LESSON 1, PART I

CHANGES TO CODAS UNDER THE SMALL BUSINESS JOB PROTECTION ACT OF 1996 AND THE TAXPAYER RELIEF ACT OF 1997 AND SELECTED EXAMINATION ISSUES

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INTRODUCTION

In a cash or deferred arrangement (CODA), an eligible employee may elect to receive an amount in cash (or some other taxable benefit if it is a nonqualified CODA) or to have the employer make payments as contributions to a plan for the employee's benefit. These contributions are called elective contributions (ECs) and are treated as employer contributions for most purposes under the Internal Revenue Code. CODAs may be qualified or nonqualified, and special requirements apply to qualified CODAS under IRC section 401(k). In addition, special nondiscrimination tests under § 401(m) apply to employee and matching contributions.

The Small Business Job Protection Act (SBJPA), (P.L. 104-188), enacted on August 20, 1996, made significant changes that affect cash or deferred arrangements (CODAs). Some of these rules directly conflict with existing income tax regulations under § 401(k) and 401(m) of the Internal Revenue Code. These changes are effective either in 1997 or 1999. Additional changes affecting CODAs were made by the Taxpayer Relief Act of 1997, Pub. L. 105-34, enacted August 5, 1997 ("TRA'97"). These changes were effective in either

1997 or 1998.

The purpose of this lesson is to highlight the changes made by the SBJPA and TRA'97 rather than to provide a general overview of all of the rules applicable to CODAS. Selected examination issues will also be discussed. For a general discussion of CODAS see the EP Phase I Course Book (May 1995), and the Examination Guidelines, IRM 7(10)(54).

OBJECTIVES

At the end of this lesson you will be able to:

1. Recognize the changes to CODAS made by the SBJPA and TRA'97.

2. Resolve selected examination issues.

BACKGROUND

Many of the rules applicable to CODAs are described in IRC § 401(k) and Treas. Reg. § 1.401(k)-1. In addition, if a plan accepts employee and matching contributions, the plan must meet rules under IRC § 401(m)(2) and Treas. Reg. § 1.401(m)-1. On August 20, 1996 the Small Business Job Protection Act was enacted. The SBJPA made substantial changes to the Tax Code affecting CODAS for years beginning after 1996. The general purpose of the SBJPA was to simplify rules relating to retirement plans and increase access to plans. Additional changes affecting CODAs were made by the Taxpayer Relief Act of 1997, Pub. L. 105-34, enacted August 5, 1997 ("TRA'97").
To provide guidance and transition relief regarding the SBJPA amendments affecting CODAs, the Service issued Notice 97-2, 1997-2 I.R.B. 22, and Notice 98-1, 1998-3 I.R.B. 42.

GENERAL SBJPA CHANGES AFFECTING CODAS

Elimination of Additional Participation Requirements

Pre-SBJPA

A qualified CODA must (A) pass the coverage and participation tests under IRC

§§ 410(b) and 401(a)(26), (B) limit ECs as provided in IRC § 401(a)(30) to the amount allowed by IRC § 402(g), (C) satisfy the distribution rules and other miscellaneous requirements of § 401(k)(2), and (D) apply a special nondiscrimination test for qualified CODAs (ADP test). A nonqualified CODA must apply the general coverage and nondiscrimination rules of §§ 410(b) and 401(a)(4), and cannot use the more generous special rules for qualified CODAs.

SBJPA Change to Participation Rules (effective post-1996 years)

Section 401(a)(26), as amended by SBJPA § 1432, applies only to defined benefit plans, effective for years beginning after 12/31/96.

Tax-Exempt Entities Entitled to Maintain Qualified CODAs

Pre-SBJPA

Tax-exempt organizations (except for organizations maintaining rural cooperative plans) and state or local governments generally could not establish qualified CODAs for years beginning after December 31, 1986, under pre-SBJPA law. Any governmental organization that adopted a CODA before May 6, 1986, or any tax-exempt organization that adopted a CODA before July 2, 1986 was allowed to continue the CODA (and add new employees to the plan). A governmental unit with a grandfathered CODA could establish new CODAs, but another tax-exempt organization could not. See Treas. Reg. § 1.401(k)-1(e)(4).

SBJPA Change (post 1996)

SBJPA § 1426 allows tax-exempt entities to maintain CODAs. Effective for plan years beginning after December 31, 1996, tax-exempt organizations (including for this purpose Indian tribal governments and their subdivisions, agencies, instrumentalities etc.) are allowed to maintain qualified CODAs. Federal, state and local governments continue to be ineligible to maintain CODAs, except to the extent applicable to Indian tribes, and except to the extent the grandfather rules summarized above apply. The legislative history specifically provides that no inference is intended with respect to whether Indian tribal governments are permitted to maintain qualified CODAs under present law (prior to SBJPA).

Note: Some employers consist of tax-exempt and taxable entities. Special rules under § 1.410(b)-6(g) and § 1.401(a)(26)-1(b)(4) of the regulations allowed employers to disregard employees of a tax-exempt entity (who could not

participate in a qualified CODA under prior law) when determining whether the qualified CODA maintained by a taxable entity satisfied § 401(a)(26) or § 410(b). Because of changes under the SBJPA these rules are no longer applicable. However, Notice 96-64, 1996-51 IRB 8 (12/16/96) extends the relief under § 1.410(b)-6(g) for these employers through the 1997 plan year, to give employers time to redesign their plans. Since § 401(a)(26) applies only to defined benefit plans beginning in the 1997 plan year, no extension of the relief under § 1.401(a)(26)-1(b)(4) was required.

Distributions Under Rural Cooperative Plans

Pre-SBJPA

IRC § 401(k)(2)(B) provides that ECs under qualified CODAs may only be distributed upon death, disability, separation from service, and as provided in § 401(k)(10). ECs to a profit sharing or stock bonus plan may also be distributed after age 59-1/2 or on account of hardship. Distribution of any contributions that could be used in the ADP test (i.e. certain qualified nonelective employer contributions (QNECs) or qualified matching contributions (QMACs), defined below and in glossary) must be similarly restricted. Note that as a general rule, QNECs, QMACs and accrued gains may not be distributed on account of hardship. The regulations permit a plan to provide a grandfather rule for interest, QNECs and QMACs accrued prior to December 31, 1988, (or, if later, the end of the last plan year ending before July 1, 1989). See Reg. § 1.401(k)-1(d)(2)(ii). This is done by determining the ECs, QNECs and QMACs on the applicable date and using this as a frozen amount. Losses in the account after that date do not reduce this amount. Other employer contributions outside of the CODA (including QNECs and QMACs)) are not subject to these more restrictive hardship rules.

SBJPA Change (post 8/20/96)

SBJPA § 1443 provides that qualified CODAs of rural cooperative plans may also distribute amounts after age 59-1/2 or on account of hardship, effective for distributions after the date of enactment of the SBJPA (August 20, 1996). The definition of a rural cooperative was also modified to include certain public utility districts, effective for plan years beginning after December 31, 1996.

USERRA

The Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103-353 ("USERRA"), codified at 38 U.S.C. §§ 4301-4333, revised and restated federal law protecting the reemployment rights of an employee following an absence because of military service. Among the protected rights is the right to receive certain pension, profit-sharing and similar benefits that would have been received but for the employee's absence during military service. To implement this right, § 414(u) was added to the Code by § 1704(n) of SBJPA. See Rev. Proc. 96-49, 1996-2 CB 79, for a summary of the requirements of USERRA and § 414(u).

Section 414(u)(2) provides that USERRA reemployment rights include the right to make elective deferrals, and receive matching contributions with respect to such elective deferrals, for the period of qualified military service. The employee must be given a period, beginning on the date of reemployment, equal to the lesser of 3 times the period of qualified military service and 5 years, within which to makeup the elective deferrals. These makeup elective deferrals must be permitted in an amount up to the maximum amount that the employee could have made during the period of qualified military service if the employee had continued to be employed by the employer during that period, and received compensation as determined under § 414(u)(7). Section 414(u)(7) provides that the employee will be treated as having received compensation during the period of qualified military service based on the rate of pay the employee would have received from the employer, or, if that is not reasonbly certain, the employee's average compensation from the employer during the 12-month period immediately preceding the qualified military service.

For purposes of the limitations of §§ 402(g), 404 and 415, makeup elective deferrals and related matching contributions are treated as made in the year to which they relate, rather than in the year in which the are made. See § 414(u)(1)(A)&(B). Further, the plan shall not be treated as failing to meet the requirements of §§ 401(a)(4), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 410(b) or 416 by reason of such makeup deferrals or contributions. See § 414(u)(1)(C).

The provisions of § 414(u) are effective as of December 12, 1994 (the USERRA effective date). However, under § 1465 of SBJPA, a plan is not required to be amended to conform with § 414(u) before the first day of the first plan year beginning on or after January 1, 1998, provided it is operated in compliance with § 414(u) after October 12, 1996, and the amendment is retroactive to the USERRA effective date. Section 414(u) may be incorporated by reference.

SBJPA CHANGES TO ADP AND ACP TESTS

Most of the SBJPA changes involving CODAs affect the determination of the ADP and ACP tests. Following the general description of the ADP test below is a summary of the SBJPA change providing for the use of prior year data for NHCEs in running the ADP and ACP tests, effective for years beginning after December 31, 1996.

Actual Deferral Ratio and Actual Deferral Percentage

General Description

The exclusive test for a qualified CODA in testing for nondiscrimination under IRC § 401(a)(4) is the actual deferral percentage (ADP) test under § 401(k)(3). This test compares the amounts contributed by the highly compensated employees (HCEs) as a percentage of compensation with the amounts contributed by the nonhighly compensated employees (NHCEs) as a percentage of compensation. The HCE ADP must satisfy either of the following tests: (1) the HCE ADP does not exceed the NHCE average times 1.25, or (2) the HCE ADP does not exceed the lesser of (2 plus the NHCE average) or (2 times the NHCE average). The ADP test is run for the entire plan year, testing each employee's compensation and deferrals for the year.

Before running the test, the employer must determine the actual deferral ratio (ADR) for each employee. The actual deferral ratio is the employee's ECs + QNECs + QMACs divided by compensation. QNECs (qualified nonelective employer contributions) are employer contributions that are used to help satisfy the ADP or the ACP test. QMACs (qualified matching contributions) are employer matching contributions on account of a participant's contribution that also are used to help satisfy the ADP or ACP tests.

Note: QNECs and QMACs may be given to participants in amounts in excess of those needed to satisfy the ADP Test.

The employer must next separately determine the ADP for the NHCE group and the HCE group. The ADP is the average of the ADRs for the group.

EXAMPLE (1):

Employer L maintains a CODA. For the 1991 plan year the employer has the following employee data. A and B are HCEs.

EEs	Compensation	ECs	ADR	ADP
A	100,000	8,000	8%	
B	88,000	4,400	5%	6.5% (average of 8 and 5)
C	50,000	3,000	6%	
D	20,000	400	2%	
E	18,000	180	1%	3% (average of 6, 2 & 1)

The maximum average percentage allowed to the HCE group is the greater of ---

A. 1.25 x 3.00 = 3.75, or

B. the lesser of (1) 2 + 3.00 = 5.00, or
(2) 2 x 3.00 = 6.00

Thus, the HCE ADP can be no more than 5.00. Since the HCE ADP is 6.50, the plan will have to "correct" the excess contribution, using one of the correction methods discussed below.

The plan must also satisfy a nondiscrimination test under IRC § 401(m) if the plan provides for employee and/or matching contributions on behalf of employees. The actual contribution percentage (ACP) test is essentially the same test as the ADP test that applies to elective contributions in a CODA, except that the ACP test applies to employee and matching contributions rather than elective contributions. If the § 401(m) test is not met, the entire plan is disqualified. This situation is not like a CODA which if it fails the ADP test can be retested under § 401(a)(4).

SBJPA Change - Use of Prior Year Data for NHCEs (post 1996)

Prior to the SBJPA changes, the ADP and ACP tests could not be run until data for the entire year was available, testing each employee's compensation and deferrals for the year. Under this testing method, calendar year plans only have 2-1/2 months to correct for failing the ADP and ACP test (March 15 after the end of the plan year) in order for the employer to avoid the excise tax under § 4979. If the correction is not made within 12 months after the close of the plan year after the failure of the test, the CODA is disqualified. In the case of a failure to correct within the 12 month period under § 401(m), the entire plan is disqualified.

Section 1433(c) of the SBJPA amended IRC §§ 401(k)(3)(A) and 401(m)(2)(A), effective for years beginning after December 31, 1996, to provide for the use of prior year data on status, contributions and compensation in determining the ADP and ACP of NHCEs, while current year data is used for HCEs. Thus, in addition to prior year data on contributions and compensation, the individuals taken into account in determining the prior year's ADP and ACP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individual's status in the current year. This change simplifies plan administration because employers can determine the percentage of elective deferrals and matching contributions that can be made by HCEs early in the plan year and have more time to plan for correction to avoid all penalties.

Alternatively, the plan can provide that current year data may be used for determining the ADP and ACP for both HCEs and NHCEs, but this election may only be changed as provided by the Secretary. Notice 97-2, 1997-2 IRB 22 (1/13/97) provides special transition relief. A plan that uses current year data in determining the ADP or ACP of NHCEs for the 1997 plan year will be permitted to use prior year data for the 1998 plan year without receiving approval from the Service. For the 1997 plan year, no plan amendment or formal election is required to be made in 1996 or 1997 in order to continue to use current year data in determining the ADP of NHCEs.

EXAMPLE (2):

In 1996 Employer X maintains Plan 1, that includes a qualified CODA for employees under IRC § 401(k). Plan 1 has a calendar year plan year and both HCEs and NHCEs make elective contributions to the plan. In January 1997 Employer X determines that Plan 1 has not passed the ADP test for the 1996 plan year, and that a corrective distribution of excess contributions must be made to the appropriate HCEs by March 15 of 1997 to avoid all penalties.

EXAMPLE (3):

Same facts as above, except that Plan 1 is being tested for the 1997 plan year and the current year election for Plan 1 is not made in determining the ADP of the NHCEs. The ADP for the NHCEs for 1996 under Plan 1 can be determined early in 1997 by Employer X, because it has obtained the necessary data on prior year NHCE status, contributions and compensation by January 1997. This simplifies plan administration for Employer X.

The individuals taken into account in determining the prior year's ADP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individual's status in the current year. A special rule applies for the first plan year. In the case of the first plan year of any plan (other than a successor plan), the amount taken into account as the ADP or ACP for NHCEs for the preceding plan year is deemed to be 3 percent, unless an election is made to use the actual ADP and ACP data for the first plan year.

Note: the SBJPA also made changes to the definition of highly compensated employee (HCE) that affects CODAs and other §§ of the Code. See discussion under <u>Other SBJPA Changes - Highly Compensated Employee</u> below.

EXAMPLE (4):

Employee A was employed by Employer X and was an NHCE in Year One. Employee A no longer works for Employer X in Year Two. For purposes of determining the prior year's ADP Employee A is taken into account. The result would be the same if Employee A is still employed but has become a HCE in Year Two.

Notice 97-2, 1997-2 IRB 22 (1/15/97) provides transitional relief with respect to an election to use current year data in determining the ADP or ACP of NHCEs for the 1997 plan year. The Notice provides that no plan amendment or formal election is required in 1996 or 1997 to continue to use current year data in determining the ADP of NHCEs. Although the general rule is that an election to use current year data may only be changed to the prior year with the Service's approval, prior year data for the 1998 plan year may still be used without receiving approval from the Service.

Notice 98-1, 1998-3 IRB 42 (January 20, 1998), provides guidance on the use of the prior year method and the current year method, and on changing from one method to the other. In general, Notice 98-1 requires that a plan must specify which of the two testing methods it is using. If the employer changes the testing method under a plan, the plan must be amended to reflect the change. See § IX of Notice 98-1.

Use of QNECs and QMACs in Prior Year Testing

Under Code §§ 401(k)(3)(D) and 401(m) and employer may take into account QNECs and QMACs in calculating the ADP, and QNECs in calculating the ACP. (See EP Phase I Course Book (May 1995), pp. 14a-22, et seq., and 14b-3, et seq.) This continues to be permissible in a plan using prior year testing, subject to certain limitations.

To be taken into account for the ADP or ACP for the prior year, a QNEC or QMAC must be allocated as of a date within that prior year, and must actually be paid to the trust by the end of the 12-month period following the end of that prior year. That is, it must actually be paid to the trust by the end of the testing year.

EXAMPLE(5):

A plan uses the prior year testing method for the 1999 testing year. QMACs that are allocated to NHCEs' accounts as of the last day of the 1998 plan year may be taken into account in calculating the ADP only if those QMACs are actually contributed to the plan by the last day of the 1999 plan year.

Note that this does not change the rule under Code § 415, that employer contributions shall not be deemed credited to a participant's account for a particular limitation year unless the contributions are actually made no later than 30 days after the end of the § 404(a)(6) period applicable to the taxable year with or within which the particular limitation year ends. See Regs. § 1.415-6(b)(7)(ii).

Note also that this does not change the requirements under §§ 1.401(k)-1(b)(5) and 1.401(m)-1(b)(5), that (i) the amount of NECs, including QNECs treated as ECs for the ADP, (ii) the amount of NECs, excluding QNECs treated as ECs for the ADP, (iii) the amount of NECs, including QNECs treated as MACs for the ACP, and (iv) the amount of NECs, excluding QNECs treated as MACs for the ACP, must **each** satisfy § 401(a)(4) for the plan year in which they are allocated to participants' accounts.

