy § 410(b).

In general, for purposes of the ratio percentage test and the nondiscriminatory classification test, an employer may permissively aggregate two or more plans, other than plans that are required to be disaggregated. If the employer does so, the aggregated plans are treated as a single plan for purposes of §§ 410(b) and 401(a)(4).

Under § 401(a)(4), a plan is not qualified under § 401(a) unless the contributions or benefits under the plan do not discriminate in favor of highly compensated employees (within the meaning of § 414(q)). Sections 1.401(a)(4)–1 through 1.401(a)(4)–13 set forth the exclusive rules for determining whether a plan satisfies this requirement. Section 1.401(a)(4)–1(b)(2) requires that either the contributions or the benefits under the plan be nondiscriminatory in amount. Section 1.401(a)(4)–3 contains the rules for determining whether employer-derived benefits under a defined benefit plan are nondiscriminatory in amount. Unless the plan satisfies a nondiscrimination safe harbor under § 1.401(a)(4)–3(b), the plan must satisfy the general test for nondiscrimination in amount of benefits under § 1.401(a)(4)–3(c) for the plan year. However, § 1.401(a)(4)–1(c)(4)(iii) and § 1.401(a)(4)–9(c) allow a plan to be treated as consisting of two or more component plans for purposes of satisfying § 401(a)(4). If each component plan satisfies §§ 401(a)(4) and 410(b) as if it were a separate plan, then the plan is treated as satisfying § 401(a)(4). A component plan consists of all the allocations or accruals and other benefits, rights, and features provided under the plan to a selected group of employees. Every employee must be included in one and only one component plan under a plan for a plan year. The requirement that each component plan satisfy § 410(b) is in addition to the requirement that the plan satisfy § 410(b). Section 1.401(a)(4)–1(c)(4)(iv) provides that, except as otherwise specifically provided, references to satisfying § 410(b) in the regulations under § 401(a)(4) mean satisfying § 1.410(b)–2, taking into account any special rules available in satisfying that section (other than the permissive aggregation rules of § 1.410(b)–7(d)).

Section 401(k)(1) provides that a profit-sharing or stock bonus plan does not fail to be qualified under § 401(a) merely because the plan includes a qualified cash or deferred arrangement. Section 401(k)(3)(A)(i) provides that a cash or deferred arrangement is not a qualified cash or deferred arrangement unless those employees eligible to benefit under the arrangement satisfy the provisions of § 410(b)(1). (This requirement corresponds to the requirement in § 1.410(b)–7(c) that a section 401(k) plan must separately satisfy § 410(b).) Section 401(k)(3)(A)(ii) provides that a cash or deferred arrangement is not a qualified cash or deferred arrangement unless the arrangement satisfies the actual deferral percentage (ADP) test described therein.

Section 401(m) provides special nondiscrimination requirements for employee and matching contributions under a qualified defined contribution plan. Section 401(m)(1) provides that the amount of employee and matching contributions under a defined contribution plan satisfies the requirements of § 401(a)(4) only if the employee and matching contributions under the plan satisfy the actual contribution percentage (ACP) test described in § 401(m)(2).

ANALYSIS

The sale of S to Y is an acquisition or disposition within the meaning of § 1.410(b)–2(f), and the defined benefit plan and each of the disaggregated portions of the profit-sharing plan satisfy § 410(b) (without regard to § 410(b)(6)(C)) immediately before the acquisition or disposition. The sale would affect the data required to be taken into account in applying the requirements of § 410(b) to the plans in the absence of the special rule in § 410(b)(6)(C).

There is no significant change in the section 401(k) plan or in the coverage of the section 401(k) plan (other than the acquisition or disposition) during the transition period under § 410(b)(6)(C)(ii). Likewise, there is no significant change in the section 401(m) plan or in the coverage of the section 401(m) plan. Therefore, the special rule in § 410(b)(6)(C) may be applied to each of the disaggregated portions of the profit-sharing plan for the transition period starting on the date of sale of S to Y (June 22, 2004) and continuing through December 31, 2005 (that is, the last day of the plan year beginning on January 1, 2005). Accordingly, under § 410(b)(6)(C), the profit-sharing plan will be treated as satisfying the requirements of § 410(b) during the transition period.

