F1

Qualified Retirement Plans

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FIGURES

F1.01 INTRODUCTION

Employee benefit plans have dominated headlines in recent years. From the cash balance plan controversy to the fall of the Enron Corporation and its impact on the 401(k) accounts of employees, employee benefit plans have received significant attention.

The Employee Retirement Income Security Act of 1974 ("ERISA") was enacted to protect the interest of workers and beneficiaries who participate in employee benefit plans. To this end, ERISA established standards of conduct for plan fiduciaries and set forth remedies, sanctions, and access to federal courts for violation of these standards. ERISA also imposed requirements for financial reporting to government agencies and disclosure to participants and beneficiaries.

Another purpose of ERISA is to improve the soundness of retirement programs that are encouraged through the use of preferential tax treatment. This special tax treatment permits employers to obtain immediate tax deductions for contributions to qualified plans yet delays the taxation of employees until funds are received. ERISA increased the security of retirement benefits through the enactment of eligibility requirements, vesting provisions, and minimum funding standards.

Legislation in this area did not stop with ERISA. In recent years, numerous laws have focused on expanding eligibility for qualified plans and promoting greater participation. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised the limits on maximum contributions, and it allowed older workers to contribute even more. Additional IRS guidance has promoted automatic enrollment in 401(k) plans. The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), the Uruguay Round Agreements Act expansion of the General Agreement of Tariffs and Trade (GATT) in 1994, the Small Business Job Protection Act of 1996 (SBJPA), the Taxpayer Relief Act of 1997 (TRA 97), the IRS Restructuring and Relief Act of 1998 (RRA), the Community Renewal Act of 2000 (CRA), the Sarbanes-Oxley Act of 2002 (SOX), and the Jobs Creation and Worker Assistance Act of 2002 (JCWRA) all enacted additional rules that affect qualified plans.

Congress has not lost sight of ERISA's original purpose of protecting employee expectations and preventing perceived abuses. EGTRRA strengthened the notice requirements for any changes to plan design that would significantly reduce future accruals (such as a conversion to a CB plan). SOX increased the disclosures required, to provide greater transparency.

The recent laws continue to focus on obtaining broader employee participation in qualified plans. Because of changing work conditions and social trends that create a more mobile work force, tax changes have attempted to provide faster vesting of benefits and certain minimum benefits. These efforts are undertaken to guarantee that lower-paid employees will receive some retirement benefits and to make such benefits more "portable" upon a change in employment. These requirements, in part, represent an effort to improve retirement benefits available in the private sector, perhaps in light of the continued financial difficulty of the Social Security system.

This chapter familiarizes the controller with the most common types of tax-qualified plans, highlights the basic requirements of all qualified plans (e.g., the eligibility, contribution, and vesting requirements), and identifies the basic reporting and disclosure requirements for which a controller may be responsible.

F1.02 TYPES OF QUALIFIED PLANS

Employee benefit plans are governed by both ERISA and the Internal Revenue Code ("IRC").

ERISA divides employee benefit plans into two types: pension benefit plans and welfare benefit plans. A pension benefit plan is defined as any plan, fund, or program that provides retirement income to employees or that results in deferral of income for a period extending until a termination of employment or beyond. In contrast, welfare plans provide medical, disability, and unemployment benefits. Welfare plans have increased in importance in recent years as the cost of providing welfare benefits has skyrocketed. Although welfare plans are also subject to both ERISA and certain Code requirements, they are discussed separately in Chapter F2.

This chapter is devoted exclusively to tax-qualified pension plans. Qualified plans can be further divided into two distinct categories; (1) defined benefit plans and (2) defined contribution plans. Several types of plans exist in each category.

The distinguishing feature of a defined benefit plan is that it promises a specific benefit. Upon attaining a specific age and/or the completion of a specific period of service, an employee will be entitled to a fixed and determinable benefit, calculable from a formula under the plan.

In contrast, a defined contribution plan makes no promises as to the ultimate benefit that will be available for an employee. Instead, a specific amount of money is set aside on a regular basis for the employee's benefit. The benefit that an employee will ultimately be entitled to receive, at a later date, depends on the amount contributed by the employer and the employee and the investment performance of the funds in which the money is invested.

In short, defined benefit plans guarantee an outcome, while defined contribution plans focus on the input of funds with the ultimate benefit as a function of that input.

Many employers maintain both a defined benefit and a defined contribution plan for their workforce. In recent years, however, the defined contribution plan has grown more popular and, in some cases, even supplanted the defined benefit plan. This trend is explained by the greater transparency of the defined contribution plan to the employee, who sees his or her benefit in concrete terms. It is also explained by the rising cost and administrative complexity of the defined benefit plan, particularly as the workforce ages. Some employers have elected to freeze or terminate defined benefit plans altogether, or to convert a traditional defined benefit plan to a cash balance arrangement (discussed in more detail below).

F1.03 DEFINED BENEFIT PLANS

A defined benefit plan is characterized or classified by the manner in which benefits are calculated. Unlike a defined contribution plan, which defines the amount going into a plan, a defined benefit plan provides a determinable benefit in accordance with a prescribed formula. The benefit cannot be discretionary. These types of plans are commonly referred to as "pension plans," defined by the Treasury Department as a plan established and maintained by an employer to provide systematically for the payout of deferred defined benefits to employees over a period of years, usually for life, after retirement. Pension plan formulas typically calculate benefits as a fraction of age, service and compensation. The basic types of pension formulas are described below.

Contributions to a defined benefit plan are generally deductible by the employer under Code Section 404. Unlike employer contributions to a defined contribution plan, which are limited to 25% of participants' total compensation for the taxable year, employer contributions to a defined benefit plan are not limited based on participant compensation.. As a result, one of the relative advantages of defined benefit plans, especially for small employers, is that this may allow the employer to deduct far greater amounts.

[1] Flat Benefit Plan

The flat benefit plan is the simplest type of defined benefit plan. It pays a set amount upon retirement, typically for life. The benefit under a flat benefit plan does not depend on a participant's compensation history or length of service. Every employee who satisfies the plan's minimum service requirement for benefit eligibility receives the same benefit.

For example, a flat benefit plan could provide a monthly income for life of $500 to any person retiring at or after age 65 with 10 or more years of service. The same benefit would be paid to an employee with annual compensation of $80,000 who had worked 21 years for the employer, and to an employee who never earned more than $35,000 per year and only worked 11 years. This type of plan, although simple to administer, is not as common as the other types of defined benefit plans, because employers generally seek to provide greater benefits to both long-service and higher-paid employees.

A flat benefit plan could also provide a retirement benefit expressed as a function of compensation. For example, it might provide a monthly income of 20% of compensation for life to any person retiring with 10 years of service. Two employees having annual compensation for plan purposes of $50,000 per year receive an annual pension benefit under a 20% plan of $10,000, even if one employee worked 11 years before retiring and the other worked 22 years. This type of formula is sometimes called a fixed benefit plan.

[2] Unit Benefit Plan

The unit benefit plan, unlike the flat benefit plan discussed above, generates a benefit that is a function of a participant's service. For example, a unit benefit plan could provide a benefit of $50 per month for every year of service completed prior to retirement. All employees who retire after completing 25 years of service under the plan would receive a monthly pension of $1250, regardless of their respective rates of compensation during their active careers. As with the flat benefit plans, lower-paid employees would receive relatively larger pension benefits than would higher-paid employees when comparing the pension benefits with career compensation levels. This is a common plan design in collectively bargained plans.

The benefit formula can also include a factor for compensation. Thus, the plan could provide 1% of compensation for every year of service completed. This would provide an annual benefit at $12,500 to an employee with 25 years of service and an average annual compensation of $50,000, and a benefit of $20,000 to a similar long-service employee with average annual compensation of $80,000.

[3] Cash Balance Plan

A cash balance plan is a defined benefit plan that defines each participant's benefits by referring to a hypothetical independent account. This account balance is calculated by referring to hypothetical contributions and is credited with interest at a rate specified in the plan. On the surface, therefore, the cash balance benefit resembles the benefit in a defined contribution plan, such as a familiar 401(k) plan. Upon retirement or other distribution event, a cash balance benefit must be available to participants in the form of an annuity.

Many cash balance plans also make benefits available in a lump sum. Although the payment of a lump sum appears straightforward, it actually requires a dual calculation. IRC Section 411 requires that the benefit be projected to normal retirement age, using an interest rate selected by the plan sponsor. This projected benefit then must be discounted back to the date of distribution, using actuarial assumptions specified by IRC Section 417(e)(3) as amended by GATT. This can result in a so-called "whipsaw", in which the plan is obligated to pay a larger lump sum than the participant's stated balance.

Cash balance design has been critiqued as inherently age discriminatory. This is because, each year, a participant gets one year closer to normal retirement age and thus has fewer years in which interest credits can grow. Although the amount of interest credited remains constant (or even increases) from year to year, the period of time in which interest credits can accumulate is shrinking. As a result, critics would argue that the accrual rate gradually declines with age, in violation of Section 204(b)(1)(H) of ERISA. Numerous courts have rejected this argument for various reasons, although at least one district court has agreed.

[4] Target Benefit Plan

The target plan contains a benefit formula similar to the flat or unit benefit plan described above. The distinction is that, once the initial employer contribution formula is determined based on the applicable actuarial assumptions, no further adjustments are made to these assumptions. As a result, the exact contribution to be made by the plan sponsor is predictable, but the benefit to be received by the participant is uncertain and would depend on investment performance.

[5] Cost of Living Adjustment

A cost of living adjustment is not an independent benefit formula, but it is an additional mechanism to enhance benefits. The purpose is to increase benefits to offset the effects of inflation on the pension benefit. COLAs typically multiply the benefit by a variable external index, such as the CPI. Other indicators include the Dow Jones Industrial Average, the New York Stock Exchange common stock averages, the minimum wage rate, the Social Security taxable wage base, and the investment performance of a specific fund of reference (which might be the plan's own trust fund).

Questions have recently been raised regarding whether a COLA component is considered a protected component of a pension plan, and whether it can be revoked.

F1.04 DEFINED CONTRIBUTION PLANS

Defined contribution plans have two elements in common. First, such plans make no promise to the participant regarding the benefit payable. Second, the amount of benefit ultimately received by each participant is a function of (1) the contributions made during his or her working career and (2) the investment performance of the fund while these funds are invested in the plan.

Under a defined contribution plan, an "account" is maintained for each plan participant, to which his or her allocated portion of each contribution, and earnings or losses, is credited. Participants merely receive the amount of their account upon retirement. If investment performance is unfavorable, the value of participants' accounts may decline during their working career and be even less than the total of the contributions made. In a bull market, the actual retirement benefit obtained may be tremendous; conversely, during adverse market conditions, the account balance of each participant may decline drastically. Unlike defined benefit plans (where there is a stated ceiling on the benefit receivable), a defined contribution plan contains no ceiling on the benefit that a participant can obtain if investment performance is favorable.

Contributions to a defined contribution plan are generally deductible by the employer to a certain extent. IRC Section 404 imposes a deduction limit of 25% of the compensation of plan participants for the employer's taxable year.

The different types of defined contribution plans are described below. Legislation has gradually eroded many of the distinctions between each of these variations.

[1] Cash or Deferred Arrangements — 401(k)

The most popular type of defined contribution plan is a cash or deferred arrangement under Section 401(k) of IRC. A 401(k) plan is generally a component of either a profit-sharing or stock bonus plan (both discussed below), which permits employees to elect to have their salaries reduced in order to allow an employer to make a contribution to the plan on their behalf. Eligible employees must be granted an effective opportunity to make or change these elections at least annually.