First Year Rule for Prior Year Testing

For the first plan year of a plan (other than a "successor plan"; see below) that uses prior year testing, the ADP for NHCEs for the prior year is 3%. See § 401(k)(3)(E). Alternatively, if the employer so elects **in the plan document**, the ADP may be equal to the ADP for that first plan year (i.e., the current year).

For purposes of this rule, the "first plan year" is the first year in which the plan provides for elective deferrals. A plan does not have a first plan year if for that year it is aggregated under § 1.401(k)-1(g)(11) with any other plan that provided for elective deferrals in the prior year.

Similarly, for the first plan year of a plan (other than a "successor plan"; see below) that uses prior year testing, the ACP for NHCEs for the prior year is 3%. See § 401(m)(3)(E). Alternatively, if the employer so elects **in the plan document**, the ACP may be equal to the ACP for that first plan year (i.e., the current year).

For this purpose, the “first plan year” is the first year in which the plan provides for employee contributions, matching contributions or both. A plan does not have a first plan year if for that year it is aggregated under § 1.401(k)-1(g)(11) with any other plan that provided for employee contributions, matching contributions or both in the prior year.

A plan is a “successor plan” if 50% or more of the eligible employees for the first plan year were eligible employees in another § 401(k) plan (or § 401(m) plan, as applicable) maintained by the employer in the prior year.

Changes in the Group of NHCEs in Prior Year Testing

In general, under the prior year testing method, subsequent changes in the group of NHCEs are disregarded. That is, the ADP or ACP for NHCEs for the prior year is determined with respect to eligible employees who were NHCEs in that prior year, and without regard to changes in the group of eligible NHCEs in the testing year. This is true even though some NHCEs in the prior year have become HCEs in the testing year, or are no longer eligible employees under the plan. It is also true even though some NHCEs in the testing year were not eligible employees in the prior year.

An exception to the general rule: If a plan results from or is affected by a “plan coverage change” that becomes effective during the testing year then the NHCE ADP for the prior year is the weighted average of the ADPs for the prior year subgroups, and the NHCE ACP for the prior year is the weighted average of the ACPs for the prior year subgroups.

A “plan coverage change” is a change in the group(s) of eligible employees on account of:

(a) the establishment or amendment of a plan;

(b) a plan merger, consolidation, or spinoff under § 414(l);

(c) a change in the way plans are (or are not) permissively aggregated under § 1.410(b)-7(d); or

(d) any combination of the above.

A “prior year subgroup” is all NHCEs for the prior year who were eligible

employees under a specific § 401(k) plan (or § 401(m) plan) maintained by the employer, and who would have been eligible employees under the plan being tested if the plan coverage change had been effective as of the first day of the prior year.

The "weighted average of the ADPs (ACPs) for the prior year subgroups" is the sum, for all prior year subgroups or the "adjusted ADPs (ACPs)."

The "adjusted ADP (ACP)" for each prior year subgroup is the ADP (ACP) for the prior year for **all** NHCEs of the specific plan under which the members of the prior year subgroup were eligible employees, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup, and the denominator of which is the total number of NHCEs in all prior year subgroups.

EXAMPLE (6):

(i) Employer B maintains two plans, Plan N and Plan P, each of which includes a section 401(k) plan. The plans were not permissively aggregated under § 1.410(b)-7(d) for the 1998 testing year. Both plans use the prior year testing method. Plan N had 300 eligible employees who were NHCEs for 1998, and their ADP for that year was 6%. Plan P had 100 eligible employees who were NHCEs for 1998, and the ADP for those NHCEs for that plan was 4%. Plan N and Plan P are permissively aggregated under § 1.410(b)-7(d) for the 1999 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 1999 testing year under § 1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan NP) for purposes of § 1.401(k)-1(g)(11). Therefore, the prior year ADP for NHCEs under Plan NP for the 1999 testing year is the weighted average of the ADPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ADPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 1999 testing year, an employee is a member of a prior year subgroup if the employee (A) was an NHCE of Employer B for the 1998 plan year, (B) was an eligible employee for the 1998 plan year under any section 401(k) plan maintained by Employer B, and (C) would have been an eligible employee in the 1998 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under § 1.410(b)-7(d) for that plan year. The NHCEs who were eligible employees under separate section 401(k) plans for the 1998 plan year comprise separate prior year subgroups. Thus, there are two prior year subgroups under Plan NP

for the 1999 testing year: the 300 NHCEs who were eligible employees under Plan N for the 1998 plan year and the 100 NHCEs who were eligible employees under Plan P for the 1998 plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of: (A) the adjusted ADP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and (B) the adjusted ADP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P. The adjusted ADP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows: 6% (the ADP for the NHCEs under Plan N for the prior year) x 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%. The adjusted ADP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the prior year) x 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year sub-groups), which equals 1%. Thus, the prior year ADP for NHCEs under Plan NP for the 1999 testing year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

An exception to the exception: If there is a plan coverage change, and 90% or more of all NHCEs from all prior year subgroups are from a single prior year subgroup, then the employer may elect to use the prior year ADP (ACP) for all NHCEs of the plan that included that single prior year subgroup.

Changing Testing Method

A plan that uses the prior year testing method may adopt the current year testing method for any subsequent testing year. Notification to or prior approval of the Service is not required for the election to be valid. However, the employer may wish to apply for a determination letter on the plan amendment needed to implement the change.

A plan that uses current year testing after the 1997 plan year (see Notice 97-2) is permitted to change to prior year testing in four situations **only**:

1. The plan is not the result of the aggregation of two or more plans, and current year testing was used for each of the 5 plan years preceding the year of the change (or, if lesser, the number of years

the plan has been in existence).

2. The plan is the result of the aggregation of two or more plans, and for each of the aggregated plans current year testing was used for each of the 5 plan years preceding the year of the change (or, if lesser, the number of years the plan has been in existence).

3. A transaction occurs that is described in § 410(b)(6)(C)(i) (i.e., the employer becomes or ceases to be a member of a § 414(b), (c), (m) or (o) group), and, as a result, the employer maintains both a plan using prior year testing and a plan using current year testing, and the change occurs within the transition period described in § 410(b)(6)(C)(ii) (i.e., by the last day of the 1st plan year beginning after the transaction).

4. The change occurs within the plan's SBJPA remedial amendment period (generally, the last day of the first plan year beginning on or after January 1, 1999; see Rev. Proc. 97-41, 1997-3 I.R.B. 51).

Notification to or prior approval of the Service is not required for the change to be valid. However, the employer may wish to apply for a determination letter on the plan amendment needed to implement the change.

Limits on Double Counting of Certain Contributions

When a plan changes from current year testing to prior year testing, contributions on behalf of many, if not all, NHCEs are likely to be double counted. For example, if a plan used current year testing in 1998, and then changed to prior year testing in 1999, elective deferrals on behalf of NHCEs for 1998 will be counted twice; once in 1998 in calculating the NHCE ADP under the current year method, and again in 1999 in calculating the NHCE ADP under the prior year method. To mitigate the effect of this double counting certain limitations apply:

1. The ADP for NHCEs for the prior year is determined taking into account **only**:

   a. elective contributions for NHCEs that were taken into account for purposes of the ADP test (and not the ACP test) under the current year method in the prior year; and

b: QNECs that were allocated to NHCEs' accounts for the prior year, but that were not used to satisfy either the ADP test or the ACP test under the current year method for the prior year.

Thus, the following contributions made for the prior year are disregarded: QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior year, elective contributions taken into account for purposes of the ACP test, and all QMACs.

2. The ACP for NHCEs for the prior year is determined taking into account **only**:

a. employee contributions for those NHCEs for the prior year;

b. matching contributions for NHCEs that were taken into account for purposes of the ACP test (and not the ADP test) under the current year method in the prior year; and

c: QNECs that were allocated to NHCEs' accounts for the prior year, but that were not used to satisfy either the ADP test or the ACP test under the current year method for the prior year.

Thus, the following contributions made for the prior year are disregarded: QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior year, QMACs taken into account for purposes of the ADP test, and all elective contributions.

These limitations on double counting do not apply for testing years beginning before January 1, 1999. Thus, for a plan that changes to prior year testing for the first time for the 1998 plan year, the ADP and ACP for NHCEs will be the same as for the 1997 plan year.

EXAMPLE(7):

(i) Employer A established Plan M, a calendar year section 401(k) plan, in 1993 and, through the 2000 testing year, has always used the current year testing method under Plan M. The ADP for the HCEs under Plan M is 7% for the 2000 testing year. Based solely on elective contributions by NHCEs under Plan M for the 2000 testing year, the ADP for NHCEs for the 2000 testing year is 4%. In order to satisfy the ADP test, Employer A provides a QNC to each NHCE for the 2000 testing year equal to 1% of compensation. No other contributions under Plan M are taken into account in determining the ADP for NHCEs. Thus, the ADP for NHCEs for the 2000 testing year is 5%. Plan M is amended to use the prior year testing method instead of the current year testing method for purposes of the ADP test for the 2001 testing year.

(ii) In determining the ADP for NHCEs under Plan M for the 2001 testing year in accordance with the prior year testing method, the elective contributions made by NHCEs under Plan M for the 2000 plan year are taken into account. However, the QNCs equal to 1% of compensation made under Plan M on behalf of NHCEs for the 2000 plan year are disregarded because they were used to satisfy the ADP test for the 2000 testing year. Thus, for purposes of the 2001 testing year, the ADP for NHCEs for the prior year is 4% (unless additional QNCs for NHCEs are timely contributed and allocated for the 2000 plan year).

EXAMPLE(8)

(i) The facts are the same as in Example 7, except that the testing years are 1997 and 1998, instead of 2000 and 2001.

(ii) For purposes of the 1998 testing year, the ADP for NHCEs for the prior year is 5%. The QNCs equal to 1% of compensation made under Plan M on behalf of NHCEs that were used to satisfy the ADP test for the 1997 testing year are not disregarded because the limitation on double counting applies only for testing years beginning on or after January 1, 1999.

Plan Provisions Regarding Testing Method

A plan must specify which of the two testing methods (current year or prior year)

it is using. If the employer changes the testing method under a plan, the plan must be amended to reflect the change.

The regulations under § 401(k) and (m) permit a plan to incorporate by reference § 401(k)(3) and (m)(2) (and, if applicable, (m)(9)) and the underlying regulations. A plan that incorporates these provisions by reference may continue to do so, but must specify which of the two testing methods (current year or prior year) it is using. Further, for purposes of the first plan year rule, a plan that incorporates these provisions by reference must specify whether the ADP/ACP for NHCEs is 3% or the current year's ADP/ACP.

Rev. Proc. 97-41 extends the remedial amendment period for SBJPA generally to the last day of the first plan year beginning on or after January 1, 1999. Any plan amendments to reflect a choice in testing method are not required to be adopted before the end of this remedial amendment period. However, plans must be operated in accordance with the SBJPA changes as of the statutory effective date (§ 1433(c) and (d), which added the prior year testing method, were effective for plan years beginning after December 31, 1996). In addition, any retroactive amendments must reflect the choices made in the operation of the plan for each testing year, including the choice of testing method (and any changes to that method), and must reflect the date(s) on which the plan began to operate in accordance with those choices (and any changes).

Distributions of Excess Contributions and Excess Aggregate Contributions

The SBJPA changed the way in which excess amounts are reallocated to HCEs, although the dollar amount of the total reduction is calculated under the same leveling method described under pre-SBJPA law.

General Description

Under pre-SBJPA law, if the plan does not meet § 401(k) and 401(m) nondiscrimination tests, an acceptable way to correct for the ADP test is to distribute excess contributions to the HCEs (excess elective contributions, including QNECs and QMACs that are treated as elective contributions), and for the ACP test to distribute excess aggregate contributions to the HCEs (excess of matching and employee contributions and any QNECs and elective contributions taken into account in computing the contribution percentage).

The dollar amount of excess contributions and excess aggregate

contributions is determined under a "leveling" method described in Code §§ 401(k)(8) and 401(m)(6), and Treas. Reg. § 1.401(k)-1(f)(2) and § 1.401(m)-1(e)(2)(i). The amount of excess contributions for a HCE for a plan year is the amount by which the HCE's elective contributions must be reduced for the employee's ADR to equal the highest permitted ADR under the plan. To calculate the highest permitted ADR under a plan, the ADR of the HCE with the highest ADR is reduced by the amount required to cause the employee's ADR to equal the ratio of the HCE with the next highest ADR. If a lesser reduction would enable the arrangement to satisfy the ADP test, only this lesser reduction may be made. This process must be repeated until the CODA satisfies the ADP test.

PRE-1997 EXAMPLES

EXAMPLE (9):

Employer X maintains a CODA under § 401(k). For the 1990 plan year the following employee data is available:

HCEs	ADR
A	4
B	6
C	8

HCE ADP = 6.0%
NHCE ADP = 3%
Maximum HCE ADP = 5% (Target ADP)
(i) Reduce C (8%) to B's level, 6%, find HCE ADP for all HCEs (5.33%).
(ii) Reduce C and B to the level necessary to produce an average of 5% overall (reduce B, and C's ADR to 5.50%). Note that the employer must not reduce B's and C's ADR to 4%, since a lesser reduction enables the CODA to satisfy the ADP test.

EXAMPLE (10):

Short Cut Leveling Method (same facts as above)

Solve for x, where x = ADR to which B and C must be reduced.

$$\frac{4 + 2x}{3} = 5$$

x = 5.50

4 = A's ADR (not reduced in this example)
2 = # of HCEs whose ADRs must be reduced
3 = total # of HCEs
5 = target ADP (maximum HCE ADP)

Treas. Reg. § 1.401(m)-1(e)(2)(i) sets forth the leveling method for 401(m). To calculate the highest permitted ACR, the highest ACR is reduced to the next highest ACR. If less of a reduction would make the plan satisfy the ACP test, only the lesser reduction may be made. This leveling process must be repeated until the plan satisfies the ACP test.

SBJPA Change in Reallocating Amounts (post 1996)

Prior to the SBJPA the amounts allocated to HCEs are returned based on the order of ADR's beginning with the highest. Section 1433(e) of the SBJPA amended § 401(k)(8) and 401(m)(6) to change the allocation of distributions to HCEs, effective for years beginning after December 31, 1996.

The dollar amount of the total reduction is still calculated under the leveling method. However, the SBJPA changes how the dollar amounts are reallocated to HCEs. If excess contributions or excess aggregate contributions are returned to HCEs in order to satisfy the ADP or ACP test, the excess must be returned on the basis of each HCE's contribution, rather than on the order of the highest ADRs. Thus, a greater portion of the excess is returned to the highest paid HCEs rather than the lower level HCEs. Excess contributions are attributable first to the HCE with the largest dollar amount deferred (the § 402(g) limit in most cases). Under prior law, the highest paid HCEs could defer a larger amount than

lower paid HCEs, but a greater portion of the excess contributions would be returned to the lower paid HCEs, whose deferrals were a higher percentage of compensation. Because the new method determines distributions based on amounts, rather than percentages of compensation, more highly paid HCEs may receive distributions.

Notice 97-2 provides steps and a detailed example on how to distribute excess contributions under IRC § 401(k)(8).

1. Calculate the dollar amount of excess contributions for each affected HCE in a manner described in § 401(k)(8)(B) and Treas. Reg. §1.401(k)-1(f)(2). However, in applying these rules, rather than distributing the amount necessary to reduce the ADR of each affected HCE in order of these employees' ADRs, beginning with the highest ADR, the plan uses these amounts in step 2.

2. Determine the total of the dollar amounts calculated in step 1. This total amount in step 2 (total excess contributions) should be distributed in accordance with steps 3 and 4 below.

3. The ECs of the HCE with the highest dollar amount of ECs are reduced by the amount required to cause that HCE's ECs to equal the dollar amount of the ECs of the HCE with the next highest dollar amount of ECs. This amount is then distributed to the HCE with the highest dollar amount. However, if a lesser reduction, when added to the total dollar amount already distributed under this step, would equal the total excess contributions, the lesser reduction amount is distributed.

4. If the total amount distributed is less than the total excess contributions, step 3 is repeated.

Notice 97-2 provides that if these distributions are made, the CODA is treated as meeting the nondiscrimination test of § 401(k)(3) regardless of whether the ADP, if recalculated after distributions, would satisfy § 401(k)(3).

A parallel method is used for the purpose of recharacterizing excess contributions under § 401(k)(8)(A)(ii) and for distributing excess aggregate contributions under § 401(m)(6)(C) as amended.

Notice 97-2 further provides that after excess contributions and excess

aggregate contributions, if any, have been distributed using the method described above, the multiple use test of § 401(m)(9) is applied. For purposes of § 401(m)(9), if a corrective distribution of excess contributions has been made, or a recharacterization has occurred, the ADP for HCEs is deemed to be the largest amount permitted under § 401(k)(3). Similarly, if a corrective distribution of excess aggregate contributions has been made, the ACP for HCEs is deemed to be the largest amount permitted under § 401(m)(2).

EXAMPLE (11):

(from Notice 97-2)

For the 1997 plan year, HCE 1 has ECs of $8,500 and $85,000 in compensation, for an ADR of 10%, and HCE 2 has ECs of $9,500 and compensation of $158,333, for an ADR of 6%. As a result, the ADP for the 2 HCEs under the plan is 8%. The ADP for the NHCEs is 3%. Under the ADP test of § 401(k)(3)(A)(ii), the ADP of the two HCEs under the plan may not exceed 5% (i.e. 2 percentage points more than the ADP of the NHCEs under the plan).