The coverage requirement for a qualified cash or deferred arrangement in § 401(k)(3)(A)(i) requires the group of employees eligible to benefit under the arrangement to satisfy § 410(b). Therefore, the special rule for certain acquisitions or dispositions in § 410(b)(6)(C) and § 1.410(b)–2(f) may be applied for purposes of satisfying that requirement. Accordingly, the cash or deferred arrangement in the profit-sharing plan will be treated as satisfying the coverage requirement in § 401(k)(3)(A)(i) during the transition period.

On the other hand, the ADP test and ACP test described in § 401(k)(3)(A)(ii) and § 401(m)(2), respectively, do not refer to § 410(b). Rather, these tests require the comparison of the average of the actual deferral ratios and actual contribution ratios of the group of eligible highly compensated employees and the group of eligible nonhighly compensated employees under the plan. Therefore, the special rule for certain acquisitions or dispositions in § 410(b)(6)(C) and § 1.410(b)–2(f) does not apply for purposes of satisfying the ADP test or the ACP test and thus provides no relief from satisfying these tests using the averages of the actual deferral ratios and actual contribution ratios, respectively, of the eligible employees under the plan. Accordingly, the cash or deferred arrangement and the matching contributions under the profit-sharing plan must satisfy the ADP test and the ACP test following the sale of S to Y using these ratios.

The benefit formula in the defined benefit plan does not satisfy a nondiscrimination safe harbor because the plan provides a subsidized early retirement benefit that is not currently available to substantially all employees. However, for purposes of satisfying § 401(a)(4), the plan is restructured, as permitted by § 1.401(a)(4)–9(c), into two component plans each of which separately satisfies a nondiscrimination safe harbor. Section 1.401(a)(4)–9(c) requires that each component plan separately satisfy § 410(b) as well as § 401(a)(4). Pursuant to § 1.401(a)(4)–1(c)(4)(iv), the requirements of § 410(b) are to be applied to the component plans taking into account any special rules available in satisfying § 1.410(b)–2 (other than the permissive aggregation rules of § 1.410(b)–7(d)). Thus, for purposes of satisfying the requirements of § 1.401(a)(4)–9(c), the special rule in § 410(b)(6)(C) and § 1.410(b)–2(f) may be applied, provided (1) each component plan separately satisfies §§ 401(a)(4) and 410(b) immediately before the acquisition or disposition and (2) neither the plan nor the coverage under the plan is significantly changed during the transition period (other than by reason of the change in the members of a group) or the plan meets such other requirements as the Secretary may prescribe.

Each component plan under the defined benefit plan separately satisfies §§ 401(a)(4) and 410(b) immediately before the sale of S to Y, and there is no significant change in the defined benefit plan or in the coverage under the defined benefit plan (other than the acquisition or disposition) during the period following the sale and prior to April 1, 2005.

The plan amendment significantly changing the benefit formula in the defined benefit plan, effective April 1, 2005, is a significant change in the plan or in the coverage of the plan (other than the acquisition or disposition) for purposes of § 410(b)(6)(C) and § 1.410(b)–2(f). For this purpose, a change in the plan means a change in the benefits or in the benefit levels under the plan.