The advantage of a cash or deferred arrangement is that employees can defer income tax on their contributions and earnings, allowing for tax-free compounding. These contributions remain subject to FICA (Social Security and Medicare) and FUTA (unemployment) taxes. They are allocated to separate accounts for each participant.

Many 401(k) plans also include a matching component. Matching contributions are an attractive method to encourage employee participation, because contributions made by an employee will be increased by the employer's portion. For example, an employer may make an additional contribution equal to 50% of an employee's contribution, up to 6% of pay. If an employee earns $50,000 a year and elects to contribute 6% of compensation to the 401(k) plan, an employer matching contribution equal to $1,500 would be made to the plan each year.

401(k) plans have become increasingly popular with employers and participants alike. For employers, 401(k) plans present an attractive complement to (or alternative to) defined benefit plans. They are less costly to administer than traditional pension plans, and they provide a savings opportunity without the long-term commitment of a defined benefit plan. Moreover, a 401(k) plan presents no investment risk to the employer. A 401(k) plan is also attractive because it is easy to communicate the benefit to employees. An employee can easily understand exactly how much money he or she has contributed and often can exercise some control over its growth.

[a] Prohibition on Prefunding

In December 2004, the Treasury Department consolidated extensive previous guidance on 401(k) plans into a new set of final regulations. These regulations, which generally became effective for the 2006 plan year, prohibited the prefunding of 401(k) plans. A plan sponsor cannot make contributions to the plan in anticipation of a participant's election. Nor can the sponsor make contributions before the participant has performed the services which relate to the compensation. This regulation represents the reversal of a prior IRS position on this issue. The controller must monitor the timing of plan contributions to ensure that this requirement is met.

[b] Availability of Plan Funds

Elective contributions to a 401(k) plan can only be distributed under certain circumstances, under IRC Section 401(k)(2)(B). These are:

- Termination of employment ("severance from employment")
- Death
- Disability
- Attainment of age 59½
- Hardship (employee elective contributions)
- Termination of the plan without replacement

In addition, even where a permissible distribution event arises, a distribution before age 59½ will generally subject a participant to a 10% penalty for early distribution, under Code Section 72(t). In some cases, this penalty will not apply to a participant who has attained age 55.

Controllers should be aware of the circumstances in which a distribution from a 401(k) plan is permissible, to ensure the continued tax qualification of the plan. This issue is highlighted in the context of mergers and acquisitions, where the plan administrator will need to determine whether a termination of employment has occurred.

Prior to EGTRRA, a termination of employment occurred only where there was a "separation from service." This phrase was interpreted by the IRS to preclude distributions where the participant continued to work at the same job for the buyer of his or her employing division or subsidiary. This principle (known as the “same desk rule”) often made it impossible for the seller’s plan to make distributions following corporate transactions.

In 2001, EGTRRA amended IRC Section 401(k)(2)(B) to substitute the phrase “severance from employment.” This phrase is interpreted more liberally by the IRS to generally allow distributions where a participant terminates his or her employment relationship with the sponsor of the plan. This would permit a distribution, for example, to the employees of a subsidiary that is sold, so long as the subsidiary does not assume sponsorship of the prior plan and does not accept an asset transfer from the prior plan.

[c] Nondiscrimination Testing

Contributions to 401(k) plans are limited to ensure an equitable balance between highly compensated employees and nonhighly compensated employees. As expected, highly compensated employees are generally in a better position to forgo current income in lieu of greater retirement benefits. Lower-paid employees, on the other hand, generally cannot afford to give up as much compensation because these funds may be required to satisfy current obligations and living expenses.

Consequently, the IRS imposes a nondiscriminatory test called the actual deferral percentage (ADP) test, to assure that the plan is not favoring the highly paid employees in an unacceptable manner (i.e., the plan is not discriminatory). This rule requires a comparison each year of the salary reduction contributions, as a percentage of compensation, made by highly compensated employees to the salary reduction contributions made by all other employees. Highly compensated employees (as a whole) can contribute slightly more than nonhighly compensated employees, so long as a mathematical test is met. A similar percentage test, known as the actual contribution percentage (ACP test) applies to after-tax employee contributions and employer matching contributions. (These percentage tests are discussed further in Section F1.05.)

To improve a plan’s performance in the ADP/ACP tests, some employers have elected to add an automatic enrollment feature to their plans. This allows the employer to deem that the employees have elected to participate, with a default initial contribution level, unless the employee affirmatively declines plan participation.

A plan can avoid conducting these nondiscrimination tests altogether through use of a safe harbor plan design. Under the safe harbor, a plan will be deemed to satisfy the ADP and ACP tests if it provides prescribed employer contributions under either a matching or nonelective contribution formula, as described below. A plan utilizing the safe harbor plan design generally must issue a notice to this effect to participants within a reasonable period (30 to 90 days) before the beginning of the plan year.

1. *Safe Harbor Matching Contributions*: The employer makes matching contributions on behalf of all nonhighly compensated employees equal to:
   - 100% of the employee’s elective contributions, up to 3% of compensation, and
   - 50% of the employee’s elective contributions, from 3% to 5% of compensation.

Alternatively, the employer may use an enhanced matching contribution formula under which, at any rate of employee contributions, a greater aggregate match is provided. This would include, for example, a match of 100% up to the first 4% of compensation.

2. *Safe Harbor Nonelective Contributions*: The employer makes nonelective contributions on behalf of all nonhighly compensated employees equal to 3% of compensation, regardless of whether the employee makes any contribution at all.

[d] Limit on Elective Contributions

In addition to these discrimination requirements, IRC Section 402(g) imposes a hard-dollar limit on the amount of salary-reduction contributions that may be made to a 401(k) plan in a calendar year by an individual. EGTRRA significantly increased the elective deferral limits under the following schedule:

Year	*Maximum Salary-Reduction*
2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000

2006	$15,000
Indexed thereafter	

[e] Catch-up Contributions

For plan years after 2001, EGTRRA expanded the amount of elective deferrals that could be made by a participant who attains age 50 during the plan year. A plan can permit these participants to make “catch-up contributions” without regard to the limitations that normally apply to elective deferrals. In other words, catch-up contributions can be made *in addition* to the elective deferral limits discussed above. Catch-up contributions will not cause a participant to exceed the 415 limitations, and will not cause the plan to violate the nondiscrimination tests of Code Section 401(a)(4) or the ADP/ACP tests.

Code Section 414(v) provides the following schedule for catch-up contributions:

Year	*Maximum Catch-Up Contribution*
2002	$1,000
2003	$2,000
2004	$3,000
2005	$4,000
2006	$5,000
Indexed thereafter	

An election to provide for catch-up contributions must be made on a consistent basis throughout the controlled group, with some exception for collectively bargained plans. In other words, a member of the controlled group cannot offer catch-up contributions in its 401(k) plan unless all other controlled group members offer a similar feature in their elective deferral plans.

[f] Roth Contributions

Beginning in 2006, plans can allow participants to make after-tax Roth contributions under IRC Section 402A. These Roth contributions can be distinguished from pre-tax contributions because they are includible in income upfront, and are exempt from taxation (along with earnings) when distributed. A five-year holding period applies to qualify for this special tax treatment.

Roth 401(k) accounts may be a welcome option to participants who are precluded from opening a Roth IRA due to the income limits. Roth contributions are particularly attractive to young participants who are many years away from retirement, due to the potential for significant tax-free build-up of earnings.

For purposes of the 402(g) limit on elective deferrals, Roth contributions are treated like elective deferrals. As a result, Roth contributions *count toward* the elective deferral limit discussed above.

[g] SIMPLE 401(k) Plans

SIMPLE 401(k) Plans. SBJPA established savings incentive match plans for employees of small employers (SIMPLEs) under IRC Section 401(k)(11), largely as a replacement for salary reduction simplified employee pension plans (SARSEPs).

A SIMPLE 401(k) plan can be established by an employer with 100 or fewer employees. Salary reduction contributions can be made up to $10,000 for 2005 (indexed thereafter), plus catch-up contributions if desired. A fixed matching contribution is required. Participants must be 100% vested in all contributions and must participate in the SIMPLE 401(k) plan exclusively (i.e., no other qualified plan).

[h] Advantages and Disadvantages of 401(k) Plans

The advantages and disadvantages of a cash or deferred arrangement can be summarized and expanded as follows:

Advantages

- Federal income tax savings are achieved by contributing to a plan through salary-reduction elections.
- Tax-deferred growth of funds until retirement.
- Funds can be accessed before retirement through hardship withdrawals and loans.
- Employee can exercise control over investment returns.

Disadvantages

- Broad employee participation is required to obtain tax savings for highly compensated employees (subject to regular testing).
- Salary reduction contributions are still subject to FICA and FUTA taxes.
- Pre-tax contributions are limited to $15,000 per calendar year (for 2006, indexed).
- Employer does not reap benefit of positive investment returns.

[2] Profit-Sharing Plan

The profit-sharing plan is the most common defined contribution plan, as it is generally the vehicle which includes a 401(k) arrangement. A profit-sharing plan is defined as a plan established and maintained to provide for participation in employer profits for participants and beneficiaries. However, profits are no longer required in order to make an annual contribution.

A profit-sharing plan must provide a definite predetermined formula for allocating contributions among participants. Typically, contributions are allocated in proportion to each participant's base compensation (as defined in the plan). Plans often have a "last day of the year" requirement (i.e., a participant only receives an annual employer contribution if he or she remains employed on the last day of the year).

A profit-sharing plan also must prescribe a method for distributing funds accumulated under the plan after a fixed number of years, attainment of a stated age, or upon the occurrence of an event such as layoff, retirement, death, or severance from employment.

There are different methods of determining contributions in a profit-sharing plan. In a discretionary profit-sharing plan, an employer decides each year how much, if anything, it will contribute. An employer is not obligated to make a contribution in any given year, as long as contributions are substantial and recurrent over a reasonable period. In a formula-driven plan, the employer is obligated to make the contributions fixed under the terms of the plan. For example, a plan could provide that an employer will contribute the lesser of 15% of the compensation of the plan participants or 10% of the net income of the employer for each fiscal year. The formulas used vary infinitely, but they share one factor: They are tied in some way to the earnings of an employer. If there are no earnings from which a contribution can be made, no contribution is made under the formula. Profit-sharing plans frequently contain a 401(k) arrangement. (See Section F1.04(1) above.)

Once an employer's money has been put into the plan in a given year, the money is allocated among individual accounts established for each participant. If employee A earns twice as much as employee B, A's share of the employer contribution will be twice B's share. This statement disregards certain refinements that may be added to these plans (e.g., integrating a plan's allocation formula with an employer's contributions for Social Security).

In addition, under profit-sharing plans, amounts forfeited by employees who leave the plan before becoming fully vested are often used to offset plan administrative expenses, or applied to reduce employer contributions. Alternatively, forfeited amounts can be reallocated among the accounts of the remaining employees in the plan on the same basis as new employer contributions are allocated.

[3] Money Purchase Plan

A money purchase pension plan is an individual account plan like a profit-sharing plan. A participant's account will reflect earnings and losses based on the underlying investment performance. Money purchase plans used to be attractive plan designs due to their higher contribution limits. This distinction evaporated in 2001 when EGTRRA raised the contribution limits for all plans.

Typically this contribution is defined as a percentage of compensation. Unlike a profit-sharing plan, however, the employer has a fixed obligation to make an annual contribution to the money purchase plan, pursuant to a formula. Failure to make the contribution required under the plan results in a funding deficiency subject to the imposition of an excise tax (in the same manner as a defined benefit plan, as discussed in section F1.05).