Step 1: ECs of HCE 1 (HCE with highest ADR) are reduced by $3,400 to reduce the ADR of HCE 1 to 6% ($5,100/$85,000), which is the ADR of HCE 2. Because the ADP of the HCEs still exceeds 5%, the ADP test of § 401(k)(3)(A)(ii) is not satisfied and further reductions in elective contributions are necessary. The ECs of HCE 1 and 2 are each reduced by 1% of compensation ($850 and $1,583 respectively). Because the ADP of the HCEs now equals 5%, the ADP test of § 401(k)(3)(A)(ii) is satisfied, and no further reductions in elective contributions are necessary.

Step 2: The total excess contributions for the HCEs that must be distributed equal $5,833, the total reductions in ECs under step 1 ($3,400 + $850 + $1,583).

The $5,833 in total excess contributions for the 1997 plan year would then be distributed **as follows**:

Step 3: The plan distributes $1,000 in elective contributions to HCE 2 (the HCE with the highest dollar amount of ECs) in order to reduce the dollar amount of the ECs of HCE 2 to $8,500, which is the dollar amount of the ECs of HCE 1.

Step 4: Because the total amount distributed ($1,000) is less than the total excess contributions ($5,833), step 3 must be repeated. As the dollar amounts of remaining ECs for both HCE 1 and 2 are equal, the remaining $4,833 of ECs is then distributed equally to HCE 1 & HCE 2 in the amount of $2,416.50 each.

Under this example, HCE 1 must receive a total distribution of $2,416.50 of ECs and HCE 2 must receive a total distribution of $3,416.50 of ECS. This is true even though the ADR of HCE 1 exceeded the ADR of HCE 2. The plan is now treated as satisfying the nondiscrimination test of § 401(k)(3) even though the ADP would fail to satisfy § 401(k)(3) if recalculated after distributions.

Disregarding Employees

Pre-SBJPA

In general, a qualified plan may prohibit employees from entering the plan prior to the attainment of age 21 and the completion of one year of service under § 410(b). An employer that allows employees to enter the plan earlier (e.g. age 18) may choose separate testing under which all employees who have not met the statutory age and service entry maximums are disregarded, provided that the plan satisfies the nondiscrimination rules taking into account only those employees whose age and service are less than the statutory age and service maximums.

SBJPA Change (post 1998)

SBJPA § 1459 adds § 401(k)(3)(F) and 401(m)(5)(C) providing for a special rule for early participation. Congress believed that some employers were reluctant to include younger or new employees in a § 401(k) plan because these employees tended to have lower deferral percentages. Participation by these employees could cause the plan to fail to satisfy the ADP test.

To encourage employers to include these employees in a plan, effective for plan years beginning after December 31, 1998, an employer may elect to disregard employees (other than HCEs) eligible to participate in the plan before they have completed one year of service and reached age 21, provided the plan separately satisfies the minimum coverage rules of § 410(b) taking into account only those employees who have not completed one year of service or are under age 21. A single ADP test is applied that compares the ADP for all HCEs eligible to make ECs with the ADP for those NHCEs eligible to make ECs and who have completed one year of service and reached age 21. A similar rule applies for purposes of the ACP test.

Design Based Safe Harbor (post 1998)

Effective for years beginning after 12/31/98 SBJPA § 1433(a) & (b) provides for an alternative way to satisfy the § 401(k) ADP and the § 401(m) ACP tests. This is a safe harbor method that permits a plan to satisfy the special nondiscrimination test through plan design rather than through the testing of actual contributions.

ADP Safe Harbor

The safe harbor requires that a plan meet one of two contribution requirements (matching contributions or nonelective contributions) and a notice requirement.

The matching contribution is met if under the plan matching contributions are made on behalf of each employee equal to 100% of the ECs of the employee up to 3% of compensation, and 50% of the ECS of the next 2% of compensation. The matching contribution rate for any EC of a HCE may not be greater than that for any NHCE.

Alternatively, if the rate of matching contribution with respect to any rate of EC is not equal to the percentages described above, the matching contribution is deemed to be satisfied if the plan provides that (1) the rate of an employer's matching contribution does not increase as an employee's rate of ECs increases, and (2) the aggregate amount of matching contributions at such rate of ECs is at least equal to the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements.

EXAMPLE (12):

Plan 2 matches 125% of Employee A's EC deferral up to the first 3% of compensation, 25% of ECs from 3 to 4% of compensation, and provides no match thereafter. The alternative test is satisfied by Plan 2, because the employer match does not increase as the employee's rate of ECs increases and the aggregate amount of matching contributions at any rate of EC is at least equal to the aggregate amount of matching contributions required under the general safe harbor rule.

EXAMPLE (13):

Plan 3 matches 80% of Employee A's ECs up to the first 5% of compensation. The alternative test is not satisfied because the aggregate amount of matching contributions at any rate of elective deferral does not equal the aggregate amount of matching contributions required under the general safe harbor rule.

Nonelective Contributions: As an alternative to providing matching contributions, an employer can make a required nonelective contribution to a defined

contribution plan of at least 3% of an employee's compensation on behalf of each NHCE who is eligible to participate in the arrangement without regard to whether the employee makes ECs or employee contributions under the arrangement.

Matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are required to be nonforfeitable and are subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified CODA, pursuant to § 401(k)(2)(B) and (C).

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

ACP Safe Harbor

This safe harbor is similar to the ADP safe harbor, except that this test does not provide an alternate way to satisfy the ACP test with respect to employee contributions. Although this safe harbor may help simplify plan administration with respect to some employers, plans that allow employee contributions must still satisfy the ACP test with respect to employee contributions.

Specifically, the ACP Safe Harbor requires a plan to meet the contribution and notice requirements under the ADP safe harbor. In addition, the plan must satisfy a special limitation on matching contributions. The employer matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6% of compensation. In addition, the rate of an employer's matching contribution may not increase as the rate of an employee's contributions or elective deferrals increases, and the matching contribution with respect to any HCE at any rate of employee contribution or elective deferral may not be greater than that with respect to an employee who is not highly compensated.

Any after-tax employee contributions made under the qualified CODA will continue to be tested under the ACP test. Employer matching and nonelective contributions used to satisfy the safe harbor rules for qualified CODAs cannot be considered in applying such test unless they are in excess of the amount required to satisfy the safe harbor rules for qualified CODAs.

SIMPLE 401(k) Plans (post 1996)

SBJPA § 1422 provides that effective for years beginning after 12/31/96, a CODA is deemed to have satisfied the ADP and ACP tests if the plan satisfies requirements for a Savings Incentive Match Plan (SIMPLE). In addition, a SIMPLE is not subject to the top heavy rules under § 416. See § 401(k)(11)(D)(ii) as amended by § 1422 of SBJPA. The following requirements must be met:

(1) An eligible employer who can maintain a SIMPLE, is, with respect to any year, an employer which had no more than 100 employees who received at least $5000 in compensation from the employer for the preceding year. A two year grace period applies in that an employer who establishes and maintains a SIMPLE for one or more years and who fails to be an eligible employer for any subsequent year shall be treated as an eligible employer for the 2 years following the last year the employer was an eligible employer. Special rules apply to acquisitions, dispositions etc.

(2) The employer may not maintain any other qualified plan for the year covering any employee who is eligible to participate in a SIMPLE 401(k) plan.

(3) Employees' elective deferrals must be limited to $6,000

(4) Pursuant to the terms of the arrangement, the employer must either (a) make matching contributions up to 3% of compensation or (b) elect to make a 2% of compensation nonelective contribution on behalf of all eligible employees with at least $5000 in compensation

(5) No other empoyer or employee contributions may be made to the arrangement.

(6) Contributions must be 100% vested.

(7) Pursuant to the terms of the arrangement, if the employer elects to make a nonelective contribution the employer must notify employees of such election within a reasonable period of time before the 60th day before the beginning of such year.

Similar rules apply to § 401(m).

Revenue Procedure 97-9, 1997-2 IRB 55, provides model amendment language on 401(k) SIMPLE plans and further information.

OTHER SBJPA CHANGES

Although many changes made by the SBJPA specifically affect qualified CODAs, other general changes impact CODAs as well as other §§ of the Code. The changes in the definition of compensation under § 415 and the change to the definition of highly compensated employee under §414(q) directly impact the amount employees may defer and the CODA nondiscrimination tests.

Compensation

Pre-SBJPA

Section 414(s)(1) states that compensation has the meaning given such term by § 415(c)(3), except 414(s) allows the employer to elect to treat deferrals pursuant to a salary reduction agreement as included in compensation. By contrast, the definition of compensation for purposes of § 415 does not include elective deferrals or other specified deferrals.

SBJPA Change (post 1997)

Section 1434 of SBJPA amends § 415(c)(3) to provide that elective deferrals to § 401(k) plans and similar arrangements, elective contributions to § 457 plans, and salary reduction contributions to a cafeteria plan are considered compensation for purposes of the limits on contributions and benefits. This increases the maximum annual addition that can be made to qualified plans on behalf of an employee. Further, amounts included in compensation are now automatically included in compensation under applicable provisions that refer to § 414(s)(2) unless the employer elects otherwise (note: the statute does not specifiy how this election is to be made). This provision is effective for years beginning after December 31, 1997. This definition of compensation is also used in determining whether an employee is highly compensated.

Highly Compensated Employee

Pre-SBJPA

An employee is an HCE if during the current year or the preceding year he or

she (1) was a 5% owner, (2) had compensation above $100,000 (for 1996), (3) had compensation above $66,000 (for 1996) and was in the "top paid group", or (4) was an officer and had compensation above $60,000. In any event, if no one fits under the officer category, then the highest paid officer is an HCE.

SBJPA Change (generally post 1996)

Section 1431 of the SBJPA amended § 414(q) of the Code. An employee will be considered an HCE if he or she is a 5% owner during the year or preceding year, or had compensation above $80,000 (indexed) for the preceding year, and if the employer so elects, was in the top paid group for that year. An employee is in the top paid group if the employee was among the top 20% of employees of the employer when ranked on the basis of compensation paid to the employees during the preceding year. This applies to years beginning after December 31, 1996, except that in determining whether an employee is a HCE for years beginning in 1997, such amendments will be treated as having been in effect for years beginning in 1996.

EXAMPLE (14):

Employer X had 200 employees. 60 employees earned above $80,000 in Year 1. Employer X made the top paid group election for purposes of determining who the HCEs are. For Year 2, the HCEs are the top 40 employees (20% of 200).

This change in the definition of HCEs may increase the number of NHCEs (those earning between $66,000 and $80,000) that in turn may contribute to the plan and raise the NHCE ADP.

Repeal of Family Aggregation Rules (post 1996)

Section 414(q)(6) requires that compensation and certain benefits for HCEs be aggregated with that of certain listed family members. Section 1431 of the SBJPA repeals these family aggregation rules, effective for years beginning after December 31, 1996, so family members will not be treated as HCEs for purposes of the rules applicable to qualified CODAs and other §§ of the Code.

Date for Adoption of Plan Amendments

Section 1465 of the SBJPA allows employers to amend plans after the effective date of the SBJPA, as long as plans operate in accordance with the new provisions and employers adopt retroactive amendments. Any amendment required shall not be required to be made before the first day of the first plan year beginning on or after January 1, 1998, if (1) during the period after such amendment takes effect and before such first plan year, the plan or contract is operated in accordance with the requirements of such amendment, and (2) such amendment applies retroactively to such period. Special rules apply for governmental plans.

MISCELLANEOUS EXAMINATION ISSUES AND AUDIT TIPS:

While the changes under the SBJPA are significant and some are currently effective, there are also ongoing examination issues that occur under the general rules applicable to CODAs. Some of the issues are discussed below. Any changes made by the SBJPA that may solve some of these examination issues in the future will be noted.

Compensation

Because the definition of compensation varies for purposes of the ADP test and the 415 limits, employers sometimes erroneously fail to reduce compensation by the elective deferrals when calculating the maximum annual additions. As a result, especially in the case of the NHCEs, the percentage limits under sec. 415(c) are exceeded.

EXAMPLE (15):

Plan A states that "base compensation" is used to determine all allocations. Base compensation, as defined in the plan, includes ECs. This definition satisfies § 414(s) of the Code. Employee O, a NHCE, contributes 15% of her base compensation to the plan as ECs. The employer makes a 10% profit sharing contribution at the end of the plan year. Employee O has base compensation equal to $20,000 and an EC of $3,000. Her § 415 compensation, which does not include ECs, is $17,000. Thus, Employee O has § 415 compensation equalling $17,000, or an annual addition of 29.41%, well over the § 415 limit.

EXAMINATION STEPS:

1. Check the plan definition of compensation for allocation or elective deferral purposes. If the definition does not satisfy § 415, and the overall contribution levels or percentages are high, determine whether the § 415 limits have been met using the § 415 definition of compensation.

2. Determine whether the employer corrected the § 415 problem in accordance with § 1.415-6(b)(6) of the regulations, or under Rev. Proc. 98-22, 1998-12 I.R.B. 11 (March 23, 1998).

Note: this will no longer be an issue under the SBJPA. Section 415(c)(3) has been amended to provide that elective deferrals and other contributions (see SBJPA change summarized above), are included in compensation for purposes of § 415. Section 414(s) uses the § 415(c)(3) definition of compensation for all types of plans, including DB as well as DC plans.

Age and Service Requirements

A qualified CODA may not require an employee to complete a period of service with the employer beyond the period permitted under IRC § 410(a)(1), which is the later of when the employee reaches age 21 or completes one year of service. The special rule under § 410(a)(1)(B) under which plans provide for 100% vesting after two years of service is not applicable to qualified CODAs.

EXAMINATION STEP:

Confirm that the employer has not erroneously provided for 2 year, 100% vesting under § 410(a)(1)(B) for the CODA.

Coverage and Participation

The CODA portion of the plan, by itself, must satisfy one of the coverage tests set forth in IRC § 410(b), either the ratio percentage test or the average benefits test. To satisfy the ratio percentage test, a CODA may be aggregated with another CODA (if it has the same plan year) but may not be aggregated with any non-CODA.

In determining whether the coverage tests have been satisfied there is a special 401(k) coverage rule for qualified CODAs. Under this rule, the CODA counts each person who is eligible to make an EC as benefiting, regardless of whether the employee elected a deferral. (Note that a nonqualified CODA may not use this special benefiting rule).

For all non CODA plans of an employer, in determining an employee's employee benefit percentage for the average benefits percentage test under IRC § 410(b), Treas. Reg. §1.410(b)-5(d)(3)(i) and 1.410(b)-7(e) require that § 401(k) and 401(m) plans (except for the after-tax, employee contributions in a § 401(m) plan) and ESOPS be taken into account.

For more information and examples on the coverage tests, see the 1996 CPE Chapter (Lesson 6) entitled "Testing and Treatment of a Non-Qualified CODA."

EXAMINATION STEP:

Determine that the § 401(k) and 401(m) contributions are included in the average benefits portion of the general test.

Definition of a CODA

Any plan that allows a participant to make a cash or deferred election has a CODA. Only a profit sharing, stock bonus, pre-ERISA money purchase pension plan or a rural cooperative plan may offer a CODA. A cash or deferred election is an election by an employee to have the employer either (A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available (only cash for a qualified CODA) or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. If such an election exists the CODA is set up even if an employer does not intend to offer one. This could have serious consequences since a plan that is not entitled to offer a CODA is disqualified.

EXAMPLE (16):

Employer X maintains Plan A, a defined benefit plan. Employees may waive out of participation every year. Employer X increases the compensation of employees that waive out of the plan. Plan A is maintaining a CODA. Since defined benefit plans may not offer CODAs, Plan A is disqualified.

An exception exists for a one-time irrevocable election made by an employee when the employee is first hired or first eligible under one of the employer's plans. Although any choice between cash and a deferral is technically a CODA, Treas. Reg. §1.401(k)-1(a)(3)(iv) provides an exception. (See also Treas. Reg. §1.402(g)-1(c).) A one-time irrevocable election by the employee when first hired or first eligible for any plan of the employer, is deemed not to be a choice between cash and a deferral and is therefore not a CODA election. Once such an election is made, it cannot be changed. In addition, a change in status, such as from associate to partner or union employee to supervisor does not give rise to another one time irrevocable election. Once an employee has participated in any plan of the employer, the one time election is unavailable.

EXAMPLE (17):

Employer X terminated Plan Y, a money purchase plan. Employer X replaced Plan Y with Plan Z, another money purchase plan. Employee A elected to receive a 5% contribution under the old plan. Employee A may only receive a 5% contribution from the new plan.

Top Heavy Rules

Every employer maintaining a qualified plan (other than a SIMPLE CODA) must satisfy the top heavy requirements of § 416. If an employer maintains only a plan containing a CODA, the required top heavy minimum contributions must be satisfied in that plan for any year the plan is top heavy. If there are other plans, the employer may (but not must) satisfy the minimum contribution requirements in another plan instead of the CODA.

ECs and QMACs on behalf of key employees must be taken into account as employer contributions for purposes of satisfying § 416. However, ECs and QMACs (if used in the ADP or ACP test) made on behalf of non-key employees may not be used to satisfy the minimum contribution requirements under § 416. See Treas. Reg. § 1.416-l(M-19 and 20). QNECs, however, whether or not used to satisfy the ADP or ACP test, can be used to also satisfy the required minimum contribution under § 416. See § 1.416-l(M-18). If any key employee has an overall allocation of at least three percent of compensation, all eligible non-key employees must receive an employer contribution of at least three percent of compensation. If the highest contribution on behalf of any key employee is less than three percent of compensation, the non-key employees should receive a percentage of compensation equalling the percentage of compensation paid to the key employee receiving the highest percentage of compensation under the plan for the year.