The effect of § 410(b)(6)(C) is to provide time for a plan sponsor to consider what coverage or other plan changes will need to be made for the sponsor's plans to continue to satisfy the minimum coverage requirements following an acquisition or disposition. Thus, the plan sponsor is relieved from having to immediately amend its plans or otherwise effect coverage changes to comply with § 410(b). The rule in § 410(b)(6)(C) is permissive, so that plan sponsors may choose to satisfy the requirements of § 410(b) after an acquisition or disposition either with or without regard to § 410(b)(6)(C). Furthermore, the transition period described in § 410(b)(6)(C)(ii) is the maximum period allowed to a plan sponsor before the sponsor must take into account the change in the employer resulting from the acquisition or disposition. There is no requirement to apply the relief in § 410(b)(6)(C) for the whole of the allowable transition period. Thus, the effect of a significant change in a plan or in the coverage of a plan (other than the acquisition or disposition) during the transition period under § 410(b)(6)(C)(ii) is to curtail the period effective as of the date of the change and not to make the plan retroactively ineligible to apply § 410(b)(6)(C). Accordingly, under § 410(b)(6)(C), the defined benefit plan will be treated as satisfying the requirements of § 410(b) and the requirements of § 1.401(a)(4)–1(b)(2) during the applicable transition period from June 22, 2004, through March 31, 2005.

Starting April 1, 2005, the defined benefit plan must satisfy the requirements of § 410(b) and the requirements of § 1.401(a)(4)–1(b)(2) without regard to the special rule in § 410(b)(6)(C). That is, the plan must satisfy these requirements taking into account the employees of Y. The profit-sharing plan must satisfy the requirements of §§ 410(b) and 401(k)(3)(A)(i) taking into account the employees of Y starting the first day of the plan year beginning on January 1, 2006. The plan amendment significantly changing the benefit formula in the defined benefit plan does not curtail the profit-sharing plan's transition period under § 410(b)(6)(C)(ii) because the plans satisfy the requirements of § 410(b) independently of each other.

HOLDINGS

ISSUE (1)

Under the facts set forth, the defined benefit plan will be treated as satisfying the requirements of § 410(b) and the requirements of § 1.401(a)(4)–1(b)(2) during the applicable transition period from June 22, 2004, through March 31, 2005. The profit-sharing plan will be treated as satisfying the minimum coverage requirements of § 410(b) by reason of the special rule in § 410(b)(6)(C) during the plan's applicable transition period from the date of the sale through December 31, 2005. The cash or deferred arrangement will also be treated as satisfying the coverage requirement of § 401(k)(3)(A)(i) during this transition period. However, the cash or deferred arrangement and the matching contributions under the profit-sharing plan will not, by reason of the special rule in § 410(b)(6)(C), be treated as satisfying the ADP test or the ACP test in § 401(k)(3)(A)(ii) and § 401(m)(2), and, therefore, the plan must satisfy these tests for the plan years ending on December 31, 2004, and December 31, 2005.

ISSUE (2)

A significant change in a plan or in the coverage of a plan curtails the transition period under § 410(b)(6)(C)(ii), so that § 410(b)(6)(C) ceases to apply to the plan as of the date of the change. The change does not make the plan retroactively ineligible to apply § 410(b)(6)(C).

REQUEST FOR COMMENTS

The facts in this revenue ruling describe only one of many situations that may involve the application of the special rule for acquisitions and dispositions in § 410(b)(6)(C). Different types of transactions or different fact patterns may raise questions other than those addressed in this revenue ruling or may require different analyses. The Service and the Treasury are considering issuing additional guidance regarding § 410(b)(6)(C) of a more comprehensive nature and invite public comments. Comments are invited on the issues on which guidance is needed and on the appropriate resolution of these issues.

Commentators are specifically asked to comment on what the appropriate analysis would be if the facts of the ruling were changed as in the situations described below. In commenting on these situations, commentators are asked to address:

- the requirement in § 410(b)(6)(C)(i)(I) (*i.e.*, that the plan satisfy § 410(b) immediately prior to the acquisition or disposition), and
- the requirement in § 410(b)(6)(C)(i)(II) (*i.e.*, that coverage under the plan not be significantly changed during the transition period),

including how each of these two requirements applies with respect to the seller, the transferred employees, and the buyer in each situation; and

- whether, without creating a potential for abuse, there are appropriate circumstances where a plan that is required to calculate employee allocation or accrual rates or employee benefit percentages to determine that the requirements of § 401(a)(4) or § 410(b) (*e.g.*, the general test or the average benefit percentage test) are satisfied should be treated as satisfying those requirements during the transition period following a § 410(b)(6)(C) acquisition or disposition.