There are several ways in which a money purchase plan resembles a defined benefit plan rather than a defined contribution plan. First, the benefit is funded by fixed employer contributions, subject to the minimum funding rules of IRC Section 412. Second, any reduction in the future contribution levels for a money purchase plan must be communicated to participants well in advance under Section 204(h) of ERISA; violations of this rule are punishable by an excise tax under IRC Section 5980F. Third, benefits to a married participant must be made in the form of a joint and survivor annuity, unless waived by the participant's spouse.

[4] Stock Bonus Plan

A stock bonus plan operates like a profit-sharing plan except that benefits are generally distributed in employer stock. Requirements for allocating and distributing stock to participants and beneficiaries are similar to a profit-sharing plan. Contributions to a stock bonus plan may be based on any of the formulas prescribed by profit-sharing plans. Employer contributions to stock bonus plans are made either in cash or in stock of the employer sponsoring the plan (or of a parent or subsidiary corporation of the employer). If the contribution is made in cash, the trustees operating the plan's trust fund use the cash to make purchases of employer stock in the open market.

Distributions from stock bonus plans are made in the stock of the plan sponsor (or its parent or subsidiary) and not in cash (except for fractional shares). Since stock has no value to employees unless they have a way to dispose of it, stock bonus plans are generally limited to companies whose shares are traded in the public marketplace. In theory, stock bonus plans are incentives to increase productivity among employees, because the value of the stock they will receive is supposed to reflect the profitability of the company, which, in turn, is supposed to reflect the efforts of the employees.

The most common type of stock bonus plan is an ESOP. This is defined as a stock bonus plan (or stock bonus/money purchase plan) designed to invest primarily in qualified employer securities. An ESOP can be distinguished from other stock bonus plans in several ways. ESOPs are exempt from the prohibited transaction rules of ERISA for an employer loan granted to the plan. In other words, the ESOP can borrow from the employer to purchase employer securities, which other plans cannot do. Tax benefits, such as the dividend deduction under 404(k), deferral of gain under 1042, and lender's interest exclusion are available only to ESOPs (discussed below).

[5] Employee Stock Ownership Plan

An employee stock ownership plan (ESOP) may be either a stock bonus plan or a combined money purchase and stock bonus plan that invests substantially all of the money contributed by the employer in stock of the plan sponsor. These plans have been granted special status under ERISA and the Code in connection with the policy goal of promoting employee ownership of the company.

[a] Dividends

In 2001, EGTRRA made ESOPs much more attractive by allowing an employer to deduct dividends on employer stock where participants and beneficiaries can elect to reinvest dividends in employer stock. This represents a significant expansion because it allows a deduction under IRC Section 404(k) even when there is no immediate distribution.

An employer can deduct the amount of certain dividends paid on securities held by an ESOP to the extent that the dividends are: (1) paid in cash to the participants and beneficiaries: (2) paid to the ESOP and distributed in cash to participants or their beneficiaries no later than 90 days after the close of the plan year in which the dividend was paid, or (3) paid to the ESOP and used to repay a loan, under certain conditions.

Dividends are also deductible if, *at the election of participants and beneficiaries*, the dividends are: (1) paid in cash to the participants and beneficiaries: (2) paid to the plan and distributed to participants or their beneficiaries, or (3) paid to the ESOP and reinvested in qualifying employer securities. Note that the deduction is conditioned on the ability of participants and beneficiaries to *elect* whether to reinvest. The JCWA imposed a requirement that reinvested dividends must be nonforfeitable.

The IRS may disallow the deduction for any ESOP dividend if it determines that the dividend constitutes, in substance, either the avoidance or evasion of tax. This includes the authority to disallow deductions of unreasonable dividends. For purposes of a deduction on reinvested dividends, a dividend on stock that is primarily and regularly traded on an established securities market would be reasonable.

Dividends received by participants are treated as distributions subject to income tax. Federal income tax withholding and FICA taxes do not apply; nor does the early distribution 10% penalty. These amounts are not eligible for rollover.

Prior to 2001, no deduction was permitted where dividends were reinvested in employer stock.

[b] Partial Interest Exclusion for ESOP Loans

Favorable tax rules formerly applied to lenders, as an incentive to make loans to ESOP at favorable rates. For loans made before August 20, 1986, lenders could exclude from income 50% of the interest income earned on loans made to ESOPs, under

IRC Section 133. For periods after 1989, this exclusion was limited to ESOPs that owned more than 50% of employers' outstanding stock.

[c] Excise Tax on Dispositions

A 10% excise tax will be imposed on an employer maintaining an ESOP if the ESOP, within three years after acquiring the employer securities, disposes of the securities and, as a result, holds fewer securities than it held after the acquisition or if the value of the securities left after the disposition is less than 30% of the total value of all employer securities at the time of the disposition.

[d] Deferring Gains on Sales to ESOPs

Another important aspect of ESOPs is that IRC Section 1042 permits a taxpayer to defer the recognition of gain on a sale of qualified securities to an ESOP if the proceeds of the sale are invested in qualified replacement property. This favorable tax treatment is intended to encourage sale of large amounts of closely held stock to ESOP. For this deferral to be received, the following conditions must be satisfied:

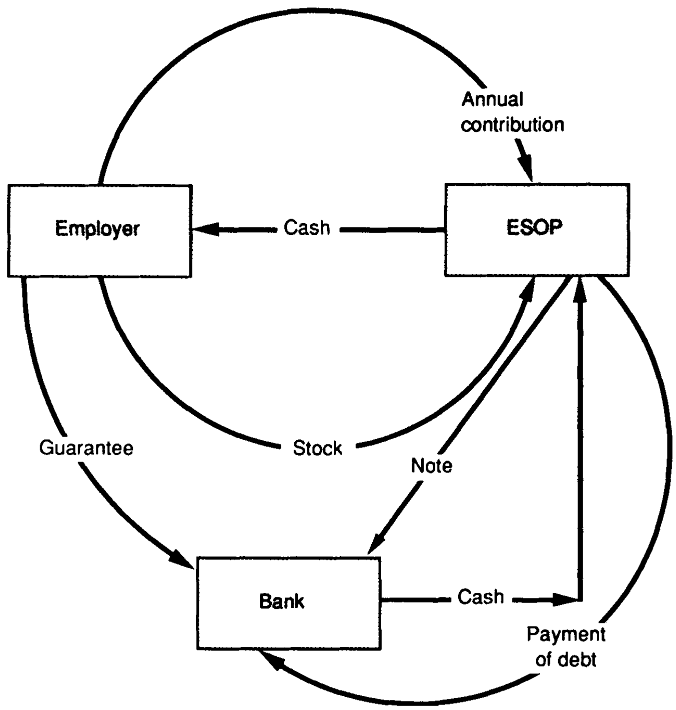
- The taxpayer has held the securities to be sold for at least three years before the sale.
- A taxpayer must elect tax deferral treatment in writing, on the tax return, including extensions, for the year of sale, under IRC Section 1042.
- The stock must be sold to an ESOP.
- After the sale, the ESOP must own at least 30% of the stock of an employer.
- A taxpayer must purchase "qualified replacement securities" within a 15-month period, beginning three months before and ending 12 months after the sale. A taxpayer's basis in the replacement securities will be the same as the taxpayer's basis in an employer's stock, for purposes of determining future gains. If more than one item of replacement property is purchased, the basis in an employer's stock will be prorated among all replacement securities.
- Qualified replacement securities that may be purchased to defer current taxation may generally include the following items issued by domestic corporations; stocks; bonds; or debentures, notes, or other evidence of indebtedness (bank certificates of deposit are not "qualified replacement securities").
- The selling taxpayer must file a written statement consenting to the application of a 10% excise tax, which applies if the ESOP disposes of the acquired stock within a three-year period.

[e] Leveraged ESOPs

Leveraged ESOPs were extremely popular in the mid-1980s as a vehicle to provide low-cost financing to an employer while making the entire repayment of the debt (including principal and interest) deductible. The popularity of leveraged transactions may have temporarily subsided, but ESOPs are still a useful financing alternative. A leveraged ESOP may be structured as follows:

1. The employer established an ESOP for the benefit of its employees.
2. The ESOP borrows money from a bank or other qualifying financial institution, which funds are used to purchase stock from the employer. Alternatively, stock may be purchased from an owner seeking to relinquish all or a portion of the owner's interest in a corporation.
3. The loan to the ESOP is negotiated at a favorable rate, since the lender may exclude 50% of the interest charged for any ESOP from its income under Section 133 of the Code.
4. The employer guarantees the debt to the ESOP and agrees to make contributions to the ESOP each year sufficient in amount to cover the interest and principal payments on the debt.
5. As the debt is extinguished each year, a portion of the stock purchased by the ESOP is allocated to the participants of the ESOP.
6. Under this simple scenario, if the ESOP borrows $1 million, the employer has the use of these funds for other corporate purposes and can deduct its contributions to the ESOP, in full, as illustrated in Figure F1.1.

FIGURE F1.1
Illustration of How Leveraged ESOPs Are Used as a Vehicle for Low-Cost Financing



[f] Advantages and Disadvantages of ESOPs

ESOPs offer many advantages, as described below:

- *Cash Flow*: A plan sponsor can contribute either cash or employer securities to an ESOP. Since the ESOP is required, however, to invest primarily in employer stock, contributions are typically made in the form of securities. This allows the plan sponsor to obtain a deduction for the value of the securities, without having to produce cash.
- *Market for Stock*: Alternatively, the plan sponsor can contribute cash to the ESOP, which is then used to purchase stock. This will create a market for the employer's stock.
- *Financing Tool*: A leveraged ESOP allows the plan to purchase employer stock on credit, backed by a commercial loan guaranteed by the plan sponsor. The employer's annual contributions are used to pay both interest and principal on the ESOP loan. This enables the plan sponsor to deduct these contributions. This ability to obtain a deduction for principal payments is often a major incentive for establishing an ESOP.
- *M&A Strategy*: An ESOP can be used as a defensive strategy against hostile takeovers. This operates by moving large amounts of employer stock into the control of employees who may be supportive of existing management. This became a popular device in the 1980s but has faded as merger activity has slowed down.
- *Employment Incentive*: Employees may be more likely to stay with an employer as they gain an ownership interest in a company through participation in an ESOP.

The failure of the Enron Corporation in 2001—and associated losses to participants who held employer stock in their benefit plans—has swayed public opinion away from ESOPs and has highlighted their disadvantages:

- *Fiduciary Liability*: Scrutiny of fiduciary decisions relating to ESOPs, such as whether to halt/allow trading where insider information regarding employer securities is available. Numerous cases have arisen in which plan participants have challenged an administrator's ability to act impartially. Following the Enron and Worldcom bankruptcies, plan participants have alleged that company executives misled them about the value of the employer stock based on misinformation about the company's finances.

- *Diversification of Investments*: As with any non-diversified investment, the risk of loss is magnified.
- *Unregistered Stock*: If the stock of an employer is not registered, participants of an ESOP will not generally vote the shares allocated to their ESOP accounts. All participants must generally be permitted to vote the shares allocated to their accounts, however, on issues such as mergers, consolidations, and other significant corporate events.
- *Excise Taxes*: If the ESOP disposes of securities within three years after acquiring employer stock, a 10% excise tax will be imposed on the employer.
- *Section 415 Limits*: Contributions to an ESOP are subject to the Section 415 annual limitation for defined contribution plans, which is $42,000 for each participant (for 2006).
- *Dilution*: The establishment of an ESOP would dilute the existing shareholders' interest in an employer if newly issued stock is sold to the ESOP.
- *Section 1042 Exchange*: Shares allocated under an ESOP may not be allocated to family members or 25% shareholders if a taxpayer uses the tax-free deferral opportunity available under Section 1042. Cash contributions may also not be made to the ESOP to make up for any lost benefits.