EXAMPLE (18):

Employer X maintains a plan with a CODA. It has not made any QNECs or QMACs for the plan year. Key employee A is the only key employee in the plan. Key employee A has received an EC allocation of 2.3% of compensation. Non key employee B has received an EC allocation of 2.0%. Employer X must make a minimum contribution under § 416 of 2.3% to the account of Employee B (in addition to the 2.0% EC).

Any amounts used to satisfy the minimum contribution requirements may not be counted as a matching contribution. See Treas. Reg. § 1.401(m)-1(f)(12)(iii). These amounts must be tested under the nondiscrimination requirements of IRC § 401(a)(4) without regard to § 401(m).

Note: SIMPLE 401(k) plans added by the SBJPA are not subject to the top heavy rules.

EXAMINATION STEPS:

1. Determine that the employer has properly provided a minimum top heavy contribution in addition to elective deferrals for non-key employees.

2. Determine that the employer has not included matching contributions used to satisfy the top heavy minimum contribution for non-key employees in the ACP or ADP tests. Matching contributions must be tested under the § 401(a)(4) general rules.

Discrimination

When employers timely reduce an HCE's ADP in order to satisfy the test, they sometimes do not make the corresponding reduction to the match. This may create a discriminatory match and a failure to follow the terms of the plan if the plan calls for the match to be reduced. When employers recharacterize § 401(k) contributions as after-tax employee contributions in order to satisfy the ADP test, they sometimes forget to include the amounts in the ACP test, which may result in a § 401(m) failure. Both of these situations may be corrected upon examination through the Closing Agreement Program.

EXAMINATION STEPS:

1. Determine that the employer has reduced matching contributions as well as deferrals under the ADP test.

2. Determine that the employer has included recharacterized contributions in the ACP test.

Loans

Under IRC § 72(p) a loan from a qualified plan is treated as a taxable distribution to the participant, unless requirements listed in § 72(p) are met, including limits on amounts and requirements on repayment periods and level amortization periods. If these are not met, all or part of the loan may be deemed a taxable

distribution under § 72(p).

Treas. Reg. §1.401(k)-1(d)(6)(ii) provides that the making of a loan under a CODA is not treated as a distribution for purposes of plan qualification even if the loan is secured by the employee's accrued benefit attributable to elective contributions or the loan is includible in the employee's income under § 72(p). However, if an employee's accrued benefit derived from elective contributions is reduced by reason of default on a loan then the reduction is treated as a distribution. See § 1.402(c)-2T Q&A 4(d).

IRC § 4979 Tax

Under IRC § 4979 the employer is liable for an excise tax equal to ten percent of any excess contributions or excess aggregate contributions that are not corrected within 2-1/2 months after the end of the plan year being tested. However, the tax is not applied if QNECs or QMACs were added within 12 months after the end of the plan year being tested. If the QNECs or QMACs added were insufficient to fully satisfy the ADP test, the tax will apply to the remaining excess contributions. The IRC § 4979 tax is applied to the employer, and is due 15 months after the end of the plan year being tested. See Treas. Reg. § 54.4979-1. The extension of the time to pay the tax is not an extension of the time to correct the plan. The tax is reported on Form 5330. Thus, if the ADP test is failed for the 1994 calendar plan year, and correction is not made, or is made by distributions after March 15, 1995, the employer must file a Form 5330 and pay the excise tax by March 31, 1996.

Only apply this excise tax one time per qualified CODA failure. The fact that the CODA remains nonqualified for more than one year does not make the excise tax apply to the second year. Of course, if the employer simply makes corrective distributions after the March 15 deadline, and does the same thing next year, the excise tax does apply next year.

EXAMINATION STEP:

Consider the excise tax when a plan has excess contributions or excess aggregate contributions that have not been timely corrected.

Multiple Use of Alternative Limitation

Multiple use occurs where an employer maintains a CODA and a 401(m) plan and both the ADP and ACP tests of that employer's plans can only be satisfied using the "2 times" or "2 plus" prong (the alternative limitation) of those tests set forth in § 401(k)(3)(A)(ii)(II) and 401(m)(2)(A)(ii). Section 401(m)(9) and Treas. Reg. §1.401(m)-2 set forth rules that prevent the multiple use of the alternative limitation for HCEs.

EXAMINATION STEP:

Consider the multiple use test when one or more HCEs of the employer are eligible employees in both a § 401(k) CODA and a plan maintained by the employer under § 401(m).

Discrepancy Adjustments

If the statute of limitations is closed on a Form 1040, the amount of HCE deferrals that should have been included in HCE income when the ADP test failed, may not be included in a later year.

If a discrepancy adjustment is made to a HCE's 1040 and the plan is requalified through a Closing Agreement Program, the employee will have basis in the amount taxed through the discrepancy adjustment so upon ultimate distribution it will not be taxed again. See IRM 7(10)54, Chapter 913.3.

Revenue Ruling 96-47

Under Rev. Rul. 96-47, 1996-2 C.B. 35, a profit sharing plan allowed participants who had not terminated employment to direct investments of their accounts. Terminated participants could not direct their investments. The plan provided that a participant who terminated employment prior to the normal retirement date would receive his or her vested account balance at normal retirement date unless the participant elected to receive an immediate distribution of the vested account balance.

IRC § 411(a)(11) requires the participant's consent before benefits are distributed. Treas. Reg. § 1.411(a)-11(c)(2)(i) provides that consent is not valid if a significant detriment is imposed on participants that do not consent to the distribution. The Revenue Ruling concluded that under the

facts and circumstances, the loss of the right to direct investments is a significant detriment, and a violation of § 411(a)(11) had occurred.

EXAMINATION STEP:

If a CODA places significant restrictions on a participant's right to direct investments after the participant has received a distribution you should consider whether a violation of § 411(a)(11) has occurred. See Rev. Rul. 96-47.

Extensions for Governmental and Tax-Exempt Organizations

Notice 96-64, 1996-2 C.B. 229, provides a special option for governmental plans for applying the § 401(k) and (m) nondiscrimination tests for years before 1999, and provides certain extensions and amendment periods with respect to tax exempt organizations and governmental plans.

Plan Asset Rule

The Department of Labor (DOL) provides rules on when participant contributions held by the employer become "plan assets." Once participant contributions become plan assets they are subject to the trust requirements of the Employee Retirement Income Security Act of 1974 (ERISA), § 403. This requirement is imposed to prohibit commingling of assets with an employer's own property. Other fiduciary responsibilities also apply. Although this is a DOL rule, the Service can impose prohibited transaction taxes under § 4975 for certain transactions involving plan assets.

The DOL's general position is that plan assets include amounts paid by a participant to the employer for contribution to the plan or withheld by an employer from a participant's wages as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets. Under prior rules, the maximum length of time employers had to treat participant contributions to pension plans as other than plan assets was 90 days from the time these contributions were withheld by the employer or paid by the participant. DOL Reg. Sec. 2510.3-102 was revised to limit the period to 15 business days after the end of the month in which contributions were withheld or submitted, with a 10 day extension possible if the employer meets all of the notice and other

requirements set forth in the regulations. This rule is effective February 3, 1997, with a special extended date of 90 days for certain employers that follow the procedures under the regulations, and a delayed effective date for collectively bargained plans.

Note: The time period for allocating ECs to an employee's account under the § 401(k) regulations does not correspond to the DOL periods. Treas. Reg. § 1.401(k)-1(b)(4)(i) provides that ECs are taken into account for the ADP test for a plan year only if the EC is allocated to the employee's account under the plan as of a date within that plan year (allocation cannot be contingent and EC must actually be paid to the trust no later than the end of the 12 month period after the plan year to which the contribution relates), and the EC relates to certain compensation as set forth in the regulations.

TRA'97 CHANGES AFFECTING CODAs

Matching Contributions for Self-Employed Individuals

Pre-TRA'97

Under Regs. § 1.401(k)-1(a)(6)(iii), matching contributions made by a partnership on behalf of a partner are treated as elective deferrals. As a result, any plan mantained by a partnership that provides for employer matching of employee contributions by a partner is a CODA, whether or not the employer intends or realizes it. Additionally, any partnership plan that provides employer matching of either employee contributions or explicit elective deferrals on behalf of partners will have difficulty passing the ADP test. This rule may also apply to a plan maintained by a sole proprietor.

TRA'97 Change

Section 1501 of TRA'97 added paragraph (9) to § 402(g) to provide that a matching contribution on behalf of a self-employed individual (as defined by § 401(c)) shall not be treated as an elective contribution under a qualified CODA. This change applies to years beginning after December 31, 1997.

Government Plans

Pre-TRA'97

The nondiscrimination tests of § 401(k)(3) and § 401(m) apply to plans maintained by state and local governments or political subdivision thereof (or agency or instrumentality thereof), but with the effective date extended to plan years beginning on or after the later of October 1, 1997, or 90 days after the opening of the first legislative session beginning on or after October 1, 1997, and with the § 401(b) remedial amendment period extended to the 1999 plan year. See Notice 96-64, 1996-2 C.B. 229.

TRA'97 Change

Section 1505(b) of TRA'97 added subparagraph (G) to § 401(k)(3), providing that a governmental plan shall be treated as meeting the requirements of the participation and nondisrimination standards for qualified CODAs. Section 1505(a)(1) added subparagraph (G) to § 401(a)(5), providing that §§ 401(a)(3) and 401(a)(4) (and therefore also § 401(m)) shall not apply to governmental plans. These changes are effective August 5, 1997 (the date of enactment of TRA'97), and government plans are treated as meeting the requirements of §§ 401(a)(3), 401(a)(4), 401(k), 401(m), etc., for years beginning before that date.

10% Tax for Nondeductible Contributions

Pre-TRA'97

Code § 4972 imposes a 10% tax on employer contributions to a combination of one or more defined contibution plans and one or more defined benefit plans to the extent that, in the aggregate, such contributions exceed the deduction limitation set by § 404(a)(7) (the greater of 25% of compensation of beneficiaries or the defined benefit minimum funding amount).

TRA'97 Change

Section 1507 of TRA'97 amends § 4972(c)(6)(B) to exempt from the tax an amount equal to the sum of elective deferrals to a qualified CODA and matching contributions to a defined contribution plan.

Investment in Employer Securities

Pre-TRA'97

Under ERISA §§ 407(b)(1) and 407(d)(3), a profit-sharing, stock bonus, thrift or savings plan that explicitly provides for acquisition and holding of qualifiying employer securities or property is exempted from the the 10% of assets limitation of ERISA § 407(a). This includes CODAs.

TRA'97 Change

Section 1524 of TRA'97 added a new paragraph (2) to § 407(b) of ERISA, to provide that, **other than in an ESOP**, elective deferrals are treated as a separate plan that is subject to the 10% of assets limitation (unless the investment is participant directed). There are two de minimis exceptions to this rule: (1) if, on the last day of the preceding plan year, the fair market value of assets in all individual account plans maintained by the employer does not exceed 10% of the fair market value of the assets of all pension plans (other than multiple employer plans) maintained by the employer; or (2) if the portion of any employee's elective deferrals required to be invested in qualifying employer securities and property does not exceed 1% of that employee's compensation. This amendment is effective for plan years beginning after December 31, 1998.

Irrigation and Drainage Entities

Section 1525 of TRA'97 added certain irrigation and drainage entities to the definition of "rural cooperative" under § 401(k)(7)(B).

SUMMARY

This text has summarized the changes to CODAs made by the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997, and has focused on selected examination issues generally applicable to qualified CODAs. You should be able to recognize the impact of the SBJPA and TRA'97 on qualified CODAs, especially in determining the ADP and ACP tests, and the distribution of excess amounts. You should also be aware of some of the issues that arise when examining plans with CODAs.

GLOSSARY

A. ADR: Actual Deferral Ratio - An employee's ECs (with QNECs and QMACs) divided by the employee's compensation.

B. ADP test: Actual Deferral Percentage test limits the amount of ECs, as a percentage of compensation, that can be made by highly compensated employees (HCEs). Test compares the average of the actual deferral ratios of the HCEs (the HCE ADP) to the average of the actual deferral ratios of the NHCEs (the NHCE ADP).

C. ACP TEST: Same test as ADP test but set forth in IRC § 401(m), testing matching and employee contributions rather than ECs.

D. CODA: Cash or Deferred Arrangement - Arrangement that allows participants an election between cash or some other taxable benefit, or an employer contribution to a trust on the participant's behalf. In a qualified CODA the choice may only be between cash or a contribution. Election must be made before the money would be "currently available" to the participant.

E. Elective Contributions (ECs): Amounts that a participant elects to have contributed on his behalf to a CODA.

F. Elective Deferrals: Any ECs to a qualified CODA, SEP, a 403(b) annuity or 501(c)(18) plan and (after 12/31/96) ECs to a SIMPLE IRA (SBJPA §1421). That is, contributions that arise because of an election by the employee between a taxable benefit and a deferral into a plan. An EC is one type of elective deferral. These deferrals are subject to the 402(g) limit.

G. Excess Deferrals: Elective deferrals which are in excess of the tax deferral limit in IRC § 402(g).

H. Excess Contributions: ECs that exceed the percentage allowed under the ADP test.

I. Excess Aggregate Contributions: Employee and matching contributions that exceed the percentage allowed under the ACP test.

J. QNECs: Qualified Nonelective Employer Contributions. Employer contributions that may be used to help satisfy the ADP test or the ACP test (but the same contributions cannot be counted in both tests). Section 1.401(k)-l(b)(4)(ii). QNECs cannot be subject to an election by a participant to accept such contributions in cash or as employer contributions.

K. QMACs: Qualified Matching Contributions. Employer contributions that are on account of some other contribution by a participant. May be used to help satisfy the ADP test, otherwise included in the ACP test. Like QNECs, the same QMACs cannot be used in both tests. Section 1.401(m)-I(b)(4)(ii)(B).

LESSON 1, PART II

SBJPA AMENDMENTS TO THE MINIMUM DISTRIBUTION REQUIREMENTS OF SECTION 401(a)(9)

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INTRODUCTION

The purpose of this lesson is to describe the changes made by the Small Business Job Protection Act of 1996 (SBJPA) (P.L. 104-188) to the definition of required beginning date under section 401(a)(9) of the Internal Revenue Code. The options that an employer has in operating and amending plans to comply with these SBJPA changes are also covered.

Section 401(a)(9) provides that distributions of each employee's interest in

a qualified plan must commence no later than the "required beginning date" for the employee. The definition of required beginning date under section 401(a)(9)(C) was amended by section 1404(a) of SBJPA effective for years beginning after December 31, 1996. Section 401(a)(9) as amended provides that, in the case of an employee who is not a 5-percent owner, the required beginning date for minimum distributions from a qualified plan is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. In the case of an employee who is a 5-percent owner, the required beginning date is the April 1 following the calendar year in which the employee attains age 70½.

In 1996 and 1997 the Service issued five separate pieces of guidance on the SBJPA changes to section 401(a)(9). Each piece of guidance is discussed and referenced below, where it is relevant to the discussion. The most comprehensive guidance on miscellaneous issues resulting from the SBJPA amendments to section 401(a)(9) is contained in Notice 97-75, 1997-51 I.R.B. 18, December 22, 1997.

OBJECTIVES

At the end of this lesson you will be able to:

1. Recognize the changes to section 401(a)(9) made by SBJPA.

2. Determine the choices available to an employer in determining the required beginning date for employees after the SBJPA effective date, and when plans must be amended for the SBJPA changes.

3. Explain the actuarial increase required for the period after age 70½ in which an employee was not receiving any benefits under a plan.

4. Describe the special relief from section 401(a)(4) for an employer that implements the SBJPA changes.

BACKGROUND

Prior Law

Prior to the SBJPA amendments the required beginning date for an

employee to commence distributions from a plan depended upon whether the employee participated in a governmental or church plans, or another qualified plan. Section 401(a)(9)(C) of the Code provided that distributions to an employee must commence no later than:

1. April 1 of the calendar year following the calendar year in which the employee attained age 70½, in the case of a qualified plan other than a governmental or church plan.

2. April 1 after the later of the calendar year in which the employee reached age 70½ or retired, in the case of a governmental or church plan.

Current Law

Under section 401(a)(9)(C) as amended by SBJPA the status of an employee as a 5-percent owner in addition to the type of plan the employee participates in determines the required beginning date. Distributions must commence no later than:

1. April 1 following the calendar year in which the employee reached age 70½ in the case of a 5-percent owner participating in a qualified plan.

2. April 1 after the later of the calendar year the employee reached age 70½ or retired in the case of an employee other than a 5-percent owner participating in a qualified plan. An employee's accrued benefit in a defined benefit plan must be actuarially increased to take into account the period after age 70½ in which the employee was not receiving any benefits under the plan.

3. April 1 after the later of the calendar year the employee reached age 70½ or retired in the case of an employee participating in a governmental or church plan. The actuarial increase mentioned in item 2 above does not apply.

An employee is treated as a 5-percent owner for purposes of section 401(a)(9) as amended by SBJPA if such employee is a 5-percent owner (as defined in section 416) with respect to the plan year ending with or within the calendar year in which such owner attains age 70½. This period for determining whether a

person is a 5-percent owner is different from the pre-SBJPA definition of 5-percent owner under which an employee was treated as a 5-percent owner if such employee was a 5-percent owner at any time during the plan year ending with or within the calendar year in which such owner attained age 66½ or any subsequent year. Under SBJPA and pre-SBJPA, once an employee is a 5-percent owner, distributions must continue to such employee even if such employee ceases to own more than 5 percent of the employer in a subsequent year.

Thus, before the SBJPA change, all employees (other than those participating in governmental and church plans) were required to begin receiving distributions by the April 1 after the year they reached 70½, even if they had not yet retired. The new law allows many employees (other than 5-percent owners) to wait until they retire to begin to receive distributions.