In the following situations, assume that the defined benefit plan sponsored by S (Plan A) provides a benefit of one percent of compensation per year of service and that S does not sponsor a profit-sharing plan. Otherwise, the facts are the same as in the revenue ruling except as described in each of the three situations.

Situation 1: Effect of Transaction if Part of Seller's Plan is Spun-off and is Maintained by Buyer. At the time of the sale of S to Y, Plan A covers other employees of group X as well as employees of S. When S is sold to Y, Plan A is split into two plans, Plan A–1 which covers employees of group X who are not employees of S, and Plan A–2, which covers employees of S. Plan A–2 is thus spun off as a separate plan that is maintained by S after the sale of S to Y.

a. Assume that, had the sale of S to Y not occurred, Plan A–1 would not satisfy § 410(b) without being aggregated with Plan A–2 (or that Plan A–2 would not satisfy § 410(b) without being aggregated with Plan A–1).

b. Assume that, after the spin-off, a significant change is made to Plan A–2, but the change is not made to Plan A–1.

Commentators are also asked to consider what the analysis would be if, when S is sold to Y, there is no plan spin-off. As a result, the employees of S do not benefit under a plan after the sale.

Situation 2: Effect on Buyer's Plan if Seller's Plan is Assumed by Buyer. S is a division of group X, rather than a subsidiary, and the transaction is the sale of all of the assets and liabilities of division S to Y. In conjunction with the sale, all division S employees become employees of Y. Y also maintains a defined benefit plan (Plan B) that provides a benefit of two percent of compensation for each year of service. Plan A is assumed by Y, so that employees of S continue to accrue benefits at the rate of one percent of compensation per year of service. The other employees of Y do not participate in Plan A, and the employees of S do not participate in Plan B. For purposes of analyzing the application of § 410(b)(6)(C) to Plan B, consider both the situation where the exclusion of the employees of S from Plan B is the result of Plan B's existing terms and the situation where the exclusion is the result of an amendment to Plan B adopted at the time of the sale of S to Y.

Situation 3: Effect on Buyer's Plan if Seller's Plan is Not Assumed by Buyer. The transaction is the same as in Situation 2, the sale of the assets and liabilities of division S to Y and the transfer of division S employees. However, Y does not assume Plan A, and there are three alternative scenarios with respect to the coverage of employees of S under Plan B:

a. Plan B does not exclude the employees of S. As a result, the employees of S immediately begin to accrue benefits at the rate of two percent of compensation per year of service under Plan B.

b. Plan B excludes the employees of S. As a result, the employees of S do not benefit under a plan after the sale.

c. Plan B is amended at the time of the sale of S to Y to provide a benefit of one percent of compensation per year of service to the employees of S, while continuing to provide the two percent benefit formula for the other employees of Y.

The Service also welcomes comments on other situations or other questions relating to the application of § 410(b)(6)(C).

SUBMISSION OF COMMENTS

Comments should be submitted by May 17, 2004, to CC:PA:LPD:RU (Rev. Rul. 2004–11), Room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to CC:PA:LPD:RU (Rev. Rul. 2004–11), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington D.C. Alternatively, comments may be submitted via the Internet at *Notice.Comments@irscounsel.treas.gov*. All comments will be available for public inspection.

DRAFTING INFORMATION

The principal authors of this revenue ruling are James Flannery of Employee Plans, Tax Exempt and Government Entities Division, and R. Lisa Mojiri-Azad of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday (a toll-free number). Mr. Flannery may be reached at 1–202–283–9888 (not a toll-free call). Ms. Mojiri-Azad may be reached at 1–202–622–6060 (also not a toll-free call).