F1.05 QUALIFICATION REQUIREMENTS

For the plans discussed previously to be or to remain qualified, they must comply with all required provisions of the Code, as amended from time to time. The most important provisions that related to qualified plans include:

- Eligibility requirements
- Minimum coverage rules
- General nondiscrimination rules
- Minimum participation requirements
- Vesting rules
- Special rules for accrued benefits
- Funding requirements
- Limitations on benefits and contributions
- 401(k) plans testing

[1] Eligibility Requirements

The Code imposes certain eligibility requirements to prevent undue exclusion of employees. For example, a qualified plan can require employees to attain 21 years of age before becoming eligible to participate. It can also require employees to complete one year of service with an employer before they are eligible to participant. A one-year service requirement is a common plan provision.

Alternatively, an employer can delay participation until the completion of two years of service under current law. Use of a two-year eligibility provision is uncommon, however, because it requires that employees be fully vested in all benefits upon entry into the plan upon the completion of the required two-year period.

A plan will not be qualified if it excludes any individuals from participation on the basis of advanced age. The Code recognizes, however, that admitting new participants who are close to normal retirement age could significantly increase a plan's minimum funding requirements. For these individuals, a plan can extend the normal retirement age to the fifth anniversary of participation. For example, if a plan requires one year of service to participate and has a normal retirement age of 65, the normal retirement age of an individual hired at age 61 may be extended to age 67 (one year of service, plus five years).

A "year of service" has a precise meaning in this context. ERISA and the Code generally define a year of service as 1,000 hours of work during a 12-month period. Participants generally have one year of service if they work at least 1,000 hours during the initial 12 months following their commencement of employment. In lieu of tracking actual hours, an employer may use "equivalencies" for ease of administration. For example, an employer could award 45 hours for every week worked, or 190 hours for every month. Alternatively, an employer could count the year of service under the elapsed time method, which does not rely on hours at all. Under this approach, service for eligibility, vesting, and benefit accruals can be determined by reference to the total period of time an employee is employed rather than by counting actual hours or equivalent hours of service.

The time at which participation must commence is also important. Once an employee has met the eligibility criteria, he or she must be permitted to enter the plan at the beginning of the next plan year, or within six months if earlier. The controller should set up a system to monitor the work records of new employees and alert the plan administrators as to when an employee becomes eligible to participate in the plan.

Because of the proliferation of acquisitions and divestitures, a controller must also be sensitive to issues that arise in connection with crediting past service with a former employer. If an employer maintains a plan of a predecessor employer, an employee's service with the prior employer will count as service with the current employer in determining eligibility to participate. If a predecessor plan is not maintained, service with the prior employer need only be considered as prescribed by regulations, which have not yet been issued. Accordingly, although service with an acquired company may be counted for the purpose of determining participation in the acquiring company's employee benefit plan, such service need not be unilaterally granted and is generally negotiated.

[2] Minimum Coverage Rules

[a] Three Alternative Coverage Tests

The IRC imposes certain minimum coverage requirements as a condition for plan qualification. If a plan satisfies one of the three alternative tests in IRC Section 410(b), described below, then it will satisfy these requirements even if some employees are excluded. Generally speaking, the Ratio Test is the preferred method for satisfying these requirements. This is because the Percentage Test requires a high degree of participation by nonhighly compensated employees, which may be difficult to achieve, and the Average Benefit Test is a burdensome test for larger controlled groups. The three tests may be summarized as follows:

Percentage test:

- 70% of all nonhighly compensated employees must be covered by the plan.

Ratio test:

- The percentage of nonhighly compensated employees covered by the plan must equal at leave 70% of the percentage of highly compensated employees covered.

The Ratio Test works as follows: If, for example, only 60% of an employer's highly compensated employees are covered, under the Ratio Test only 42% (70% multiplied by 60%) of the nonhighly compensated employees need be covered.

Average benefits test:

- Both of the following conditions must be satisfied.
  - ☐ A plan covers a classification of employees that does not discriminate in favor of highly compensated employees (i.e. the "classification test").
  - ☐ The "average benefit percentage" (calculated separately with respect to each employee) under all qualified plans maintained by an employer for nonhighly compensated employees is at least 70% of the average for highly compensated employees.

The "average benefit percentage" for any group is the average of the "benefit percentage" calculated separately with respect to each employee in the group. The benefit percentage is equal to the employer-provided contribution or benefit of an employee under all plans divided by an employee's taxable compensation. This test is quite burdensome to run for an employer who maintains more than a small number of plans.

An employer *may* elect to compute the "benefit percentage" for any plan year on the basis of contributions or benefits for *that* year, or any consecutive plan period up to three years. This *election* may play an important role in qualifying certain plans if the coverage of employees has changed significantly in a short period of time.

All employees are considered when calculating the average benefit percentage unless an employer *elects* to exclude employees who do not satisfy the minimum age or service requirements. Once again, the determination of whether to make this election is important. For example, if an employer hires several highly compensated employees who are not participating in employer plans, the election may not be desirable, since the inclusion of such employees will help to depress the average benefit of the highly compensated group.

[b] Highly Compensated Employees

In applying all of these tests, the starting point in each instance is to identify the highly compensated employees. A highly compensated employee includes *any* employee, who meets *any* of the following conditions:

- Owned 5% or more of the employer during the current or preceding year.
- Earned more than $80,000 as indexed, from the employer ($100,000 as of 2006) in the preceding year.
- If desired, also was among the top-paid 20% of employees when ranked on the basis of compensation in the preceding year. (A top-paid group election must be stated in the plan document, and must be made consistently throughout the controlled group.)

[c] Seperate Line of Business

If an employer is treated as operating a "separate line of business" (SLOB) for a year, the employer may apply these coverage requirements separately to the employees in each line of business if the plan to be tested benefits the employees under a classification that does not discriminate in favor of highly compensated employees. In general, a SLOB exists if an employer operates a SLOB for bona fide business reasons, as determined by the facts and circumstances of each situation. In addition, a SLOB includes an operating unit separately operating for a bona fide business reason. If a company is structured in such a manner that these rules apply, a controller should refer to IRC Section 414(r) and should consult with a benefit attorney. (The SLOB rules are further addressed in Section F1.06.)

[d] Aggregation

In applying the coverage rules, an employer can also elect to aggregate certain plans. If plans are aggregated, they are treated as one plan for purposes of determining whether a plan is discriminatory in favor of the prohibited group. Plans must have the same plan year in order to be aggregated.

[e] Sanctions

If a plan does not meet the coverage requirements, the trust of such a plan will be treated as remaining tax-exempt for all nonhighly compensated employees. Highly compensated employees, however, will be subject to tax on their vested accrued benefit (other than employee contributions) as of the close of the employer's taxable year that ends with or within a taxable year of the trust for which the trust is not tax-exempt.

[3] General Nondiscrimination Rules

IRC Section 401(a)(4) provides that contributions and benefits under a plan may not discriminate in favor of highly compensated employees. Although simple in intent, the Treasury regulations are extremely technical and beyond the scope of this chapter. These regulations prescribe detailed methods for demonstrating that the plan is nondiscriminatory, both in its core accrual formula and with respect to any benefits, rights or features offered to sub-groups of participants. In addition, a special set of nondiscrimination rules (ADP/ACP tests) apply to 401(k) plans. (See Section F1.05(9) below.)

For defined benefit plans, controllers are encouraged to determine whether their plans satisfy any safe-harbor rules contained in the final regulations or if the general rules must be applied in any instance. Thereafter, both the safe-harbor and general tests should be monitored. For defined contribution plans, controllers should ensure that the applicable nondiscrimination tests are satisfied.

[4] Minimum Participation Rules

In addition to the minimum coverage rules of IRC Section 410(b), a defined benefit plan must also satisfy the minimum participation rules of IRC Section 401(a)(26). These rules generally provide that a plan must, on each day of the plan year, benefit the lesser of: (1) 50 employees of the employer, or (2) 20% of all employees of the employer. For purposes of applying this rule, employees who are covered by a collective bargaining agreement or who have not satisfied a plan's eligibility requirements may be excluded from consideration. This test may not be satisfied by aggregating plans, and no SLOB exception is available. Note that the minimum participation rules no longer apply to defined contribution plans.

The basic thrust of this provision is to eliminate the use of individual defined benefit plans. For example, a dentist has a professional corporation with three employees, including himself. The two other employees are not excludable for purposes of applying the minimum rule.

In enacting this rule, as previously noted, Congress did not want employers to combine certain plans, while maintaining different benefit structures, to circumvent its objective. This rule permits the IRS to issue regulations that may provide that any separate benefit structure or trust will be treated as a “separate plan” for purposes of applying this rule. Therefore, if a plan provides two different benefit formulas for calculating benefits or contributions, two separate plans may be deemed to exist.

In general, this new rule does *not apply* to the following:

- Multiemployer plans
- Certain plans that the IRS may exclude, such as:
  - Plans that do not benefit highly compensated employees
  - Certain underfunded plans

If any plan fails to satisfy the minimum participation rules, the entire plan is disqualified, with income tax recognition resulting for all employees. However, plans may be retroactively amended after the close of the plan year in order to satisfy the minimum participation rules for the prior year. Once again, controllers should review their plans for compliance on an ongoing basis.

[5] Vesting Rules

Vested benefits are those retirement benefits to which an employee is entitled, whether or not he continues in the service of an employer organization. Accrued benefits derived from an employee’s contribution to a qualified plan are always nonforfeitable whether such contribution is made on a pretax basis (as in a 401(k) salary reduction contribution) or an after-tax basis. The rules concerning vesting therefore relate only to the employer’s contributions.

[a] General Requirements

The vesting rules in IRC Section 411 are intended to protect the benefits of workers. A plan can offer either of the following vesting schedules for the retirement benefit derived from employer contributions:

- *Five-year cliff vesting.* 100% vesting upon the completion of five years of service.
- *Seven-year graded vesting.* A graduated vesting schedule, in which employees will be 20% vested after three years of service and 100% vested after seven years of service, as follows:

Years of service	*Nonforeitable percentage*
3	20%
4	40%
5	60%
6	80%
7 or more	100%

Different vesting schedules apply to the matching contribution in a 401(k) plan. EGTRRA shortened these schedules to promote benefit “portability” — the ability to accrue retirement benefits for workers who change jobs frequently.

- *Three-year cliff vesting:* 100% vesting in employer matching contributions upon the completion of 3 years of service.
- *Six-year graded vesting:*

Years of service	*Nonforeitable percentage*
2	20%
3	40%
4	60%
5	80%
6 or more	100%

[b] Additional Considerations

All controllers must carefully consider the cost of implementing these rules and the vesting schedules that they adopt. By requiring faster vesting, fewer forfeitures will occur. This may increase the cost of maintaining the plan. In the context of a defined benefit plan that uses forfeitures to reduce required employer contributions, fewer forfeitures equate with higher pension costs. For defined contribution plans that utilize forfeitures to reduce employer contributions or offset plan expenses, these changes will mean increased out-of-pocket expenses for the employer.

In making the determination of the schedule to be applied in any old or new plan, additional consideration should be given to the top-heavy vesting schedules discussed in the following section. If a plan is determined to be top-heavy, adoption of the top heavy vesting schedules may be desirable to eliminate the need to maintain numerous schedules. In addition, the six-year, top-heavy vesting schedule may be the most desirable alternative. This conclusion is premised on the fact that the new eligibility rule that precludes the denial of participation for more than two years will probably override the three-year, top-heavy schedule. Therefore, to achieve the slowest method of vesting, the six-year schedule may be preferred.