For purposes of this lesson, the definition of required beginning date ("RBD") prior to the SBJPA change is referred to as the "old RBD" and the SBJPA change is called the "new RBD." Further, unless otherwise noted, the discussion concerns the special rules applicable to employees (other than 5-percent owners) participating in qualified plans (other than governmental or church plans).

OPTIONS FOR EMPLOYERS

Although SBJPA delays the RBD for many employees, an employer may be prohibited from amending its plan or plans to immediately implement this change. An amendment that eliminates the right to receive distributions by April 1 after the year in which the employee reaches age 70½ violates section 411(d)(6) (which prohibits the accrued benefit of a participant to be decreased by a plan amendment, including an elimination of an optional form of benefit). The right to receive distributions at age 70½ and thereafter is an optional form of benefit under section 411(d)(6).

The guidance issued by the Service provides that an employer has the option to retain the old RBD in its plan provisions (Notice 97-75) or to amend its plan to allow each employee to choose whether to delay or commence distributions (Announcements 97-24 and 97-70). In section 1.411(d)-4, Q&A 10 of the proposed Income Tax Regulations, the Service has also proposed permitting an employer to adopt the new RBD and eliminate the old RBD without violating

section 411(d)(6) under certain circumstances. These options are discussed below.

A) Retaining Old RBD

Section 401(a)(9) provides that minimum distributions must commence beginning "no later than" the RBD. Although the definition of RBD has been deferred under SBJPA for employees that are not 5-percent owners, an employer may retain the old RBD definition for all employees in its plan.

1) Effect on Distributions

Notice 97-75 provides a special rule for an employer that retains the old RBD in its plan. The amount and the timing of required minimum distributions from a qualified plan depends upon whether the employee died before or after the RBD, and who the employee’s designated beneficiary is for purposes of determining life expectancy. If the old RBD is retained pursuant to Q&A-10, both the employee’s designated beneficiary and whether recalculation of life expectancy applies will be determined based on any elections in effect as of that date. Further, this old RBD is treated as the employee’s RBD for purposes of determining whether he died before or after the RBD under section 401(a)(9)(C).

2) Effect on Excise Tax and Rollover Rules

Although retaining this old RBD is permitted, the legal RBD is contained in section 401(a)(9), as amended by SBJPA. This has a significant impact on the applicability of the rollover rules and the excise tax on accumulations in qualified plans. Section 402(c)(4)(B) provides that a distribution is not an eligible rollover distribution to the extent that it is required under section 401(a)(9). Section 4974 imposes an excise tax on amounts accumulated in retirement plans that exceed the minimum required distribution for each year.

Regardless of whether the plan provides for minimum distributions commencing no later than the old RBD (an employee’s required beginning date of April 1 of the calendar year following the calendar year the employee attained age 70½), the employee's RBD for purposes of section 4974 (excise tax on excess accumulations) and section 402(c) (definition

of eligible rollover distribution) is determined in accordance with section 401(a)(9) as amended by SBJPA.

EXAMPLE (1): Employee A is not a 5-percent owner and has reached the April 1 date after age 70½. He participates in Employer M's qualified plan, Plan Y. Employer M has retained the old RBD in Plan Y, so Employee A receives distributions under Plan Y on that April 1 date. No excise tax under section 4974 applies prior to the calendar year in which Employee A retires. However, beginning with that year, the amount that is required to be distributed each year to satisfy section 401(a)(9), as amended by SBJPA, for purposes of section 4974 will be determined using the old RBD under the plan.

EXAMPLE (2): Employer N maintains Plan X, a profit-sharing plan. After SBJPA, Employer N chooses to retain the old RBD in Plan X in accordance with Q&A-10 of Notice 97-75. In 1998 Employee B, who does not retire in 1998, accelerates his distribution and takes a lump sum distribution. Employee B has reached the RBD under Plan X. Since the amount was distributed before the new RBD under SBJPA, Employee B may rollover the amount to the extent it otherwise meets the definition of an eligible rollover distribution under section 402(c) and other rules are satisfied, including the direct rollover option under section 401(a)(31), the written explanation under section 402(f), and applicable withholding requirements under section 3405(c).

B) Option to Defer Distributions

Employers may allow employees to make an affirmative election to defer distributions until a date no later than the new RBD, or to commence distributions by their old RBD as stated in the plan. This is a choice available to employers even if their plans have not yet been amended to provide for this option.

1) General Rule

Announcement 97-24, 1997-11 I.R.B. 24, dated March 17, 1997, provides that an employer is permitted to offer an employee (other than a 5-percent owner) who attains age 70 1/2 after 1995 and has not retired by the end of that calendar year the option to delay commencement of benefit distributions until no later than April 1

following the calendar year in which the employee retires from employment with the employer maintaining the plan.

2) Transition Rule for Employees Reaching 70½ in 1996

Some plans failed to commence distributions to employees reaching age 70½ in 1996 by the old RBD stated in the plan, and also did not give employees the option to defer by this date. Announcement 97-70, 1997-29 I.R.B. 14, dated July 21, 1997, provides transition relief for a plan that failed to make distributions under the terms of the plan to an employee who reached age 70 1/2 in 1996 and who did not retire in 1996. The relief in Ann. 97-70 applies to a plan with respect to distributions required under the terms of the plan to be made to such an employee between August 20, 1996 (the date of enactment of SBJPA) and December 31, 1997. Basically, the relief extends the date by which an employee must elect to defer or receive a make-up distribution from April 1, 1997 to December 31, 1997. Plans that decide not to give employees this option also have until December 31, 1997 to pay a make-up distribution. This distribution must include all of the employee's distributions required under the plan terms up to that date, and in the case of a defined benefit plan, must be increased to take into account the delayed payment consistent with the plan's actuarial adjustments.

3) Plan Amendments

A plan may give an employee the option to defer commencement of benefits until the new RBD even if the plan has not yet been amended to provide for this new RBD. **However, the employer must amend the plan retroactively to conform the plan to its pre-amendment operation regarding the option to defer. Revenue Procedure 97-41, 1997-33 I.R.B. 51, dated August 18, 1997, provides that the retroactive amendment described in Ann. 97-24 and Ann. 97-70 must be adopted by the end of the remedial amendment period.** For most plans, this remedial amendment period is extended to the last day of the first plan year beginning on or after January 1, 1999 (which would be December 31, 1999 for a calendar year plan). A later remedial amendment period applies to governmental plans.

C) Adopting New RBD

Although SBJPA changed the definition of RBD effective for years after 1996, an employer that decides to implement the SBJPA changes immediately could violate section 411(d)(6) of the Code. Section 411(d)(6) generally provides that a plan will not be treated as satisfying the requirements of section 411 if the accrued benefit of a participant is decreased by a plan amendment. Under section 411(d)(6)(B), a plan amendment that eliminates an optional form of benefit will be treated as reducing accrued benefits to the extent that the amendment applies to benefits accrued as of the later of the adoption date or the effective date of the amendment.

The problem for an employer who wishes to immediately amend the plan to provide for a deferred required beginning date is that the right to commence preretirement benefit distributions in a plan after age 70 1/2 is an optional form of benefit. Thus, eliminating this right violates section 411(d)(6) if the amendment applies to benefits accrued as of the later of the adoption or effective date of the amendment. One alternative is mentioned above (See Part B) - to give employees an option to defer or commence distributions by the old RBD provided in the plan. This does not violate section 411(d)(6) because employees choose whether or not to receive distributions by the old RBD. If an employer does not wish to give employees a choice, the employer has two other alternatives:

1) Amendments Applicable to Future Accruals

Section 411(d)(6) only applies to amendments that reduce benefits already accrued. Thus, the employer could amend the plan to eliminate the right to preretirement distributions solely with respect to future accruals. However, each current participant would retain the right to receive preretirement distributions after age 70½ with respect to a portion of his or her accrued benefit that had accrued as of the later of the adoption date or effective date of the amendment.

2) Other Amendments Eliminating Preretirement Distributions

Section 411(d)(6)(B) permits the Secretary to provide in regulations that section 411(d)(6) will not apply to an amendment that eliminates an optional form of benefit. The Service recognized that it could be complex for an employer to administer a plan that either gives employees a choice to decide whether to begin receiving distributions by the old or the new RBD, or to apply the new rules solely with respect to future accruals as

noted above. Section 1.411(d)-4, Q&A 10 of the proposed Income Tax Regulations allows the optional form of benefit to be eliminated under certain circumstances.

Under these regulations, an employer may only eliminate the "age 70½ distribution option" stated in the plan for employees who reach 70½ after 1998 (without regard to whether or not benefits have accrued before the amendment). The regulations define the age 70½ distribution option as an optional form of benefit under which benefits payable in a particular distribution form (including any modifications that may be elected after benefit commencment) commence at a time during the period that begins on or after January 1 of the calendar year in which an employee attains age 70½ and ends April 1 of the immediately following calendar year. These regulations do not allow forms of benefit other than the timing of commencement of payments to be eliminated. Thus, an employee who retires after the calendar year in which the employee attains age 70½ may not be precluded from receiving benefits in any of the same optional forms of benefit that would have been available had the employee retired in the calendar year in which the employee reached age 70½, except for the difference in timing.

For older employees (reaching age 70½ before 1999), this option may not be eliminated with respect to benefits that have already accrued. The reason for this distinction is that older employees who are closer to age 70½ may have a greater expectation of receiving benefits by the date stated in the plan.

3) Amendment Date

It is important to note that amendments relating to the elimination of the age 70½ distribution option under the proposed regulations that would otherwise violate section 411(d)(6) may not be retroactive, unlike the retroactive amendments permitted when an employer gives employees an option on whether or not to defer distributions. Further, at the time of publication of this CPE chapter, these proposed regulations had not yet been finalized. The guidance in the proposed regulations are only effective after the date that final regulations are adopted and will only apply to amendments adopted and effective after that date. Finally, the amendment eliminating the age 70½ distribution option must be

adopted no later than the last day of the SBJPA remedial amendment period, so this is not an ongoing rule. The following example is from the proposed regulation.

EXAMPLE (3): Plan A, a defined benefit plan, provides each participant with a qualified joint and survivor annuity (QJSA) that is available at any time after the later of age 65 or retirement. However, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan A provides that if an employee does not retire by the end of the calendar year in which the employee attains age 70½, then the QJSA commences on the following April 1. On October 1, 1998, Plan A is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence before the employee retires but must commence no later than the April 1 following the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. This amendment satisfies the regulations and does not violate section 411(d)(6).

The regulations provide other examples, including one of a profit- sharing plan that permits an employee to elect distributions after age 59½ at any time and in any amount. In this case, the section 411(d)(6) relief proposed in the regulation is not required because the right to commence distributions at age 70½ continues to be available under the plan under the general distribution provisions even after the plan is amended to eliminate the existing age 70½ distribution option language. For further details, see section 1.411(d)-4, Q&A 10 of the proposed regulations.

D) Stopping and Recommencing Distributions

The guidance discussed up to this point has not addressed whether employees who had begun to receive distributions under the old RBD could stop these distributions and wait until a date no later than the new RBD to recommence distributions. Notice 97-75 describes how employees may stop and recommence distributions.

1) New RBD

The first determination that must be made is whether the employee receiving distributions has a new RBD under the SBJPA changes. With respect to employees already receiving distributions, this new

RBD only applies to employees who reached age 70½ before 1996, had not retired by January 1, 1997, and had not received irrevocable distributions under an annuity as provided in section 1.401(a)(9)-1, B-5 of the proposed Income Tax Regulations. Generally, these employees have an RBD of the April 1 after the calendar year in which the employee retires.

EXAMPLE (4): Employee X turned 70½ in 1990. He retired in 1997 and was not receiving amounts under an irrevocable annuity. He has a new RBD of April 1, 1998. Employee Y turned 70½ in 1990 and retired in 1994. Employee Y has no new RBD and the SBJPA changes have no effect on that Employee Y's minimum distribution requirements under section 401(a)(9).

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2) Qualified Domestic Relations Order (QDRO)

The terms of any applicable QDRO will control in determining whether an employee may stop distributions and recommence at a later date. A QDRO is generally an order providing that an alternate payee such as a spouse, former spouse, child or other dependent will receive benefits under a plan, as described in section 414(p) of the Code.

3) Spousal Consent Rules

An employee's election to stop and recommence distributions is subject to the requirements of sections 401(a)(11) and section 417 of the Code if the plan is otherwise subject to those rules. Under section 401(a)(11) certain plans must provide benefits in the form of a qualified joint and survivor annuity (QJSA) or qualified preretirement survivor annuity (QPSA). Section 417 permits a participant to waive the QJSA or QPSA and to elect another form of benefit with spousal consent. Generally, the annuity starting date is significant because the spouse at the time of the annuity starting date is the spouse whose consent is required. Notice 97-75 sets forth two alternatives for plans. The timing of spousal consent, if any, depends in part upon the alternative provided for under the plan.

Alternative One - No New Annuity Starting Date

One alternative is for the plan to provide that there is no new annuity starting date under section 417 upon recommencement of benefits. Under this alternative, distributions recommence in the same form unless the employee elects a different form at the time of recommencement. No spousal consent is required for an employee to elect to stop distributions. No spousal consent is required when payments recommence to the employee unless the employee elects a different form of benefit. Specifically, Notice 97-75 states that no spousal consent is required on recommencement if:

(A) payments recommence to the employee with the same beneficiary and in a form of benefit that is the same but for the cessation of distributions,

(B) the individual who was the employee’s spouse on the annuity starting date executed a general consent within the meaning of section 1.401(a)-20, A-31 of the Income Tax Regulations, or

(C) the individual who was the employee’s spouse on the annuity starting date executed a specific consent to waive a QJSA within the meaning of section 1.401(a)-20, A-31, and the employee is not married to that individual when benefits recommence.

However, consent of the individual who was the employee’s spouse on the annuity starting date is required prior to recommencement if the employee chooses to recommence benefits either in a different form than the form in which they were being distributed prior to the cessation of distributions or with a different beneficiary and if:

(A) the original form was a qualified joint and survivor annuity (QJSA) within the meaning of section 417(b), or

(B) the individual who was the employee’s spouse on the annuity starting date originally executed a specific consent to waive a QJSA within the meaning of section 1.401(a)-20, A-31 and the employee is still married to that individual when benefits recommence.

Alternative Two - New Annuity Starting Date

A second alternative is designed to put the employee back in the position the employee would have been if distribution had never recommenced. Thus, the plan provides that there is a new annuity starting date under section 417 upon recommencement of benefits. In such case, no spousal consent is required for an employee to elect to stop distributions except where such distributions are being paid in the form of a qualified joint and survivor annuity (QJSA) within the meaning of section 417(b). Where such distributions are being paid in the form of a QJSA the person who was the employee's spouse on the original annuity starting date must consent to the election to stop distributions and the spouse's consent must acknowledge the effect of the election. Because there is a new annuity starting date upon recommencement of benefits, the plan must comply with all of the requirements of section 417 upon such recommencement, including payment of a qualified preretirement survivor annuity (QPSA) if the employee dies before the new annuity starting date.

Plan Amendment and Operational Compliance

In order to rely on one of the two alternatives specified above, the plan must operationally comply with the alternative chosen, and must be amended to reflect this operational compliance within the SBJPA remedial amendment period. Further, the distributions must actually stop prior to the end of that remedial amendment period. Notice 97-75 does not address the applicable rules for an employer to follow on allowing employees to stop and recommence distributions after the remedial amendment period.

4) Treatment of Distributions

Whether or not a plan allows an employee with a new RBD to stop distributions, a distribution to such an employee prior to the year

the employee retires is not a required distribution under section 401(a)(9). It will be an eligible rollover distribution unless it is excepted for some other reason.

An exception is provided under section 402(c)(4)(A) for a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and the employee's designated beneficiary, or for a specified period of 10 years or more. If an employee's benefit is being distributed in a series of annual payments that would equal the required minimum distribution determined in accordance with Q&A F-1 of section 1.401(a)(9)-1 of the proposed Income Tax Regulations, then the series of payments will be considered a series of substantially equal payments over the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and the employee's designated beneficiary, or for a specified period of 10 years or more, in accordance with Q&A-5 of section 1.402(c)-2 of the regulations. Therefore, payments under such a series of payments are not eligible rollover distributions.

EXAMPLE (5): Employee M reached age 70½ in 1995. Employee M retired from employment with the employer maintaining the plan in 1997. Employee M's new RBD is April 1, 1998. This RBD for purposes of determining minimum distributions that are required on or after January 1, 1997 is different from the RBD for the employee for purposes of determining minimum distributions that were required prior to January 1, 1997.

A special rule described in the section above on the old RBD, permits an employee's RBD determined without regard to the SBJPA amendments to be treated as the RBD for purposes of determining the minimum distributions required after January 1, 1997.

5) Special rules

The first guidance on the SBJPA changes was Notice 96-67, 1996-53 I.R.B. 12, dated December 30, 1996. It addressed the situation of employees who reached age 70½ in 1996 but had not yet retired by the end of 1996. After SBJPA was passed there were some pressing questions facing this group of employees. Employers did

not know which law applied. The RBD under old law for employees reaching age 70½ in 1996 would be April 1, 1997. They reached 70½ before the SBJPA effective date. However, the April 1 date was after the SBJPA effective date. So, did they have a deferred RBD until after retirement? Notice 96-67 stated that the RBD would be the new deferred RBD of April 1 after the employee retired.

Even if an employee was not required to receive distributions in 1996, if the employee receives 1996 distributions, they are not eligible for rollover to the extent that they would have been required under pre-SBJPA section 401(a)(9). However, distributions made in 1997 or in future years and before the employee's new SBJPA RBD are not required minimum distributions. They are eligible for rollover if they otherwise meet the definition of an eligible rollover distribution under section 402(c).

