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.

Department of the Treasury
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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 300-18 and Exhibit 300-19 of IRM 7690 and their use is explained in Exhibit 7620-3 and Exhibit 7620-4 of IRM 7600.

Note that 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. However, some termination/reestablishments on spinoff/terminations may not be part of an integrated transaction. Any case in which the Key District Director determines an integrated transaction does not exist must be submitted to the National Office for technical advice.
Implementation Guidelines, Treasury news release dated May 24, 1984
401(a)(2)(A)
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 7753, Plan Termination Handbook

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)(3), 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)(3). 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 alternate 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) Effective for judgments, orders, decrees, and settlements arising on or after August 5, 1997, 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 involving 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)

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).

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. Certain other distributions, such as corrective distributions of excess contributions or excess deferrals under a qualified CODA, are not eligible rollover distributions.

An eligible retirement plan is an IRA or a qualified plan that accepts the distributee's eligible rollover distribution. However, if the distributee is the employee's surviving spouse, only an IRA will be an eligible retirement plan.

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 model language that plan sponsors may adopt to satisfy the direct rollover plan provision requirement.

401(a)(31)
1.401(a)(31)-1
1.402(c)-2
Rev. Proc. 93-12
Notice 93-3
Notice 93-26
Rev. Proc. 93-47

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. Proc. 90-49, 1990-2 C.B. 620

Line 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)

Line 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)
1.404-4

Line 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(d)(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. 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. 98-6, 1998-1 I.R.B. 183.

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)

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 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(l), 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)

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)(17)-1(e)

V. TRA '86 AND OTHER AMENDMENTS RELATING TO ESOPs

Line a. 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 b. 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 c. 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 $500,000 (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 $100,000 (or fraction thereof) by which the balance exceeds $500,000.
409(o)

Line d. If employer securities are not readily tradeable on an established securities market at the time a participant is entitled to a distribution, the participant has the right to require the employer to repurchase the employer securities. TRA ‘86 added sections 409(h)(5) and (6) to specify the period in which the employer must honor this put.

If the participant receives a total distribution which is required to be repurchased by the employer, the employer must make payments in 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 five years. The employer must provide adequate security and pay reasonable interest on the unpaid amounts of the total distribution. If the participant receives installment distributions which are required to be repurchased by the employer, the employer must pay for the securities not later than 30 days after the exercise of the put option. To the extent an employee has diversified his or her account pursuant to a diversification election under section 401(a)(28)(B), this portion of the employee's account cannot be put to the employer. If amounts are diversified in excess of the minimum amounts required by section 401(a)(28)(B), the employee retains the right to require that the employer repurchase such amounts.

409(h)(5) & (6)
Notice 88-56, Q&A 11

Line e. If an employer does not have a registration class of securities, section 409(e)(3) states that a plan must provide that participants have the right to direct the voting of shares allocated to their accounts with respect to the approval or disapproval of a corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all assets of a trade or business.

409(e)(3)

Line f. 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 g. Prior to the Omnibus Budget Reconciliation Act of 1989 (OBRA ‘89), section 415(c)(6) provided that a participant's account in an ESOP was permitted to have an annual addition of up to $60,000, as long as not more than 1/3 of the employer contributions to repay a loan to the ESOP were allocated to highly compensated employees. OBRA ‘89 eliminated the doubling of the dollar limit on annual additions to ESOP accounts. All ESOPs are now subject to the $30,000 dollar limit of section 415(c)(1)(A). This applies to plan years beginning after July 12, 1989.

415(c)(1)(A)