[6] Special Rules for Accrued Benefits

The term "accrued benefits" generally refers to the amount set aside for a participant under a defined contribution plan and the present value of a participant's retirement benefit under a defined benefit plan. All plans must provide a means of determining the accrued benefit of any participant at any point in time. A participant's accrued benefit will thereafter be subject to the other provisions of a plan with respect to vesting and so on. For defined contribution plans, this is simple. A participant's accrued benefit in a defined contribution plan is the amount credited to a participant's account. Individual accounts must therefore be maintained for each participant to assist in this determination.

With respect to a defined benefit plan, a participant's accrued benefit is the annual benefit to which the participant will be entitled, commencing at the attainment of a plan's normal retirement age, or the actuarial equivalent of such a benefit. A typical defined benefit plan formula might calculate benefits based on a participant's final average compensation. For example, the monthly benefit might be 1% of the participant's highest compensation looking at the three highest years of the past ten, multiplied by the participant's years of service.

IRC Section 411(b) requires that the method for calculating benefits must not be "backloaded." This reflects Congress' concern that the benefit would accrue at a low rate over many years, only to "pop up" just before retirement. Specifically, a plan avoids backloading where it satisfies at least one of the following:

- The 3% method
- The 133⅓% rule
- The fractional portion rule

[a] 3% Method

Under the 3% rule, the minimum rate of accrual for any year before the end of 33⅓ years of participation is 3% of the maximum benefits to which the participants would be entitled if they began participation in the plan at the earliest possible entry age and participated continuously until either the earlier of normal retirement age or age 65.

For example, *Plan A* may provide a flat amount pension payable at a normal retirement age of 65. Smith became a participant in the plan at age 25 and he participates continuously until he reaches the retirement age of 65. His pension after 40 years of service would be $150 per month or $1,800 per year. This pension benefit under the 3% rule would accrue at the minimum rate of 33⅓ years. The accrued benefit at the end of any year must be equal to at least $54 times the number of years of participation to the end of the plan year. This rule may also be followed if the pension benefit is based on an individual's compensation. In this case, the maximum benefit would be based on the average compensation for the employee's most highly compensated continuous period of not more than 10 years.

[b] 133⅓% Method

Under this alternative, the accrual rate for any given year cannot be more than 133⅓% of any other year on either a dollar or percentage basis. The plan must provide for a full accrued retirement benefit at normal retirement age.

For example, *Plan B* provides for an annual benefit, commencing at age 65, of a percentage of a participant's average compensation for the period of three consecutive year of participation for which his compensation is the highest. The percentage is 2% for each of the first five years of participation; 1% for each of the next five year of participation; and 1.5% for each year thereafter. This plan does not satisfy the 133⅓% rule because the rate of accrual for all years of participation in excess of 10 (i.e, 1.5%) for any employee who is actually accruing benefits or who could accrue benefits exceeding 133⅓% of the rate of accrual for the sixth through the tenth years of participation (i.e., 1.5% is greater than 133⅓% of 1% benefit accrual in Year 6).

[c] Fractional Rule

This rule requires employees' accrued pension benefits at any given date to be an allocable portion of the benefits that they would be entitled to at their normal retirement age. Under the rule, the minimum benefit to be accrued is equal to the annual benefits due the employees if they had separated from service, which is equal to the annual benefits beginning at normal retirement age (to which the employees would have been entitled), multiplied by the years of their active participation in the plan over the total years that they would have participated if they continued their employment until their normal retirement age. This alternative is the most common method of benefit accrual used.

For example, *Plan C* provides for pension benefits based on 2% of the average annual compensation of the employee's highest five years of participation, multiplied by the number of years of participation. For example, Johnson began participation in the plan at age 25. Normal retirement age is 65, and Johnson's average annual compensation for the highest five years of participation is $40,000. Johnson has been a participant in the plan for 20 years. The accrual of benefits for the 20 years of participation must be at least $16,000 and is determined as follows:

Annual benefit at normal retirement:

$2\% \times 40 = 80\%$

$80\% \times 40{,}000$ average annual compensation = $32,000 annual benefit

Required accrued benefit is:

$\$32{,}000 \times 20/40 = \$16{,}000$

[d] Protection for Accrued Benefit

A participant's accrued benefit is protected by IRC Section 411(d)(6)(A) and ERISA Section 204(g). Accordingly, a plan cannot be amended to reduce the accruals that a participant has already accumulated at any given point in time. EGTRRA expanded these provisions to provide that an amendment reducing or eliminating an early retirement benefit or a retirement-type subsidy will be treated as the reduction of an accrued benefit as well.

These rules do not prevent a plan from being amended to reduce future accruals, so long as the proper participant notices are provided. (See Section F1.06(2) below for information on reducing or freezing a participant's benefit.)

[e] Requirement to Continue Benefit Accruals

The Age Discrimination in Employment Act (ADEA) prohibits qualified plans from reducing or terminating benefit accruals upon attainment of normal retirement age (except for certain highly compensated employees). This requirement is reflected in both the IRC and ERISA, which were amended in 1989 to reflect ADEA's prohibition on mandatory retirement policies.

[f] Disclosure of Accrued Benefits

The plan administrator must maintain sufficient records to calculate a participant's accrued benefits at any given time. Upon request, the plan administrator must be able to furnish to any participant or beneficiary the latest information available about his or her total accrued benefits, including the nonforfeitable portion, if any. Participants are entitled to ask for and obtain such information once every year.

[7] Minimum Funding Requirements

Defined benefit plans and money purchase plans must satisfy certain minimum funding requirements under IRC Section 412. These requirements are imposed to assure that sufficient assets will be available to pay promised benefits. Defined contribution plans, other than money purchase plans, are not subject to these rules. A money purchase plan will satisfy the minimum funding requirements by making the contribution specified in the plan document. The remainder of this subsection focuses on defined benefit plans.

[a] General Requirements

For most defined benefit plans, an employer's (or plan sponsor's) annual contribution to the plan must be sufficient to cover (i) the normal cost for the period; (ii) annual interest on unfunded amounts; (iii) amortization of past service liability; (iv) increases in past service liability resulting from plan amendments; (v) liability attributable to experience losses; and (vi) liability resulting from changes in actuarial assumptions. The controller should have an actuary compute amortization on a level payment basis, including interest and principal needed to comply with the minimum funding requirements.

Assuming that a plan does not have an accumulated funding deficiency from prior years, the contribution will be sufficient to satisfy the minimum funding standards if it satisfies each of the following:

- ☐ The normal cost for current services incurred, with respect to the plan year for which the contribution is made.
- ☐ The past service cost (including principal and interest), amortized on a level payment basis over a period of up to 30 years in the case of any single employer plan coming into existence after January 1, 1974, or over a period of up to 40 years for a plan in existence on January 1, 1974.
- ☐ Any net increase in unfunded past service liability arising from plan amendments adopted in such year, amortized over a period of up to 30 years for a single employer plan.
- ☐ Any net loss resulting from changes in actuarial assumptions used with respect to the plan, amortized over a period of up to 10 years for a single employer plan.
- ☐ Any net experience loss suffered by the plan, amortized over a period of up to five years for a single employer plan.
- ☐ Any waived funding deficiency, amortized on an equal annual installment basis over a period of five years for a single employer plan.
- ☐ If the employer so elects, amortized costs may be combined into a single cost, with the amortization period determined on the basis of the remaining amortization period for all costs entering into the combined amount.
- ☐ Special rules apply to multiemployer plans.

It is the controller's responsibility to make these calculations or have them made (or at least reviewed) by an actuary. Defined benefit pension plans require that an enrolled actuary prepare an actuarial statement for inclusion in the annual report (Form 5500).

[b] Funding Standard Account

The IRC requires plans subject to the minimum funding requirements to maintain an account called the funding standard account (FSA). This account is a memorandum account and is not included in the plan's financial statements. Every defined benefit pension plan is required to maintain an FSA. A limited FSA must also be maintained in the case of a money purchase plan, in which the employer is charged each year for the amount that must be contributed under the plan and is credited with the amount actually paid.

For a defined benefit plan, the FSA is charged each year with the plan's normal costs for the year and with the minimum amortization payment required for initial past service cost, increased plan liabilities, actuarial losses, experience losses, and waived contributions for each year. The plan may offset against these charges any credits attributable to the employer's contribution for the year, the amortization of any cost decreases due to plan amendments, actuarial gains, or experience gains, and any waived contributions.

The Secretary of the Treasury may waive all or part of the minimum funding requirements for a plan year in which the minimum funding standards cannot be met without imposing substantial business hardship on an employer. A waiver is only issued if failure to do so would be adverse to the participants' interests, and for a single employer plan, a waiver may only be issued in three years out of any 15-year period. An employer must notify all participants, beneficiaries, and alternate payees of its application for a funding waiver. If a plan's overall funding deficiency exceeds a certain amount, the Pension Benefit Guaranty Corporation ("PBGC") will be given the opportunity to comment on the application. During the waiver period, a plan may not be amended to increase benefits or increase the rate of vesting or benefit accrual.

In the absence of a waiver and if the employer does not make sufficient contributions (either under a defined benefit plan or a money purchase plan) to meet the minimum funding requirements, the IRS will impose a nondeductible excise tax on the employer under IRC Section 4971, equal to 10% of the accumulated deficiency at the end of the year. If an employer fails to correct an accumulated funding deficiency by the earlier of (i) the date a notice of deficiency is mailed with respect to the excise tax, or (ii) the date on which the excise tax is assessed, a further excise tax is imposed on the employer equal to 100% of the accumulated funding deficiency to the extent the deficiency is not corrected.

Before issuing a deficiency notice, the IRS must notify the Department of Labor ("DOL"), which will have an opportunity to require the employer to correct the deficiency and to comment on the prospective imposition of the tax.

Operating an FSA. The operation of an FSA is illustrated in Example 1.

EXAMPLE 1:

In 2004, Z Corporation established a defined benefit pension plan for its employees. When the plan was established, a past service liability of $1.5 million existed to provide for benefits attributable to employees' service prior to the adoption of the plan. Normal cost for current service is $100,000. The interest rate used to determine the plan cost is 7 percent. In the first year, Z Corporation contributes $220,880. All amounts are credited and charged to the accounts at the beginning of the year. The plan's FSA for 2004 is:

Credits	
Z Corporation's contributions	$220,880
Charges	
Normal Cost	$100,000
Amortization of past service cost required annual payment over 30 years at 7%	$120,880
Total	$220,880

In 2005, Z Corporation amended the plan to improve employee benefits. The past service liability was increased by $200,000. This increase was to be amortized over a 30-year period, beginning in 2005. This change also increased the plan's normal cost to $120,000. The plan had a net actuarial gain of $8,000 for 2004, to be amortized over a 10-year period. All amounts other than interest are charged and credited to the accounts at the beginning of the year. Z Corporation contributed $262,319 in 2005. The plan funding accounts for 2005 are:

Credits	
Z Corporation"s contributions	$261,180
Amortization of $8,000 actuarial gain over 10 years at 7%	1,139
Total	$262,319
Charges	
Normal cost	$120,000
Amortization (initial past service cost)	120,880
Amortization of $200,000 additional past service cost from amendment plus 7% interest over 30 years	16,117
Total	$256,997
Positive balance	$ 5,322
Interest on balance (at 7%)	373
Net balance (credit for future years)	5,695

[c] Quarterly Funding Requirements

An employer may make any required minimum contributions with respect to a given plan year within the 15th day of the ninth month after the close of the plan year. However, a defined benefit plan with a funded current liability percentage of less than 100% must make four installment payments for the year for which the required contribution becomes due. (Funded current liability percentage is the extent to which a plan would be funded in the event of a plan termination). The shift to quarterly funding requirements for certain plans was made to provide an early warning that an employer might have difficulty satisfying its contribution requirements, and it essentially eliminates the "float" that employers could obtain by not making any contributions until well after the close of a plan year.