EXAMPLE (6): Employee C reached age 70½ in 1996. Employee C was not a 5-percent owner. Employee C did not retire from employment with the employer by the end of 1996. The RBD for Employee C is the April 1 of the calendar year after Employee C retires, rather than April 1, 1997.

EXAMPLE (7): Same as above except Employee C receives some distributions in 1996. This distribution is treated as a required distribution to the extent that the total required minimum distribution under pre-SBJPA section 401(a)(9) has not been satisfied.

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6) Transition rule for 1997 distributions

Notice 97-75 recognizes that plan administrators may have been confused about the character of distributions received from qualified plans in 1997. If employers did not realize that distributions in 1997 were not required distributions under section 401(a)(9) and therefore may be eligible for rollover, the employer may have inadvertently failed to comply with other rules applicable to rollovers. Thus, the notice gives transition relief from some of the rules applicable to rollovers.

Section 401(a)(31) and section 1.401(a)(31)-1 of the Income Tax Regulations specify that a plan must give an employee of any eligible rollover distribution an option of having it paid in a direct rollover to an eligible retirement plan. Notice 97-75 specifies that a plan will not fail to satisfy section 401(a)(31) merely because the plan administrator or payor did not offer an employee (other than a 5-percent owner), who has attained age 70½ but has not retired from employment with the employer maintaining the plan, a direct rollover option with respect to eligible rollover distributions paid in calendar year 1997 that would have been a required minimum distribution not eligible for rollover under pre-SBJPA section 401(a)(9). In addition, a plan will not be required to satisfy the written explanation requirement to employees of distributions eligible for rollover under section 402(f) or the mandatory 20-percent withholding requirement under section 3405(c) that applies if the employee has not elected to make a direct rollover under section 401(a)(31).

ACTUARIAL INCREASES APPLICABLE TO DEFINED BENEFIT PLANS

In addition to considering the character of distributions made after the SBJPA effective date, actuarial increases may be required. Notice 97-75 describes these actuarial increases and provides a frame of reference for their relationship to the existing rules under section 411 of the Code.

Section 401(a)(9)(C)(iii) of the Code requires that in the case of an employee (other than a 5-percent owner) who retires in a calendar year after the calendar year in which the employee attains age 70½, the employee's accrued benefit be actuarially increased in order to take into account the period after age 70½ in which the employee is not receiving benefits under the plan.

Note that this actuarial increase does not apply to:

a) defined contribution plans,

b) defined benefit plans that have chosen to retain the old RBD in accordance with Q&A-10 of Notice 97-75 (discussed above under **Options for Employers**) so that distributions to an employee commence no later than this RBD in an amount sufficient to satisfy pre-SBJPA section 401(a)(9), or

c) any type of governmental or church plans.

A) Period of Actuarial Increase

The starting date for this increase is April 1 after the calendar year in which the employee reached age 70½, which is the date distributions must begin if the employee retires at 70½. In the case of an employee who reached age 70½ before 1996, the starting date for actuarial increases is January 1, 1997. The period ends on the date on which benefits commence after retirement in an amount sufficient to satisfy section 401(a)(9). This increase to account for the delay in benefits is required to place employees who are not 5-percent owners in the same economic position they would have been in absent the statutory change.

B) Amount of Actuarial Increase

The amount of actuarial increase required is the actuarial equivalent of the benefits that would have been payable as of the start date for increases, plus the actuarial equivalent of the additional benefits accrued, reduced by the actuarial equivalent of any distributions made after the start date. This is payable as of the end of the period. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalency for purposes of satisfying section 411.

C) Relation to section 411

Section 411(a) requires an actuarial increase to reflect delays in payment past normal retirement age to prevent an impermissible forfeiture in an employee's accrued benefit. The amount of the actuarial increase required under section 401(a)(9) is generally the same as, and not in addition to, the section 411 actuarial increase. However, section 411(a)(3)(B) provides that no actuarial adjustment to an accrued benefit is required while an employee is performing a certain type of service after normal retirement age, which is generally 40 or more hours a month, provided that all of the rules on suspension of benefits are met. Under section 401(a)(9) the actuarial increase must be provided and cannot be suspended while the employee is in this service.

Additional accruals beyond normal retirement age required under section 411(b)(1)(H) may be reduced by actuarial increases required

under section 401(a)(9)(C)(iii) in certain circumstances. Notice 97-75 specifies that for purposes of section 411(b)(1)(H)(iii)(II), the actuarial increase required under section 401(a)(9)(C)(iii) will be treated as an adjustment attributable to the delay in distribution of benefits after the attainment of normal retirement age. Accordingly, to the extent permitted under section 411(b)(1)(H), the actuarial increase required under section 401(a)(9)(C)(iii) may reduce the benefit accrual otherwise required under section 411(b)(1)(H)(i). However, the rule in the last sentence of section 1.411(b)-2(b)(4)(iii)(B) of the proposed Income Tax Regulations regarding the actuarial adjustment in the case of a plan that suspends benefits in accordance with section 203(a)(3)(B) of ERISA does not apply to the calculation of additional accruals for the period of time for actuarial increases under section 401(a)(9)(C)(iii).

SPECIAL RULES UNDER SECTION 401(a)(4)

Under section 1.401(a)(4)-4 of the Income Tax Regulations, each optional form of benefit must be currently available to a group of employees that satisfies section 410(b). Section 410(b) provides rules to prevent a plan from disproportionately covering highly compensated employees. An employer that eliminates the availability of a preretirement optional form of benefit for employees who attain age 70½ after a specified year, other than for 5-percent owners, under the proposed section 411(d)(6) relief could face a potential section 401(a)(4) problem. The problem arises if the group for which the benefit is retained (5-percent owners and older employees with longer service required under section 411(d)(6) to have this benefit) is disproportionately highly compensated.

Notice 97-75 provides that optional forms of benefit available to 5-percent owners and the protected group of employees above a specified age under the proposed section 411(d)(6) regulations at age 70½ and retirement and to other employees only at retirement will be treated as the same optional form of benefit for purposes of testing the nondiscriminatory availability of benefits, rights and features. The notice also provides that an optional form of benefit available to 5-percent owners that provides for interim installment payments under a defined contribution plan between age 70½ and retirement equal to the annual minimum required distribution is treated as satisfying the requirements of section 1.401(a)(4)-4. See Q&A-5 of Notice 97-75 for further details and specific definitions of applicable terms.

SUMMARY

This text has summarized the changes to the definition of required beginning date under section 401(a)(9) made by the Small Business Job Protection Act of 1996, including guidance issued by the Service on options available to employers in operating and amending their plans.

The guidance issued by the Service and discussed in this text is:

Notice 96-67, 1996-53 I.R.B. 12, 12/30/96

Announcement 97-24, 1997-11 I.R.B 24, 3/17/97

Announcement 97-70, 1997-29 I.R.B 14, 7/21/97

Notice 97-75, 1997-51 I.R.B. 18, 12/22/97

Proposed Income Tax Regulation section 1.411(d)-4, Q&A 10, 8/11/97

Revenue Procedure 97-41, 1997-33 I.R.B. 51, 8/18/97

Agents should note that employers have several choices in determining the RBD for distributions from qualified plans with respect to employees other than 5-percent owners. As discussed under **Options for Employers** in this text, employers may, depending on the circumstances, choose to:

1. Retain the old RBD

2. Adopt a new RBD

3. Allow employees to defer distributions

4. Allow employees to stop distributions and recommence at a later date.

Appropriate plan language will vary according to the choices the employers make, and plan amendments must generally be made by the remedial amendment period as discussed in Rev. Proc. 97-41.

The treatment of distributions after the SBJPA changes for purposes of the rollover rules under section 402 and the excise tax under section 4975 are also

covered.

Finally, this chapter has also reviewed the actuarial increase required for certain periods that an employee is not receiving benefits under a defined benefit plan, as well as special relief from certain section 401(a)(4) requirements.

LESSON 1, PART III

CHANGES TO SECTION 401(a)(5) UNDER THE SMALL BUSINESS JOB PROTECTION ACT OF 1996 AND THE TAXPAYER RELIEF ACT OF 1997

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IRC 401(a)(5)

Section 401(a)(5) of the Code provides special rules relating to nondiscrimination. Most of the rules pertaining to nondiscrimination are contained in sections 401(a)(4) and 401(l). These nondiscrimination rules apply to qualified retirement plans (including plans with cash or deferred arrangements (CODAs)) and annuity plans under section 403(a) or (b). Elective deferrals under plans with CODAs (section 401(k) plans) satisfy the nondiscrimination rules by passing the ADP test under section 401(k). Similarly, employer matching and after-tax contributions satisfy the nondiscrimination rules by passing the ACP test under section 401(m).

The Small Business Job Protection Act of 1996 (SBJPA) and the Taxpayer Relief Act of 1997 (TRA ’97) each amended section 401(a)(5) by adding a new paragraph.

Changes Made by SBJPA

Section 1445(a) of SBJPA amended section 401(a)(5) of the Code by adding section 401(a)(5)(F) which provides that for purposes of the nondiscrimination rules of section 401(a)(4), social security retirement age (as defined in section 415)

(SSRA) is a uniform retirement age. Furthermore, this new Code section also provides that subsidized early retirement benefits and qualified joint and survivor annuities shall not be treated as being unavailable to employees on the same terms merely because such benefits or annuities are based on an employee's SSRA.

The addition of section 401(a)(5)(F) of the Code by SBJPA allows employers to test benefits for discrimination by actuarially adjusting the benefits to SSRA and comparing the benefits at SSRA. In the two examples below, the actuarial adjustment is six percent per year.

EXAMPLE (1):

In 1997, the Odessa Filing Cabinet Company establishes a defined benefit plan with a normal retirement age (NRA) of 65. For a participant with a SSRA of 65, the benefit payable at age 65 is 2% of final average compensation (FAC) times years of service. For a participant with a SSRA of 66, the benefit payable at age 65 is 1.88% of FAC times years of service. The benefit formula provides that for a participant with a SSRA of 67, the benefit payable at age 65 is 1.767% of FAC times years of service.

The Odessa plan has three distinct benefit structures. However, because SSRA is now a uniform retirement age, when each structure is adjusted to SSRA, the benefit is a uniform 2% of FAC, and the three different benefit structures are considered uniform for purposes of section 401(a)(4). Thus, these different benefit structures do not cause the plan to fail to be a safe harbor plan.

Note, however, that while employers are now allowed to provide benefit structures similar to those contained in the Odessa plan, employers are not forced to make actuarial adjustments like those contained in this example. Also, employers need not do additional adjustments that would be needed if NRA were not a single age (e.g., the later of age 65 or the 5th anniversary of plan participation). For instance, Odessa could have provided a safe harbor plan with a benefit of 2% of FAC times years of service (for all participants) payable at age 65 with benefits paid at later dates increased accordingly.

The new Code section 401(a)(5)(F) also impacts plans with permitted disparity. The effect of this new Code section is to allow more options under section 401(l) than were provided in the regulations. This issue is addressed in Line II.d.(vi) of Worksheet No. 5B (Permitted Disparity) of the Alert Guidelines. Specifically, see

the explanation of Line II.d.(vi) in Explanation No. 5B.

EXAMPLE (2):

In 1997, the Power Tower Company establishes a defined benefit plan with permitted disparity. The plan covers participants with SSRAs of 65, 66, and 67. NRA under the plan is 65. The benefit formula provides for a base benefit percentage of 2% and an excess benefit percentage of 2.75% if SSRA is age 65.

Under one option, for a participant with a SSRA of 66, the base benefit percentage could remain at 2% and the plan could provide for an excess benefit percentage of 0.70% (the greatest disparity allowed under section 1.401(l) of the regulations for a participant with a SSRA of 66 at NRA 65). For a participant with a SSRA of 67, the base benefit percentage could remain at 2% and the plan could provide for an excess benefit percentage of 0.65% (the greatest disparity allowed under section 1.401(l) for a participant with a SSRA of 67 at NRA 65).

In addition, Power's plan is also permitted to provide that the 2.75% excess benefit percentage is actuarially reduced for participants with SSRAs over age 65. For a participant with a SSRA of 66, the excess benefit percentage at NRA 65 could be actuarially reduced to 2.585%. Because the greatest permitted disparity remains 0.70%, the resulting base benefit percentage would need to be at least 1.885%. For a participant with a SSRA of 67, the excess benefit percentage at NRA 65 could be actuarially reduced to 2.43%. Because the greatest permitted disparity for such a participant remains 0.65%, the resulting base benefit percentage would need to be at least 1.78%. These differing base and excess benefit percentages would not cause the plan to fail to satisfy section 401(l) or fail to be a safe harbor plan.

However, Power is still permitted to increase a participant's base benefit percentage under the plan and keep the excess benefit percentage at 2.75% as currently described in section 1.401(l)-3(c)(2)(iv) of the regulations. Whichever way that Power decides to reduce the .75% factor must be contained in the plan provisions. Other optional formulations are also possible.

Changes Made by TRA '97

Section 1505(a) of TRA '97 amended section 401(a)(5) of the Code by adding section 401(a)(5)(G) which provides for a permanent exemption from the

requirements of Code sections 401(a)(3) and (4) for state and local governmental plans (Note: section 401(a)(3) provides that qualified plans must satisfy the coverage requirements of section 410). Section 414(d) of the Code describes governmental plans.

Prior to the enactment of TRA '97, in the case of a governmental plan, the Service had, through notice and announcement, extended the effective date of sections 1.401(a)(4)-1 through 13 to plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with the authority to amend the plan. For plan years beginning prior to the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements of section 401(a)(4).

Due to the enactment of TRA '97, state and local governmental plans are exempt from the nondiscrimination rules under sections 401(a)(3) and (4) and the minimum participation rules under section 401(a)(26). This exemption becomes effective with plan years beginning on or after the date of enactment (August 5, 1997). Governmental plans are treated as satisfying the nondiscrimination and minimum participation rules for plan years beginning before the effective date.

Note also that pursuant of section 1505(b) of TRA '97, a CODA under a state or local governmental plan is treated as meeting the requirement of section 401(k)(3). In other words, elective contributions made by a state or local government employer on behalf of an employee are not treated as distributed or made available to the employee merely because the ADP test would not be satisfied (if it applied).

Lesson 1, PART IV

CHANGES TO THE DEFINITION OF HIGHLY COMPENSATED EMPLOYEE AND FAMILY AGGREGATION UNDER THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

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INTRODUCTION

The Small Business Job Protection Act of 1996 (SBJPA) (P.L. 104-188) made significant changes to the definition of highly compensated employee (HCE)

contained in IRC section 414(q), effective for years after 1996. The purpose of this lesson is to highlight the SBJPA changes to this definition.

Section 414(q)(1) was amended by SBJPA section 1431(a) effective for years after 1996. This section now provides that an HCE is any employee who was a 5-percent owner at any time during the year or the preceding year, or for the preceding year had compensation from the employer in excess of $80,000 and, if the employer so elects, was in the top-paid group for the preceding year.

In addition, the family aggregation rules under section 414(q)(6) were repealed by SBJPA section 1431(b).

Various sections of the Internal Revenue Code refer to the definition of HCE under section 414(q) in applying nondiscrimination requirements to qualified plans and other employee benefit arrangements. For a discussion of some of the coverage and discrimination issues applicable to qualified plans, see the 1997 EP/EO CPE Coursebook, Chapter 1, Guide to Coverage and Discrimination Issues.

OBJECTIVES

At the end of this lesson you will be able to:

1. Recognize the changes to section 414(q) made by SBJPA.

2. Determine who is a highly compensated employee under SBJPA.

3. Explain the effective dates and the amendment dates for plans to comply with section 414(q).

PRE-SBJPA DEFINITION OF HCE

Section 414(q) prior to the SBJPA changes required an employer to consider several categories in determining whether an employee was an HCE. In general, the employer had to determine whether an employee was a 5-percent owner at any time during a two year period, in addition to considering whether an employee was an HCE under several other categories based on compensation levels and other factors. Family members had to be taken into account under the family aggregation rules.

Because the laws were so complex, the Service developed options in regulations and other guidance to simplify the determination of HCE status. Some of the rules remain applicable to the extent they are not inconsistent with the SBJPA changes.

Internal Revenue Code

Under section 414(q) as in effect before 1997 an employee could be an HCE if the employee was described in one or more of the categories listed under section 414(q)(1). An employee was an HCE for a plan year if, during the year or the preceding year, the employee:

(A) was a 5-percent owner,

(B) received compensation from the employer over $75,000 (as adjusted under section 415(d)),

(C) received compensation from the employer over $50,000 and was in the top-paid group of employees for such year, or

(D) was at any time an officer and received compensation greater than 50 percent of the amount in effect under section 415(b)(1)(A) for such year. Other parts of section 414(q) provided special definitions relevant to determinations of HCE, including rules for determining HCEs in the current year that depended in part on whether an employee was one of the top 100 highest paid employees and a simplified method for determining HCEs. Section 414(q)(6) provided that certain family members of 5-percent owners or of the top 10 highest paid HCEs were aggregated with the HCEs. All of these individuals were treated as a single HCE under the family aggregation rules.

Regulations

Section 1.414(q)-1T of the temporary Income Tax Regulations provided details on determining HCE status under pre-SBJPA law. The general rule was that an employee was an HCE if the employee was an HCE during the current plan year (determination year) or the preceding plan year (look-back year). The determination year was the plan year for which the determination of HCE was being made, and the look-back year was the preceding twelve month period.

Section 1.414(q)-1T, A-14(b) of these regulations provided for a calendar-year calculation election. If the employer made this election, the calendar year ending with or within in the current plan year was treated as the look-back year. Under this election the determination of HCE was made on the basis of the most recent calendar year, and the remaining lag period that extended past that calendar year to the end of the current plan year. This election especially simplified the determination of HCE for calendar year plans. The effect of making this election was that only one year - the current calendar year - had to be analyzed.

The regulations also provided details on other aspects of HCE status including certain special rules in determining whether an employee was considered an HCE for the current year, the determination of the top paid group, and details of the family aggregation rules. Certain portions of these regulations no longer reflect current law after the SBJPA. However, these regulations are still relevant to the extent that they are not inconsistent with the new definition of HCE.

Other Pre-SBJPA Guidance

The Service also provided a simplified method of determining HCE in Revenue Procedure 93-42, 1993-2 C.B. 540. This simplified definition allowed an employer to look only at the current year for determining HCE, with an option to use a "snapshot" day during the year to determine the status. Employers could also estimate compensation. Revenue Procedure 95-34, 1995-2 C.B. 385 provided a model amendment to implement this simplified method.

The emphasis under the SBJPA rules has shifted to a preceding year analysis for determining HCE status based on compensation. Many of these rules to simplify the determination of HCE are no longer needed, because employers already have information on HCE status and compensation for the preceding year. Notice 97-45, 1997-33 I.R.B. 7, issued on August 18, 1997, states that the calendar year calculation election under A-14(b) of section 1.414(q)-1T of the temporary income tax regulations does not apply for years beginning after December 31, 1996 (except as a transition rule in 1997). Section 4 of Rev. Proc. 93-42 and Rev. Proc. 95-34 do not apply for years beginning after December 31, 1996.

SBJPA DEFINITION OF HCE

Section 414(q)(1) as amended by SBJPA provides that an HCE is any employee who:

(A) was a 5-percent owner at any time during the year or the preceding year, or

(B) for the preceding year had compensation from the employer in excess of $80,000 and, if the employer so elects, was in the top-paid group for the preceding year. The $80,000 amount is adjusted at the same time and in the same manner as under section 415(d), except that the base period is the calendar quarter ending September 30, 1996.

In summary, SBJPA simplified the definition of HCE by:

1. Eliminating a two year analysis for determining whether an employee is an HCE based on compensation.

2. Using the preceding (look-back) year to determine whether an employee is an HCE based on compensation with respect to a particular determination year. This simplifies the collection of relevant data for employers.

3. Eliminating several categories of compensation levels and officer status in determining HCE.

4. Eliminating family aggregation rules.

NOTICE 97-45

The remainder of this chapter is based primarily on the guidance provided in Notice 97-45 issued on August 18, 1997. This notice provides details on how to determine whether an employee is an HCE under the SBJPA changes. The notice discusses the top-paid group election and a new calendar year data election that employers may make. It sets forth consistency rules for elections, and provides guidance on the timing of plan amendments to reflect the revised definition of HCE. Other transition rules and miscellaneous matters relating to the determination of HCE status are also covered.

Periods for Determining HCE Status

An employee is an HCE as a 5-percent owner for a determination year if the employee was a 5-percent owner at any time during the determination year (generally the plan year) or the preceding twelve-month period (look-back year).

An employee is an HCE for a particular determination year based on compensation if, for the look-back year, the employee had compensation from the employer in excess of $80,000 (as adjusted) and, if the employer so elects, was in the top-paid group. The employee's compensation in the current determination year does not need to be reviewed.

EXAMPLE (1): Employer A maintains one defined benefit plan, Plan M. Plan M has a plan year beginning April 1, 2000 and ending March 31, 2001. Employer A has never had a 5-percent owner and no top-paid group or calendar year data elections (discussed below) have been made. The look-back year is the preceding twelve month period which begins April 1, 1999 and ends March 31, 2000. Employer A determines whether any of the employees is an HCE on account of compensation for the determination year by examining the employees compensation for the look-back year. Thus, the HCEs are those employees who had compensation over $80,000 (as adjusted) during the period beginning April 1, 1999 and ending March 31, 2000.

EXAMPLE (2): Same facts as Example 1, except that Employer A hires a new employee, Employee X, on March 1, 2000 at an annual salary of $240,000. Employee X is not a 5-percent owner during the determination year or the look-back year. During the month of March, 2000, Employee X's compensation was $20,000. Because Employee X's compensation during Plan M's look-back year beginning April 1, 1999 and ending March 31, 2000 was less than $80,000 (as adjusted), Employee X is not an HCE for Plan M's determination year beginning April 1, 2000.

EXAMPLE (3): Employer B has maintained a qualified profit-sharing plan, Plan N, with an April 1 to March 31, 2001 plan year. In determining whether any of Employer B's employees is an HCE on account of being a 5-percent owner, the employee's ownership in Employer B is examined for Plan N's look-back and determination years (April 1, 1999 to March 31, 2000 and April 1, 2000 to March 31, 2001).

Elections

Under SBJPA and Notice 97-45, employers may make certain elections that affect the determination of HCE status. These elections are the top-paid group election and the calendar year data election. Both elections, once made, apply for all subsequent determination years unless changed by the employer. Note that these elections may not be utilized to determine whether a person is an HCE on account of being a 5-percent owner.

Top-paid group election

An employer may make a top-paid group election for a particular determination year. If this election is made, the HCEs for a particular determination year are employees who for the preceding look-back year had compensation in excess of $80,000 and are in the top-paid group for the preceding year. An employee is in the top-paid group if the employee is in the group consisting of the top 20 percent of the employees when ranked on the basis of compensation paid to employees during such year. Thus, an employee who otherwise would have been an HCE because the employee earned over $80,000 may not be if he or she is not in the top 20 percent.

Example (4): Employer C has maintained a qualified defined benefit plan (Plan O) since 1996 that has a calendar plan year. Employer C makes a top-paid group election for Plan O's 1998 determination year, which is the 1998 calendar year. Employer C had 15 employees in the 1997 calendar year and has never had a 5-percent owner. These employees, along with their compensation for the 1997 calendar year, are listed below.

Employees	1997 Compensation
1	$200,000
2	110,000
3	101,000
4	90,000
5-15	50,000 or less

In determining Employer C's HCEs for the calendar year 1998 under the top-paid group election, Plan O's relevant look-back year is the 1997 calendar year. Employer C must determine whether any employee had compensation above $80,000, and was in the group consisting of the top 20 percent of the employees of Employer C in the 1997 calendar year, when ranked on the basis of compensation from Employer C during the 1997 calendar year.

Employees 1, 2 and 3 comprise the top 20 percent of Employer C's 15 employees for the 1997 calendar year based on compensation from Employer C during the 1997 calendar year.

Although Employee 4 had compensation over $80,000 in the 1997 calendar year, Employee 4 was not in the top-paid group for the 1997 calendar year and is therefore not an HCE for Plan O's 1998 determination year. This will be the case (Employee 4 will not be in the top-paid group and will not be an HCE for the 1998 determination year) regardless of whether Employees 1, 2 and 3 continue to be employed in the 1998 calendar year.

Calendar year data election

Notice 97-45 provides for a new calendar year data election that an employer may make for a determination year. This allows a calendar year rather than a plan year to be treated as the look-back year. The look-back year under this election is the calendar year beginning with or within what would have been the look-back year without such an election.

The purpose for this election is to simplify the determination of HCE based on compensation for employers with fiscal year plans. This will simplify matters because employers usually record employees' compensation based on the calendar year. Of course, if an employer's plan has a calendar year plan year, the look-back year is the same whether or not the election is made - it is the preceding calendar year.

Note that this election is different from the calendar year calculation election under section 1.414(q)-1T, A-14 of the temporary Income Tax Regulations, discussed above.

EXAMPLE (5): Employer D has maintained a qualified profit sharing plan (Plan R) since 1996 with an April 1 to March 31 plan year. Employer D has also maintained a defined benefit plan (Plan S) since 1996 with an October 1 to September 30 plan year. Employer D decides to make the calendar year data election for determination years of Plan R and Plan S beginning in the 2000 calendar year. Thus, Employer D makes the election for Plan R's determination year beginning April 1, 2000 and ending March 31, 2001, and Plan S's determination year beginning October 1, 2000 and ending September 30, 2001.

The 2000 calendar year begins within Plan R's look-back year beginning April 1, 1999 and ending March 31, 2000, and Plan S's look-back year beginning October 1, 1999 and ending September 30, 2000 and is treated as Employer D's look-back year for both Plans R and S for purposes of determining Employer D's HCEs on the basis of compensation. Thus, in determining HCE status under section 414(q)(1)(B) Employer D determines whether an employee has compensation for the look-back year in excess of $80,000 (as adjusted), and if applicable, the composition of the top-paid group, on the basis of compensation for the 2000 calendar year.

Making Elections

No notification to the Service is required when elections are made. The elections, once made, apply to all subsequent years unless changed by the employer. The elections are independent of each other. Thus, an employer making one of the elections is not required to make the other election as well. But, if both elections are made, the look-back year in determining the top-paid group must be the calendar year beginning with or within the look-back year. Notice 97-45 does not specify how employers make elections.

Transition Rule for Calendar Year Calculation Election

There is one other election that employers may make for years beginning on or after January 1, 1997 and before January 1, 1998. Employers may continue to utilize the calendar year calculation election contained in section 1.414(q)-1T, Q&A 14 of the temporary Income Tax Regulations, discussed above, only during this time period.

Consistency Requirement for Elections

General Rule

Consistency in making the top-paid group election and/or the calendar year data election among plans is required to insure that employers do not avoid the nondiscrimination requirements. Employers maintaining several plans may not select different methods of determining HCE status for each plan. The general rule, as stated in Notice 97-45, is that the election must apply consistently to the determination years of all plans of the employer that begin with or within the same calendar year.

Exceptions

The following exceptions apply: First, in applying the consistency requirement multiemployer plans are disregarded. Second, if a plan has a calendar year as its determination year, then the immediately preceding calendar year is the look-back year for the plan. This is the case whether or not a calendar year data election is made. Thus, a calendar year data election would have no effect on the HCE determination for a calendar year plan and the consistency requirement is satisfied regardless of whether the calendar year data election is made for that calendar year plan.

Transition Rules

The notice also provides transition rules for employers. The consistency requirement did not apply to determination years beginning with or within the 1997 calendar year. Thus, an employer could make a top-paid group election or a calendar year data election for a plan for a determination year beginning with or within 1997, without regard to whether the employer made that election for any other plan with a determination year beginning with or within 1997. For determination years beginning on or after January 1, 1998 and before January 1, 2000, (i) nonretirement plans are not subject to the consistency requirement, and (ii) satisfaction of the consistency requirement with respect to retirement plans is determined without regard to any plans of the employer that are nonretirement plans. See Notice 97-45 for definitions of "retirement" and "nonretirement plans".

EXAMPLE (6):

Employer E has a qualified profit-sharing plan (Plan P) with a calendar plan year. Employer E also has a qualified defined benefit plan (Plan Q) with a plan year beginning April 1 and ending March 31. Employer E makes the top-paid group election (but not the calendar year data election) for Plan P for the calendar year 2000. Pursuant to the consistency rule requiring that the employer make the same election for all determination years of all plans of the employer that begin with or within the same calendar year, Employer E must also make the top-paid group election for Plan Q's determination year beginning April 1, 2000 and ending March 31, 2001.

The look-back year for purposes of determining whether any of Employer E's employees is an HCE under Employer E's top-paid group election for Plan P is the 1999 calendar year and for Plan Q is the April 1, 1999 to March 31, 2000 year. The group of Employer E's employees that are HCEs for Plan P's 2000 determination year are those employees who had compensation above $80,000 (as adjusted) and who were in the top 20 percent of employees based on compensation for the 1999 calendar year, while the group of Employer E's employees that are HCEs for Plan Q's determination year beginning April 1, 2000 are those employees who had compensation above $80,000 (as adjusted) and who were in the top 20 percent of employees based upon compensation for Plan Q's look-back year beginning April 1, 1999.

EXAMPLE (7):

Same as above except that Employer E also makes a calendar year data election. The look-back year for purposes of determining whether any of Employer E's employees is an HCE under Employer E's top-paid group election for Plan P is the 1999 calendar year, and for Plan Q is the 2000 calendar year. The group of Employer E's employees that are HCEs for Plan P's 2000 determination year are those employees who had compensation above $80,000 (as adjusted) and who were in the top 20 percent of employees based on compensation for the 1999 calendar year, while the group of Employer E's employees that are HCEs for Plan Q's determination year beginning April 1, 2000 are those employees who had compensation above $80,000 (as adjusted) and who were in the top 20 percent of employees based upon compensation for the 2000 calendar year.

Plan Amendments

Required Amendments

Some plans may not contain the definition of HCE because other sections of the Code cross-reference this HCE definition for purposes of nondiscrimination testing, which is an operational requirement not required to be included in a plan. However, some plans contain this definition when nondiscrimination testing affects the contributions or benefits provided to employees under a plan. If a qualified retirement plan contains the pre-SBJPA definition of HCE the plan must be amended to reflect the SBJPA definition of HCE. If an employer makes either a top-paid group or calendar year data election for a determination year, a plan that contains the definition of HCE must reflect the election. If the employer changes either a top-paid group or calendar year data election, the plan must be amended to reflect the change. However, a plan is not required to add a definition of HCE merely to reflect a top-paid group or calendar year data election.

Remedial Amendment Period

Rev. Proc. 97-41, 1997-33 IRB 51, provides that qualified retirement plans have a remedial amendment period under section 401(b) so that certain plan amendments for SBJPA are not required to be adopted before the last day of the first plan year beginning on or after January 1, 1999 (with a later date for governmental plans). Pursuant to Rev. Proc. 97-41, a plan provision reflecting the definition of HCE is a disqualifying provision and thus any plan amendments to reflect the definition of HCE in section 414(q), as amended by SBJPA, and to reflect any choices regarding the top-paid group or calendar year data elections, are not required to be made until the end of this remedial amendment period. However, plans must be operated in accordance with the SBJPA changes to the HCE definition in section 414(q) as of the statutory effective date, and plans required to be amended to reflect those changes must be amended retroactively effective as of that date. In addition, under Rev. Proc. 97-41, any retroactive amendments must reflect the choices made in the operation of the plan for each determination year, including choices made with respect to the top-paid group election and the calendar year data election (and any changes to those elections), and the first date that the plan operated in accordance with those choices (and any such changes).

Transitional Rules

Determining HCE Status for 1997

The SBJPA HCE amendments generally apply to years beginning after December 31, 1996. However, section 1431(d)(1) of SBJPA provides that, in determining whether an employee is an HCE for years beginning in 1997, the amendments to section 414(q) are treated as having been in effect for years beginning in 1996. Accordingly, in determining whether an employee is an HCE for any determination year beginning with or within the 1997 calendar year, an employer must consider whether the employee was a 5-percent owner or had compensation in excess of $80,000 for the look-back year that began with or within the 1996 calendar year. An employer also may make the calendar year data election and/or the top-paid group election with respect to determination years beginning with or within the 1997 calendar year. The SBJPA amendments to section 414(q) do not apply in determining the employer's HCEs for determination years beginning prior to January 1, 1997.

Highly Compensated Former Employees

In some cases, former HCEs may be subject to nondiscrimination testing. Section 414(q)(6) provides that a highly compensated former employee is treated as an HCE if (A) such employer was an HCE when such employee separated from service, or (B) such employee was an HCE at any time after attaining age 55. This is the same definition that applied prior to the SBJPA changes. Notice 97-45 clarifies that for purposes of determining status as a highly compensated former employee under § 1.414(q)-1T, A-4, whether an employee was a highly compensated active employee for a determination year that ended on or after the employee's 55th birthday, or that was a separation year, is based on the rules applicable to determining HCE status as in effect for that determination year.

EXAMPLE (8):

Employer G maintains Plan U, a defined benefit plan with a calendar year plan year. Employee Y was employed by Employer G since 1990. Employee Y retired at age 65 from employment with Employer G in 1998. Employee Y was an HCE in 1992 under the rules applicable in 1992 to determine HCE status, but was not an HCE in any other year, including 1998. Because Employee Y was an HCE for a determination year (1992) ending on or after Employee Y's 55th birthday, Employee Y is a highly compensated former employee for determination years beginning after Employee Y's retirement.

Family Aggregation

SBJPA repealed the family aggregation requirements of section 414(q)(6) and section 401(a)(17)(A), effective for years beginning after December 31, 1996. Prior to its repeal, section 414(q)(6) required the compensation and benefits of certain family members of a highly compensated employee who was a 5-percent owner or among the ten highest paid employees of the employer to be combined with the compensation and benefits of the highly compensated employee. The resulting family unit was treated as one employee. Section 401(a)(17)(A) provided similar rules with respect to the application of the limitation on compensation that may be taken into account under a qualified plan.

Although the family aggregation rules have been repealed, SBJPA did not change the definition of 5-percent owner under section 414(q)(2). Section 414(q)(2) provides that an employee will be treated as a 5-percent owner for any year if at any time during such year such employee was a 5-percent owner (as defined in section 416(i)(1)) of the employer. Section 416(i)(1) in turn refers to the attribution rules of section 318. Under section 318, an individual is considered to own any stock owned directly or indirectly by the individual's spouse, children, grandchildren or parents. Consequently, an employee who is the spouse, child, parent or grandparent ("family member") of an individual who has a 5-percent interest in the employer at any time during the look-back year or the determination year is treated as an HCE under section 414(q)(1)(A), regardless of the family member's compensation level. These attribution rules continue to apply after SBJPA.