For a calendar-year plan, contributions are due on April 15, July 15, October 15 of the plan year for which the contribution is due, and January 15 of the following plan year. The amount of each installment is calculated in the same manner as corporate estimated tax payments, and is equal to 25% of the lesser of (1) 90% of the required contribution for the current plan year or (2) 100% of the required contributions for the preceding plan year.

[d] Sanctions for Failure to Make Quarterly Contributions

[i] Interest. If a required quarterly installment payment is not paid, interest must be paid to the plan for the period between the due date for the contribution and the date on which the contribution is made. The interest rate is the greater of 175% of the applicable federal mid-term rate under IRC Section 1274 or the interest rate used for purposes of a plan's funding standard account. These contribution and interest requirements may be imposed on any member of a controlled group.

[ii] Notice requirement. If any required quarterly installment is not paid within 60 days of the required due date, written notice of this failure must be distributed to all participants, beneficiaries, and alternate payees under any qualified domestic relations order. An employer must also notify the PBGC within 10 days of any failure to make a quarterly payment.

[iii] Potential lien. A lien is automatically established on behalf of a plan if overdue installments, including interest, exceed $1 million. All property of an employer or any member of a controlled group is subject to this lien. This provision applies to all single-employer defined benefit plans unless their funded current liability percentage is at least 100%. The lien ceases to exist as of the last day of the first plan year in which the overdue amount drops below $1 million.

[e] Limit on Maximum Contributions

In order to limit an employer's ability to make deductible contributions to a defined benefit plan, employers may make deductible contributions only up to the "full-funding limitation." The full-funding limitation is the excess, if any, of a plan's accrued liabilities (including normal cost) over the lesser of (a) the fair market value of the plan's assets (including normal cost) or (b) the fair market value of the plan's assets as otherwise determined under any reasonable actuarial method of valuation.

In previous years, the full-funding limitation could not exceed a certain percentage of a plan's current liability (i.e., liability in the event of a plan termination), but for plan years beginning on or after January 1, 2004, this restriction no longer applies. However, the full funding limitation may not be less than the excess of 90% of a plan's current liability (including the expected increase in current liability due to benefits accruing during the plan year) over the fair market value of the plan's assets.

[f] Increase in Minimum Contributions for Underfunded Plans

All defined benefit plans are required to meet certain minimum funding standards. However, an employer may satisfy the minimum funding rules and still leave the plan with insufficient assets to provide all benefits in the event of a plan termination. Under such circumstances, participants may be denied promised benefits, and liability may be imposed on the PBGC. Accordingly, underfunded plans must make additional contributions.

This rule generally applies to plans with a funded current liability percentage of less than 90 percent. However, a plan with a funded current liability percentage of 80% is exempt from this rule if its funded current liability percentage for each of the two preceding plan years (or the second and third preceding plan years) was at least 90%. This rule also does not apply to plans that cover 100 or fewer participants, and some relief is provided for plans that cover 101 to 150 participants. For purposes of determining eligibility for this exemption, all defined benefit plans in the employer's controlled group (including participants in multiemployer plans) are considered a single plan, but only employees of the employer are taken into account. (See also the discussion on GATT, below).

Under a complicated formula, the additional contribution is equal to the sum of (1) the excess, if any, of the "deficit reduction contribution" for the plan year over the sum of the charges for the plan year (reduced by the sum of any credits for the plan year) plus (2) the "unpredictable contingent event amount," if any, for the plan year. However, the additional contribution may not exceed the amount that brings the plan's funded current liability percentage to 100%.

A plan that is required to make this additional contribution also must provide notice to plan participants, beneficiaries, and alternate payees of both the plan's funding status and the limit on the amount of benefits protected by the PBGC upon plan termination. In addition, in some cases, certain underfunded plans may not be amended to increase benefits or increase the rate of vesting or benefit accrual.

[8] Limitations on Maximum Contributions and Benefits

IRC Section 415 imposes specific limitations on the amount of benefit payable to a participant under a defined benefit plan, and on the amount of contributions made on a participant's behalf under a defined contribution plan. In addition, IRC Section 401(a)(17) limits the amount of a participant's annual compensation that can be taken into account in calculating a participant's benefit or contribution levels. These rules are essential to preserve the tax-qualification of a plan.

EGTRRA substantially increased these limits with the stated purpose of improving the nation's rate of retirement savings.

[a] Defined Benefit Plans

Prior to EGTRRA, the annual benefit payable under a defined benefit plan was limited by IRC Section 415(b) to the lesser of: (1) 100% of a participant's annual compensation, or (2) $90,000 (indexed to $140,000 for 2001). Furthermore, the dollar limit was actuarially reduced for retirements before Social Security retirement age (at that time, age 65), and increased for retirements after this point.

EGTRRA increased the base amount of the defined benefit plan limit under IRC Section 415(b) to $160,000. This limit is actuarially reduced for retirements before age 62, but is no longer reduced for retirements between age 62 and age 65. This allows a plan to provide a significantly larger benefit to a participant retiring a few years early. The limit continues to be increased for retirements after age 65. IRC Section 415, as further amendment by the Pension Funding Equity Act of 2003, prescribes specific assumptions for these actuarial adjustments.

This dollar limit was indexed to $175,000 for 2006.

[b] Defined Contribution Plans

Prior to EGTRRA, the defined contribution plan limit was the lesser of: (1) 25% of a participant's compensation, or (2) $30,000 (indexed to $35,000 for 2001).

EGTRRA replaced the 25% limitation with a 100% limitation, and it increased the dollar limit to $40,000. It also modified the indexing methodology, to allow annual cost of living increases more frequently, in $1,000 increments.

This dollar limit was indexed to $44,000 for 2006.

[c] Compensation Limit

The pre-EGTRRA compensation limit under IRC Section 401(a)(17) was $150,000 (indexed to $170,000 for 2001). This meant that a plan's formula could not consider compensation in excess of this amount.

EGTRRA increased this amount to $200,000. It is indexed in $5,000 increments and was $220,000 for 2006.

[9] 401(k) Plan Testing

A 401(k) plan must satisfy a series of additional nondiscrimination tests to remain qualified under IRC Section 401(a).

[a] Calendar-Year Limit on Elective Deferrals

Participants in a 401(k) plan face a limit on the amount of pre-tax elective deferrals that can be made each calendar year, under Section 402(g)(1) of the IRC. Congress dramatically increased this limit in EGTRRA, raising it to $15,000 for 2006 and indexed thereafter (see F1.04(1)). This limit applies to regular elective deferrals as well as Roth contributions which are treated as elective deferrals. It does not apply to catch-up contributions, which are subject to a separate limit in IRC Section 414(v), equal to $5,000 for 2006 and indexed thereafter.

The dollar limit in IRC Section 402(g) applies to individuals. This means that a person who contributes to more than one plan (whether within the same controlled group or not) must limit his or her total contributions to comply with the 402(g) cap.

Amounts contributed in excess of the calendar year limit under Section 402(g) are referred to as “excess deferrals.” A participant can request distribution of any excess deferrals, if the plan so provides, by April 15 of the year following the year of deferral. The tax treatment of distributed excess deferrals is discussed in Section F1.01 [9][d] below.

A controller should be aware that the amount of employee deferrals must be reported to each participant on Form W-2. Any amounts deferred in excess of the 402(g) limit, as indexed, must be included in gross income. Additional reporting requirements exist when any excess deferrals are returned to an employee.

[b] Nondiscrimination Testing for Pretax Salary Reduction Contributions

For a 401(k) plan to be qualified, it must satisfy the actual deferral percentage (ADP) test, to assure that the plan is not favoring the highly paid employees in an unacceptable manner (i.e., the plan is not discriminatory). This rule requires a comparison each year of the salary reduction contributions, as a percentage of compensation, made by highly compensated employees to the salary reduction contributions made by all other employees. Highly compensated employees (as a whole) can contribute slightly more than nonhighly compensated employees, so long as a mathematical test is met. A similar percentage test, known as the actual contribution percentage (ACP) test applies to after-tax employee contributions and employer matching contributions.

The ADP test will be satisfied if one of the following tests is met, or if the plan utilizes a safe-harbor plan design (see section F1.04 above):

- The ADP for the highly compensated employees is not greater than the ADP of all other eligible employees multiplied by 1.25.
- The excess of the ADP for the group of highly compensated employees over the ADP for all other eligible employees is not more than two percentage points, and the ADP for the group of highly compensated employees is not more than the ADP of all other eligible employees multiplied by two.

In applying these tests, the following rules apply:

- The ADP for either group is the average of the ratio (calculated separately for each employee in such group) of (1) the employer contribution actually paid to a plan on behalf of an employee to (2) the employee’s compensation.
- The computation of the employer contribution will include (1) all salary reduction contributions and (2) at the election of the employer, certain employer matching contributions and nonelective contributions (i.e., basic contributions).

These rules may be clarified by Example 2.

EXAMPLE 2:

Assume that Employer *A* has 100 employees, of which 10 are highly compensated and 90 are nonhighly compensated. Employer *A* maintains a 401(k) plan, which permits employees to reduce their salaries up to 6% to contribute to the 401(k) plan. No matching contributions or discretionary or other employer contributions are contained in the plan. If only 45 of the nonhighly compensated employees contribute to the plans, and each contributes at a rate of 6 percent, the ADP for the lower paid employees will be 3% of compensation. That is, 45 employees each have an ADP of 6 percent, and 45 employees have an ADP of 0 percent. This averages out to 3%. In this instance, the ADP for the highly compensated employees may not exceed 5%, computed as follows. The ADP for the highly compensated employees may not exceed the greater of the ADP for the lower-paid employees (3% × 1.25% = 3.75%) or the lesser of (1) the ADP for the lower-paid employees, plus two percentage points (3% + 2% = 5%), or (2) the lower-paid ADP (3% × 2 = 6%). Any contribution in excess of 5% for the highly compensated employees must generally be refunded.

To avoid this result, the excess contribution, plus earnings, must be distributed before the close of the plan year following the year in which such excess contribution occurs. Contributions made to a 401(k) plan in excess of the ADP limitation will jeopardize the plan's tax-qualified status unless corrected. There is a precise methodology for calculating how corrective distributions should be made. A 401(k) plan must distribute excess contributions starting with the HCEs who deferred the most dollars into the plan (not the highest percentage). The tax consequences of a corrective distribution are summarized in (d) below.

Alternatively, if specifically permitted under the plan, the excess may be recharacterized as a voluntary after-tax contribution and treated as if it had been contributed to the plan.

Prior to 2006, 401(k) plans with an ESOP feature were required to disaggregate the ESOP portion for purposes of conducting the ADP and ACP tests. This requirement was eliminated in the final Treasury regulations under IRC Section 401(k), which generally take effect for plan years beginning in 2006.

Plan administrators must report any payment of excess contributions, as they do for payments of excess deferrals. A controller should ensure that all amounts are properly reported on the appropriate Forms W-2 for the correct year.

[c] Rules for Matching and Ater-Tax Employee Contributions

Some 401(k) plans permit employees to make voluntary after-tax contributions in addition to pre-tax contributions. This offers two benefits to employees:

- It allows earnings on after-tax contributions to accumulate on a tax-deferred basis, and
- After-tax contributions are more accessible to participants since they are subject to fewer withdrawal restrictions than pre-tax contributions.

IRC Section 401(m), however, may limit the use of after-tax contributions. This section was enacted because of congressional concern that employer matching contributions and employee after-tax contributions received greater utilization by highly compensated employees. Therefore, this provision establishes a nondiscrimination requirement for employer matching contributions and employee contributions.