OTHER ISSUES RELATING TO THE REPEAL OF FAMILY AGGREGATION

There are several other issues and questions that necessarily flow from the repeal of family aggregation. This section will examine some of these issues.

Effect of Plan Amendments to Eliminate Family Aggregation

Under Rev. Proc. 97-41, as a general rule, SBJPA amendments are not required to be adopted before the last day of the first plan year beginning on or after January 1, 1999. These amendments can be made retroactively effective to conform to the earlier operation of the plan in accordance with SBJPA changes. Section 411(d)(6) of the Code, however, prohibits amendments that have the effect of reducing accrued benefits retroactively. Rev. Proc. 97-41 clarifies that a plan amendment eliminating the family aggregation requirements will not violate section 411(d)(6) provided the amendment is effective no earlier than the first day on which the plan was operated in accordance with the amendment, and in no event earlier than the first day of the first plan year beginning after December 31, 1996.

Effect of Not Amending Plan for Elimination of Family Aggregation

Rev. Proc. 98-14, 1998-4 I.R.B. 22, notes that plans could remain qualified even if the family aggregation rules of section 414(q)(6) and section 401(a)(17)(A) continue to apply under the plans subsequent to the repeal of these rules. However, the continued application of these rules will cause a plan to fail to be a safe harbor plan within the meaning of the income tax regulations under section 401(a)(4) of the Code. This is because the application of family aggregation may, in some circumstances, result in lower allocations or benefits for employees who are not highly compensated. Thus, a plan will not satisfy a nondiscrimination in amount safe harbor for a plan year beginning after December 31, 1996, unless family aggregation is disregarded in the operation of the plan and the plan is amended within the remedial amendment period, retroactive to the first day of such plan year, to eliminate its family aggregation provisions. Therefore, in an application for a determination letter (other than with respect to an M & P or regional prototype plan) that is filed on or after April 27, 1998, an employer may not designate a plan as one that is intended to satisfy a nondiscrimination in amount safe harbor if the family aggregation rules continue to apply under the plan. Instead, the employer must either demonstrate that the plan satisfies the general test for nondiscrimination in amount or request a letter that contains a caveat regarding the nondiscrimination in amount

requirement.

Determining Benefits under Defined Benefit Plans

When determining participants' benefits under a defined benefit plan, the plan may pay benefits based on a percentage of the participant's average compensation for the three consecutive years of service which produces the highest average. The repeal of the family aggregation rule invites the issue of how benefits are computed when the high three years of compensation include years in which the family aggregation rule applied (years beginning before January 1, 1997). For example, participant A is part of a family group in which the family aggregation rules required that for the 1995 and 1996 years, that the total compensation for the group be limited to the section 401(a)(17) compensation amount. In 1997 when computing participant A's benefit the question becomes whether the amount of participant A's compensation for the 1995 and 1996 year should be limited as required by section 401(a)(17) to take into account family aggregation or whether his compensation should be computed without taking into consideration family aggregation. A plan provision must make clear, when computing A's compensation for 1995 and 1996, if family aggregation is treated as if it was repealed for those years. Thus, A's high three average compensation would be computed without regard to the family aggregation requirement and the compensation for each member of the family unit for the 1995 and 1996 years may equal the section 401(a)(17) amount in effect for those years.

Section 411(b) Accrued Benefit Requirements

The application of the accrual requirements under section 411(b) to defined benefit plans prohibits backloading. This prohibition means that a qualified plan may not accrue benefits in a manner in which a significant amount of a participant's benefit is accrued in his later years. However, section 411(b) is usually satisfied by plan amendments which increase benefit accruals. Because of the repeal of the family aggregation rule, affected participants' compensation used to compute benefit accrual will increase and consequently will result in a corresponding increase in those participants' accruals. Generally, increasing a participant's accrual because of the repeal of the family aggregation rule will not create backloading in violation of section 411(b).

A subsidiary concern is the application of the plan amendment rules of section 1.401(a)(4)-5(a) of the regulations to plan amendments which repeal family aggregation. These regulations are not satisfied if the timing of an amendment or

a series of amendments has the effect of discriminating significantly in favor of highly compensated employees or former highly compensated employees. For purposes of the regulation a plan amendment includes, for example, the establishment or termination of the plan, and any change in the benefits, rights, or features, benefit formulas, or allocation formulas under the plan. The regulation applies to plan amendments that provide additional benefits based on an employee's prior service or compensation. Theoretically, the regulation may apply to plan amendments that repeal family aggregation since some participants' compensation in prior years will be computed without regard to family aggregation, which results in an increase in both prior year compensation and accruals. In a June 20, 1997 field directive regarding the processing of determination letter applications after the enactment of the Small Business Job Protection Act of 1996, the Service provided that if an amendment to eliminate family aggregation affects prior years' service or compensation (**other than by applying the limitation under section 401(a)(17) to prior years' compensation without regard to family aggregation),** it is subject to the plan amendment rules of the regulations. Thus, an amendment to eliminate family aggregation which results in a participant's prior compensation being computed without reference to family aggregation will not be subject to this regulation.

SUMMARY

This text has summarized the changes to the definition of HCE made by the Small Business Job Protection Act of 1996, including the periods for determining highly compensated employee status, the effect of making various elections, the repeal of the family aggregation rules, and secondary requirements relating to this repeal. Required amendments and the timing of amendments are also discussed.

LESSON 1, PART V

UNIFORMED SERVICES EMPLOYMENT AND REEMPLOYMENT RIGHTS ACT OF 1994

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Introduction

The Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), Pub. L. 103-353, grants certain reemployment rights and pension benefits rights to an employee who is absent from his job due to his duty in the uniformed military service. The Small Business Job Protection Act of 1996 ("SBJPA"), Pub. L. No. 104-188, added §414(u) to the Internal Revenue Code. That section delineates the requirements that qualified plans must satisfy in order to fulfill the USERRA requirements. This section will discuss the requirements under §414(u) and the procedural requirements relating to §414(u) and USERRA

as outlined in Revenue Procedure 97-41, 1997-33 I.R.B. 51 (Rev. Proc. 97-41"), Revenue Procedure 96-49, 1996-2 C.B. 369 ("Rev. Proc. 96-49"), and §1465 of SBJPA.

USERRA and 414(u) Requirements

A) USERRA Qualification Requirements

A qualified plan and a plan under §457 of the Code will not be treated as satisfying USERRA unless they meet the following three requirements provided under section 414(u)(8).

1) A former employee, who is reemployed under USERRA, must be treated by the plan as not having incurred a break in service with the employer maintaining the plan by reason of the employee's period of qualified military service.

2) The employer must treat the period of qualified military service relating to a reemployed employee who is covered under USERRA, as service with the employer for purposes of determining the nonforfeitability of the employee's accrued benefits under the plan and for the purpose of determining the employee's accrued benefits.

3) An individual reemployed under USERRA is entitled to accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the individual makes a payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the individual would have been permitted or required to contribute had the individual remained continuously employed by the employer throughout the period of qualified military service. Any payment to such plan shall be made during the period beginning with the date of reemployment and whose duration is three times the period of the qualified military service (but not greater than 5 years).

In general, an individual has rights under USERRA and 414(u) if his military service is qualified military service. Section 414(u)(5) defines qualified military service as service in the uniformed services (as defined in USERRA) by any individual if such individual is entitled to reemployment rights under USERRA with respect to such service. The term "uniformed services" means the Armed Forces, the Army National Guard and the Air National Guard when engaged in active duty for

training, inactive duty training, or full-time National Guard duty, the commissioned corps of the Public Health Service, and any other category of persons designated by the President in time of war or emergency.

B) Elective Deferrals

An employee who is entitled to benefits under USERRA and who is a participant in a plan which provides for elective deferrals must be permitted to make-up elective deferrals he/she would have made during the period in which he/she performed qualified military service. Section 414(u)(2) provides that an employer sponsoring a plan which permits elective deferrals will satisfy USERRA only if such an employee is permitted to make additional elective deferrals to makeup elective deferrals not made while on military duty. For the purpose of this requirement, elective deferrals are treated as including after-tax employee contributions. The term elective deferrals has the same meaning as defined under §402(g)(3), except it includes deferrals under an eligible deferred compensation plan under §457.

The amount of make-up contribution that employees can make is equal to the maximum amount of elective deferrals that they would have been permitted to be made under the plan, taking into account all of the applicable Code limitations on contributions, during the period of qualified military service if the employee had continued to be employed by the employer during such period and received compensation. The employee may choose to make-up less than the maximum amount. The amount of the make-up contribution is reduced for any elective deferrals that the employee actually made during the period of qualified military service.

In order to satisfy 414(u)(2), an employee must be permitted to make-up elective deferrals during a specific period. The employee has three times the amount of time that he was away performing military duty, up to five years, to make-up missed elective deferrals. The period begins on the date of the employee's reemployment with the employer. For example, an employee who performed qualified military service for a year would have three years from the date of his reemployment with the employer to make-up elective deferrals.

Finally, 414(u)(2) requires the employer to make matching contributions relating to make-up elective deferrals that would have been required had the make-up contributions actually been made during the period of qualified military service.

C) Compensation during a period of Qualified Military Service

When computing compensation for an employee who is in qualified military service, for the purposes of §403(b)(3), §415(c)(3), and §457(e)(5) of the Code, the employer must increase the amount of compensation by the amount that the employee would have received during such period if he/she were not in qualified military service. The amount of compensation is based on the rate of pay the employee would have received from the employer but for absence during the period of qualified military service. If the employer cannot reasonably ascertain the compensation that the employee would have received during the period of qualified military service, then the amount of compensation during such period is the employee's average compensation from the employer during the 12-month period immediately preceding the qualified military service (or if shorter, the period of employment immediately preceding the qualified military service).

Treatment of USERRA Contributions and Loan Suspension

A) Treatment of USERRA Contributions

Pursuant to §414(u)(1), if an employer or an employee makes a contribution that is required to be made pursuant to USERRA to either an Individual Account Plan or to a defined benefit plan that provides for employee contributions, the contribution, for the year in which it is made, is not subject to some of the limitations applicable to qualified plans. An Indiviual Account Plan is defined as a defined contribution plan and includes:

1) a §403(b) plan,

2) a simplified employee pension under §408(k),

3) a qualified salary reduction arrangement under §408(p), and

4) a §457 plan.

Also, any elective deferral or employee contribution that the employee makes-up pursuant to §414(u)(2) is treated as required by reason of the employee's rights under USERRA.

The contribution that the employee or employer makes in accordance with §414(u)(1) is not taken into account, for the plan year in which it is made, in applying the applicable qualification limitations to other contributions made during the year. However, the contribution is subject to the those limitations with respect

to the year in which the contribution relates. This section of 414(u)(1)(A) applies to the following limitations:

1. elective deferral limitations under §402(g).
2. the limitation on employer contributions to a simplified employee plan under §402(h) and the limitation on deductible contributions to such plan pursuant to §404(h).
3. the limitations applicable to tax-sheltered annuities under section 403(b).
4. The deductible contribution limitation under 404(a).
5. the limitations under §408 relating to individual retirement accountsand annuities.
6. the §415 limitations on benefits and contributions.
7. the limitation under §457 relating to deferred compensation plans of state and local governments and tax-exempt organizations.

Likewise, plans to which contributions are made pursuant to USERRA are relieved, to the extent of the contribution made in accordance with USERRA (or the right to make such a contribution), from some of the Code requirements which pertain to qualified plans. Section 414(u)(1)(C) provides that a plan shall not be treated as failing to meet the following requirements by reason of the making of a contribution (or the right to make such a contribution) pursuant to USERRA:

1. the nondiscriminatory requirements under §401(a)(4).
2. the additional minimum participation requirements under §401(a)(26)
3. the nondiscrimination requirements relating to regular cash or deferred arrangements under both §401(k)(3) and 401(k)(12); and the requirements relating to simple 401(k) plans under §401(k)(11).
4. the nondiscriminatory requirements relating to employee contributions and matching contributions under §401(m).
5. the nondiscriminatory requirements relating to tax sheltered annuities under §403(b)(12).
6. the nondiscriminatory requirements relating to simplified employee pension plans under §408(k)(3) and §408(k)(6).

7. requirements relating to simple individual retirement annuities under §408(p).
8. the minimum coverage rules under §410(b).
9. the top-heavy requirements under §416.

B) Loan Suspension

§414(u)(4) permits a plan to suspend an employee's loan repayment obligation during the period that the employee is performing service in the uniformed services (whether or not it is qualified military service). If the plan does suspend an employee's obligation, such suspension is not taken into consideration for purposes of:

(1) whether a loan is a distribution under §72(p),

(2) plan qualification rules under §401(a) and

(3) the applicability of the loan exemption exception (§4975(d)(1)) from the prohibited transactions rules under §4975.

USERRA defines "service in the uniformed services" as the performance of duty on a voluntary or involuntary basis in a uniformed service (see definition above) under competent authority and includes active duty, active duty for training, initial active duty for training, inactive duty training, full-time National Guard duty, and a period for which a person is absent from a position of employment for the purpose of an examination to determine the fitness of the person to perform any such duty.

WHAT IS NOT REQUIRED BY USERRA

Section 414(u)(3) highlights two things that USERRA does not require of employers who maintain qualified plans. First, USERRA does not require an employer to credit earnings to an employee with respect to a contribution before it is actually made. Second, USERRA does not require an employer to allocate any forfeiture to an employee with respect to the period of qualified military service.

USERRA PROCEDURAL MATTERS

A) Effective Date

Section 8 of USERRA provides that it is effective with respect to reemployment initiated 60 days after the date of enactment (i.e. reemployment initiated on or after December 12, 1994). 414(u), which was added by SBJPA, was effective as of December 12, 1994.

B) Plan amendments and the Remedial amendment period

Section 401(b) of the Code provides a remedial amendment period during which a plan may be amended retroactively, under certain circumstances, to comply with the Code's qualification requirements. Such relief is needed when there has been a change in the qualification requirements due to a change in the law. The Commissioner has authority under §1.401(b)-1(f) of the Regulations to extend the remedial amendment period. The remedial amendment period applies to disqualifying provisions (defined in §1.401(b)-1T(b)(3) of the Income Tax Regulations). In general, the period begins with the date on which the change becomes effective with respect to the plan, or in the case of a provision that is integral to a qualification requirement that has been changed, the first day on which the plan was operated in accordance with the provision as amended, and ends with

the later of (1) the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the remedial amendment period begins or (2) the last day of the plan year that includes the date on which the remedial amendment period begins.

In Rev. Proc. 97-41, 1997-33 I.R.B. 51 ("Rev. Proc. 97-41") pursuant to his authority under §1.401(b)-1T(b)(3), the Commissioner designated as a disqualifying provision, those provisions that cause a plan to fail to satisfy the qualification requirements of the Code because of changes made to those requirements by SBJPA that are effective before the first day of the first plan year beginning on or after January 1, 1999. For purposes of the remedial amendment period, the changes in the qualification requirements made by SBJPA include §414(u) and USERRA.

In section 6.04 of Rev. Proc. 97-41, the remedial amendment period for SBJPA is extended to the last day of the first plan year beginning on or after January 1, 1999 ("SBJPA remedial amendment period"). Therefore, plans do not have to be amended to conform to USERRA and §414(u) until this date.

Pursuant to Rev. Proc. 98-14, 1998-4 I.R.B. 22, the SBJPA remedial amendment period for governmental plans is extended to the later of (i) the last day of the last plan year beginning before January 1, 2001, or (ii) the last day of the first plan year beginning on or after the "1999 legislative date."

C) Model Amendments

Rev. Proc. 96-49, 1996-2 C.B. 369, provides model amendments that give plan sponsors a streamlined way to amend their plans to comply with the USERRA requirements. The model language is available only to sponsors of M&P, regional prototype, volume submitter specimen, and individually designed (including volume submitter and SEP) plans that, as of the date of the adoption of the model amendment, have reliance on a favorable opinion, notification, advisory, ruling, or determination letter that takes into account the requirements of TRA 86. **If a sponsor adopts the model amendments, neither application to the Service nor a user fee is required.** Section 3 of Rev. Proc. 96-49 points out that the Service will not issue new opinion, notification, advisory, ruling, or determination letters for plans that are amended solely to add the model language.

There are two model amendments:

1) "Notwithstanding any provision of this plan to the contrary, contributions, benefits and service credit with respect to qualified military service will be provided in accordance with §414(u) of the Internal Revenue Code.".

2) The second model amendment is available for sponsors who choose to suspend loan repayments during a participant's period of military service. It reads as follows: "Loan repayments will be suspended under this plan as permitted under §414(u)(4) of the Internal Revenue Code."

D) Operational compliance with USERRA

Pursuant to §1465 of SBJPA, a plan amendment applying the changes made by SBJPA shall not be required to be made before the first day of the first plan year beginning on or after January 1, 1998, if:

(1) during the period after the amendment takes effect and before such first plan year, the plan is operated in accordance with the requirements of such changes and

(2) the amendment applies retroactively to the period.

The same rule applies to governmental plan, as defined in §414(d) of the Code, except that the year 2000 is subsituted for the year 1998. **Thus, even though plan amendments are not required for the changes by USERRA pursuant to the SBJPA remedial amendment period until the last day of the first plan year beginning on or after January 1, 1999, section 1465 of SBJPA requires plans to operate in compliance with any SBJPA provision that is effective before the first day of the first plan year beginning on or after January 1, 1998 as of such provision's effective date. Therefore, plans must currently operate in compliance with USERRA and 414(u) as of the effective day of the laws, December 12, 1994.** Consequently, this means that plan can only be retroactively amended to reflect USERRA and §414(u) to the date that it first operated in accordance with them.