Section 401(m) establishes a rule that a plan will not be deemed to satisfy the general nondiscrimination rules of IRC Section 401(a)(4) unless it complies with an ACP requirement. A plan meets the ACP requirement if the contribution percentage for eligible highly compensated employees does not exceed the greater of 1.25 times the contribution percentage for all other eligible employees or the lesser of: (1) two times the contribution percentage for all other eligible employees or (2) the contribution percentage for all other eligible employees plus two percentage points.

Similar to the ADP test for 401(k) plans discussed previously, the ACP is the average of the ratios for each member of either group, as separately calculated. The result of this test is that higher-paid employees are generally limited as to the amount of employee contributions they can make to a plan. This rule requires annual testing, because it can also trigger plan disqualification. A plan will not be disqualified for failure to satisfy this test, however, if any excess aggregate contributions for a plan year are distributed (or if forfeitable, forfeited) before the end of the plan year following the year in which the excess aggregate contribution was made. Excess aggregate contributions must generally be distributed in the same manner as excess contributions, discussed previously.

[d] Summary of Sanctions for Noncompliance

[i] Excess deferrals. Excess deferrals are salary-reduction contributions in excess of the $12,000 limitation of IRC Section 402(g), as indexed ($15,000 for 2006). Excess deferrals are includable in gross income in the calendar year of deferral, with any earnings taxed in the year of distribution. If excess deferrals are not properly withdrawn, the excess amount is includable in the participant's gross income in *both* the year of deferral and the year of distribution (i.e., *a double tax exists*).

[ii] Excess contributions. Excess contributions are salary-reduction contributions in excess of the amount permitted under the ADP test, under IRC Section 401(k). If such excess contributions and any earnings are not distributed within 12 months after the plan year in which discrimination occurs, a plan will be disqualified and a 10% tax will be imposed on each employee. In addition, if an excess contribution is not distributed within 2½ months after the end of a plan year, a 10% excise tax is imposed on the employer under IRC Section 4979.

Excess contributions and earnings made to an employee within 2½ months after the close of a plan year, are includable in a participant's gross income in the taxable year for which such contributions are *made* (and are not taxable in the year of receipt). If the excess contribution and earnings are not distributed within this 2½-month period, or if they are less than $100, they will be included in the participant's gross income when *distributed*. Some employers intentionally make distributions after the end of this 2½ month period, despite the 10% excise tax to the employer, to avoid requiring the employee to file amended tax returns for a prior year.

To the extent permitted in the regulations, excess contributions (but not excess deferrals or excess aggregate contributions) may be recharacterized as employee after-tax contributions instead of being distributed. In this event, recharacterized excess contributions must nevertheless be reported as a corrective distribution in order for such amount to be properly included in an individual's income.

[iii] Excess aggregate contributions. Excess aggregate contributions are matching and after-tax contributions (and any basic or salary reduction contributions taken into account under the ADP test on an elective basis). Excess aggregate contributions and earnings must generally be distributed in the same manner as excess contributions.

F1.06 MISCELLANEOUS PLAN PROVISIONS

Numerous other rules also apply to qualified plans. The purpose of this chapter is not to provide an exhaustive explanation for all these rules, but rather to alert controllers to important issues that warrant a general understanding. The following provisions are summarized to provide a more complete understanding of qualified plans.

[1] Social Security Integration

All employers provide retirement benefits to their employees, whether or not a qualified plan is in existence, because of the employer's portion of Social Security tax payments made on behalf of each employee. In recognition of these payments, the law permits an employer to "integrate" its retirement plan with the Social Security system. If a plan is integrated, it essentially means that an employer may reduce the contribution that it would otherwise be required to make to a plan by the amount it is paying as employment taxes to provide Social Security benefits to all plan participants. The result of this approach is generally that reduced benefits are provided under a plan for lower-paid employees, since their Social Security benefits will represent a significant portion of their ultimate benefit.

Establishing an integrated plan can achieve substantial savings for an employer while providing larger, although not disproportionate, benefits to higher paid employees.

[2] Plan Freeze and Plan Termination

As the funding obligations and other ERISA requirements on defined benefit plans increase, employees have become more receptive to freezing or terminating their pension plans. In some cases these former defined benefit plan accruals are being replaced by new defined contribution plans, or by supplemental contributions to existing defined contribution plans.

[a] Freeze versus Termination

As an initial matter, a plan termination is different from a plan freeze. A termination is the complete cessation of a plan, followed by the distribution of all assets to participants. A plan freeze, on the other hand, generally means a cessation of future accruals for covered participants. Existing benefits remain untouched, and no new participants can enter the plan. In some cases, however, a plan may be frozen as to new entrants, but may allow existing participants to continue to accrue new benefits. Unlike a terminated plan, a frozen plan continues to be subject to all legislative and regulatory changes, filing requirements, PBGC premiums, reporting and disclosure on the same basis as an active plan.

When a qualified plan termination occurs, the plan sponsor must fund all "benefit liabilities" under the plan. This means that all accrued benefits to the extent funded (for a defined benefit plan), or the amounts credited to a participant's account (in a defined contribution plan) must become 100% vested and payable under Section 411(d)(3) of the IRC. If plan assets are inadequate to pay benefits, the plan sponsor must commit to make-up the difference with additional contributions.

[b] Plan Document

The decision to terminate a plan is generally made by the board of directors, or perhaps by senior officials on behalf of the plan sponsor. As a threshold matter, it is critical to check the terms of the plan to verify which entity is authorized to effect a plan termination. A board resolution may be required, depending on the terms of the plan.

For both a plan freeze and a plan termination, an amendment to the plan document is required. Again, the plan terms will confirm the proper procedures for a plan amendment. In some cases, an amendment can be executed by an individual official on behalf of the plan sponsor, and in other cases the signature of a committee may be required.

After the appropriate corporate action is taken to approve the freeze or termination, plan administrators must undertake certain actions to terminate the plan effectively under the rules of both the PBGC and the IRS. A plan must be amended to comply with all tax laws prior to termination. In addition, plan participants must be timely notified of the termination.

[c] Participant Communications

In addition to an amendment to freeze or terminate the plan, the administrator of a defined benefit or money purchase plan must provide a notice to each participant and alternate payee regarding the cessation of benefit accruals. This notice generally must be provided at least 45 days before the effective date of the amendment, although a shorter period applies for certain corporate transactions and for small plans (fewer than 100 participants). This notice is known as the "204(h) notice." Section 204(h) of ERISA requires that participants be given notice of any plan amendment that significantly reduces the rate of future benefit accruals. Although a "significant" reduction is not defined by statute, this concept is interpreted by the Treasury Department based on the reasonable expectations of the applicable participant, in light of the relevant facts and circumstances at the time the amendment is adopted.

The 204(h) notice must include sufficient information to enable applicable individuals to understand the effect of the plan amendment, and the magnitude of the change. Treasury regulations require both a narrative explanation, in layperson's terms, and either illustrative examples or individualized statements. A 204(h) notice can be delivered by first class mail or hand delivery, but it cannot be posted. Under certain conditions, a 204(h) notice can be delivered electronically (such as by email, or by hyperlink to a webpage).

In 2001, EGTRRA extended the reach of Section 204(h), to encompass any plan amendment that eliminates or reduces any early retirement benefit or retirement-type subsidy. This substantially broadens the contexts in which this participant notice may be required. EGTRRA also added an excise tax for noncompliance.

Failure to deliver the required 204(h) notice results in two adverse consequences. First, an egregious failure to comply with the notice requirement can result in disregard of the amendment altogether. In other words, participants are granted the "better of" the benefit they would have received with—or without—the amendment. Second, a failure to provide notice can subject the plan to a steep excise tax under Section 4980F of the IRC. This excise tax equals $100 *per recipient* for each day until the notice is provided. There are some exceptions where reasonable diligence is exercised, including a cap of $500,000 per taxable year.

A 204(h) notice is not required for a 401(k) plan, or any other type of profit-sharing or stock bonus plan.

[d] PBGC Requirements

A series of notices must be issued in order to effect a standard plan termination of a defined benefit pension plan. Below are the various steps to be taken to satisfy the PBGC requirements.

First, the plan administrator must provide a Notice of Intent to Terminate (NOIT) to all affected parties (other than the PBGC). For this purpose, "affected parties" include plan participants, beneficiaries of deceased participants, and alternate payees under a qualified domestic relations order. The NOIT must be issued at least 60 days but not more than 90 days prior to the proposed termination date. A Power of Attorney form may be required as well.

Second, the plan administrator must notify each affected party of the plan's upcoming termination. This Notice of Plan Benefits must be issued no later than the filing of the PBGC Form 500 described below. It must include a description of the amount and form of benefit that each individual is entitled to receive, calculated as of the proposed date of termination. This notice must be either hand-delivered or delivered by first class mail to each individual's last known address.

Third, the plan administrator must notify the PBGC, no later than 180 days after the proposed termination date. This is accomplished by filing PBGC Form 500 (Standard Termination Notice), along with Schedule EA-S (Standard Termination Certification of Sufficiency). The PBGC has 60 days after receiving a complete Form 500 to review the termination for compliance with the law and regulations; this 60-day period may be extended by the agency.

Note that the PBGC is not required to take any action in order for a termination to be effective. If the PBGC does not issue a Notice of Noncompliance within its 60-day review period, the plan administrator has 180 days to distribute all plan assets (or

120 days after receiving a favorable determination letter from the IRS, if later). The plan administrator may request an extension of time by written request with the PBGC. Extensions are discretionary on the part of the PBGC.

Fourth, where the PBGC does not issue a Notice of Noncompliance, the plan administrator can prepare to distribute the plan's remaining benefits. Several additional notices must first be delivered to affected parties (other than the PBGC) where benefits are available in the form of an annuity. These notices include the Notice of Annuity Information, no later than 45 days before the distribution date, and the Notice of Annuity Contract, no later than 30 days after the annuity contract is available.

Fifth, the plan administrator will distribute all plan benefits to participants and beneficiaries. Typically, this means purchasing annuities on behalf of these individuals. After all liabilities have been satisfied, any excess assets may revert to an employer, to the extent that the plan permits a reversion and has not been amended within the last five years to permit a reversion to occur. If any participants and beneficiaries cannot be located, the plan administrator must file a Schedule MP and the applicable attachments with the PBGC. (See discussion below.)

The final step is for the plan administrator to file PBGC Form 501 (Post-Distribution Certificate for Standard Termination) to inform the PBGC that all benefits have been paid. This form is due no later than 30 days after all benefits have been distributed. The PBGC will assess a penalty for late filings of the Form 501 only to the extent that it is filed more than 90 days after the distribution deadline.

Throughout the termination process, the PBGC may make inquiries about the manner in which payments will be made (i.e., annuities or lump sum payments) and the insurance carriers being considered for the purchase of any annuities. The issues raised in connection with the purchase of annuities are addressed further in the following.

[e] IRS Requirements

It is standard practice to request a favorable determination letter from the IRS upon termination of a plan. Receipt of this letter ensures that all benefits from the plan are treated as tax-qualified distributions, entitling the participants to favorable tax treatment. The steps in the process are as follows:

First, as with the PBGC, the plan administrator begins by notifying the affected individuals. This notice is called a Notice to Interested Parties. It can be issued via first class mail, between 10 and 24 days before the IRS filing date. Alternatively, it can be posted at the site where other employment notices are displayed, between 7 and 21 days before the filing.

Second, the following items must be filed with the IRS:

- Form 5310 (Application for Determination Upon Termination)
- From 6088 (Distributable Benefits from Employee Pension Benefit Plans), for all defined benefit or underfunded defined contribution plans.
- Form 2848 (Power of Attorney)
- Form 8717 (User Fee for Employee Plan Determination Letter Requests). The application fee for terminating a plan is $1,000 if no determination is requested with regard to the general test or average benefits test, and the fee is $1,800 if a broader determination letter is desired (as of 2006).
- Copies of all records of all actions taken to terminate the plan (e.g., Board resolution)
- A copy of the plan document
- A copy of all amendments since the last determination letter, along with a statement explaining their impact. It is expected that each plan will be amended to comply with all recent tax legislation and other guidance prior to termination.
- The most recent favorable determination letter for the plan

Third, at the time that all benefits are paid, all participants must receive a rollover notice under IRC Section 402(f) to explain the tax treatment of their distributions and the alternatives available to them.

Fourth, after the assets have been distributed, any excess assets may be returned to an employer. If excess assets revert to an employer, Form 5330, "Return of Excise Taxes Related to Employee Benefit Plans," must be filed with the IRS no later than the last day of the month following the month in which the reversion occurred.

[f] Excise Tax on Reversion

Once all plan assets have been distributed, an employer may be able to recover any excess assets. The amount of this reversion generally is subject to a 50% excise tax under IRC Section 4980. The excise tax may be reduced to 20%, however, if an employer either (1) transfers at least 25% of the reversionary assets to a qualified replacement plan, or (2) increases benefits in the terminating plan equal to at least 20% of the prior benefits available to participants. If neither of these actions is taken, the 50% excise tax applies.

In applying these rules, a “qualified replacement plan” is any qualified plan maintained or established by an employer in connection with the termination of the defined benefit plan in which 95% of the active participants in the terminated plan who remain as employees of the employer after the termination are active participants in the replacement plan. If the replacement plan is a defined contribution plan, the transferred assets must be allocated among the participants in the plan year in which the transfer occurs or ratably over a seven-year period.

Employers that are in bankruptcy are subject to the 20% tax, whether or not they maintain a qualified replacement plan.

Any amendment to a defined benefit plan entitling an employer to a reversion upon the termination of a plan generally will be ineffective for five years following the adoption of such an amendment, under IRC Section 4044(d)(1). Accordingly, all plans should be reviewed, or, if necessary, a special amendment should be adopted to permit reversions.

[g] Missing Participants

A plan administrator must distribute all plan benefits to participants and beneficiaries before completing the plan’s termination. The plan administrator has a fiduciary obligation to conduct a diligent search for each individual. A diligent search includes utilizing a commercial locator service and/or the letter forwarding services offered by the IRS and Social Security Administration. It also includes inquiry of any plan beneficiaries of the missing participant whose names and addresses are known.

Where an individual cannot be found after a diligent search, the plan administrator must either: (i) purchase an annuity from a private insurer in that person’s name and provide information to the PBGC on his or her behalf, or (ii) transfer the value of the person’s benefit to the PBGC’s Missing Participants Program. In addition, as described above, a Schedule MP must be filed with the PBGC. The deadline for purchasing an annuity is the same as applies to other benefits generally. The deadline for transferring assets to the Missing Participants Program generally is the deadline for filing the PBGC Form 501 (Post-Distribution Standard Certification). However, the PBGC will only assess a penalty for late payment on behalf of a missing participant to the extent that payment is made more than 90 days after the benefit distribution deadline.

[h] Reportable Events

As discussed in more detail below, the plan administrator must notify the PBGC of certain “reportable events” that might jeopardize a defined benefit plan’s funding status. These include certain events which may precipitate a plan termination, such as a failure to make required contributions, a reduction in the number of active participants, or an inability to pay benefits when due. The PBGC may assess a penalty up to $1,000 for each day for a failure to comply.

[i] Transfer of Excess Assets to Fund Retiree Health Benefits

A pension plan can provide for retiree medical benefits under certain limited circumstances. IRC Section 401(h) allows a pension plan to transfer excess assets to a special account for these purposes, without disqualifying the plan. The amounts transferred would not be treated as a reversion subject to excise tax under IRC Section 4980, and they would not be subject to the prohibited transaction provisions of the IRC or ERISA. In order to qualify for the special treatment, the following conditions must be met:

- A separate account must be established for the transferred funds. In addition, a separate sub-account must be created with respect to benefits payable to 5% owners and their spouses and dependents.
- The medical benefits must be secondary to the pension benefits, which remain primary.
- The transfer may be made only once in any taxable year of the employer, under IRC Section 420. Transfers are limited to tax years ending before January 1, 2013, unless this provision is further extended (as it has been several times).
- The transferred assets must be used to pay certain retiree health benefit liability, and any excess funds must revert to the employer when this purpose is satisfied.
- Certain vesting requirements must be satisfied with respect to benefits under the pension plan.
- The employer must satisfy a minimum cost requirement with respect to the retiree health benefits provided in the year of the transfer and the following four years.
- The amount transferred cannot exceed certain limits.
- The transfer must satisfy the qualification rules of the Code and the fiduciary and prohibited transaction rules of the ERISA.

[3] Claims Rules

A qualified plan must set forth a claims procedure for participants and beneficiaries to seek redress for denied benefits. Where the claim of a participant or beneficiary has been denied, the plan must provide written notice explaining the specific reasons for denial, in a manner designed to be understood by the average plan participant. Generally, this notice must be sent within 90 days, although extensions are available.

The claims procedures must allow the participant to request review of the decision within 60 days. This includes the right to review plan documents relating to the denial, the right to submit written comments, and the right to be represented by counsel. A decision by the plan on review is generally due within 60 days. A participant cannot pursue legal action against the plan in court until these administrative remedies are exhausted.

[4] Separate Line of Business Rule

The qualified separate line of business rules represent an exception to the general IRC requirement that all employees of a single employer be taken into account in the aggregate, and that all employees of a controlled group be treated as if employed by a single employer for purposes of the minimum coverage rules and minimum participation rules. This allows an employer to cover a much smaller group of employees, since the coverage and participation rules can be limited to a subgroup of employees. To satisfy these QSLOB requirements, each line of business must offer distinct products or services and must be organized separately.

[5] Pension Benefit Guaranty Corporation Premiums

The Deficit Reduction Act of 2005 raised PBGC premiums substantially, to $30 (from $19) per participant for single-employer defined benefit plans, and to $8 (from $2.60) per participant for multiemployer defined benefit plans. These dramatic increases took effect for plan years beginning on or after January 1, 2006 and will be (for the first time) indexed for wage inflation beginning in 2007.

Underfunded pension plans pay an additional variable-rate premium of $9 for each $1,000 of unfunded vested benefits, up to a maximum additional premium of $53 per participant.

The Deficit Reduction Act also introduces a new termination premium payable when a company transfers its underfunded pension plan to the PBGC in a distress termination (such as a bankruptcy or insolvency). This premium equals $1,250 per participant per year, payable for three years after termination.

A plan with fewer than 500 participants must file PBGC Form 1 with the PBGC by the fifteenth day of the ninth month of the plan year. Plans with more than 500 participants must file Form PBGC-1ES and Form PBGC-1 with the PBGC. Form PBGC-1ES is used to pay the flat-rate portion of the premium and is due by the end of the second month of such plan year. Form PBGC-1 is used to pay the variable-rate portion of the premium and is due by the fifteenth day of the ninth month of such plan year.

[6] User Fees

In 2006, the IRS dramatically increased the user fees applicable for issuing determination letters and private letter rulings. Some of these fees as contained in Revenue Procedure 2006-8 are as follows:

	Determination letter without average benefit test and/or any general test Design-based or nondesign-based safe harbor	***Determination letter for the average benefit test and/or any general test:***
Form 5300	$1,000	$1,800
Form 5303	$1,000	$1,800
Form 5310	$1,000	$1,800
Form 5307	$ 300	$1,000

[7] Military Service

USERRA requires that certain military veterans be granted additional rights under qualified benefit plans. Eligible veterans generally include those who are reemployed with the plan sponsor immediately following the completion of military service, where service lasts no more than five years.

These reemployed individuals are entitled to receive service credit for the period of military service, for purposes of vesting in plan benefits. They are also entitled to make up missed contributions to the plan.

[8] Deadline for Qualified Plan Amendments

Qualified retirement plans, in order to retain their qualified status, must be periodically amended to comply with current tax rules. It is important to check the particular deadline for updating plan documents to comply with each piece of legislation. Note that, in general, operational compliance is expected before plan documents need to be formally updated.

For example, as a result of changes made by EGTRRA, employers were initially required to adopt good faith amendments to their plans by the last day of the 2002 plan year, in order to become eligible for a longer remedial amendment period extending until the end of the 2005 plan year. IRS Revenue Procedure 2005-66 further extended this amendment deadline by granting a series of staggered, five-year remedial amendment periods under IRC Section 401(b), with initial ending dates ranging from January 31, 2007 through January 31, 2011. The exact end date for a plan's EGTRRA remedial amendment period depends on the EIN used for reporting purposes, as stated on the plan's most recent Form 5500.

The IRS has also begun publishing a cumulative list of required changes to qualified plans on an annual basis, beginning with IRS Notice 2005-101. This list encompasses statutory, regulatory, and other changes that must be taken into account in a plan sponsor's subsequent submission for a determination letter.

[9] Reporting Obligation for IRA Eligibility

An individual's ability to make deductible (i.e., pre-tax) contributions to an individual retirement account (IRA) is limited if he or she also participates actively in a qualified plan. Specifically, an individual who is an active participant in a qualified retirement plan for any part of a plan year may not make deductible IRA contributions if he or she exceeds certain income limits. Individuals who are not active participants, and whose spouses are not active participants, in a plan may continue to make deductible IRA contributions regardless of their income levels.

Accordingly, employers must report whether an employee is an active participant in a qualified plan, on Form W-2. If controllers are responsible for supervising the issuance of Form W-2, they should consider identifying which employees are active participants well in advance of the preparation of this form.

A limited IRA contribution deduction is permitted for a taxpayer whose adjusted gross income (AGI) (combined with his or her spouse's gross income) is between the income levels listed in the following table. For these individuals, the maximum IRA deduction ($4,000 in 2006, plus potential catch-up contributions of $1,000) is proportionately reduced. No IRA deduction is allowed if the applicable limit is exceeded.

For 2006:

	Full IRA deduction if AGI is below	*Pro-rata IRA deduction if AGI is between limits*	*No IRA deduction if AGI is above*
Single	$50,000	$ 50,000-60,000	$60,000
Married	$75,000	$ 75,000-85,000	$85,000

For 2007 and thereafter:

	Full IRA deduction if AGI is below	*Pro-rata IRA deduction if AGI is between limits*	*No IRA deduction if AGI is above*
Single	$50,000	$ 50,000-60,000	$ 60,000
Married	$80,000	$ 80,000-100,000	$100,000

The determination of whether employees are active participants depends on the type of plan in existence. For example, individuals are participants in a defined benefit plan if they are not excluded from participation under the eligibility requirements for any part of the plan year ending with or within the employees' taxable year. Thus, if employees are *eligible* to participate in a defined benefit plan, they are generally considered active participants. This is so even if the employees are required to make an employee contribution to the plan and elect not to contribute to the plan. With respect to a profit-sharing plan, by contrast, employees are only active participants if (1) any employer contribution is added to their account, (2) any forfeiture is allocated to their account, or (3) any employee contribution is made to the plan. Individuals are not active participants in a profit-sharing plan merely because earnings are allocated to their accounts.

[10] Distribution of Benefits

A thorough discussion of the rules relating to distributions from qualified plans is beyond the scope of this chapter. However, several important issues relating to plan distributions warrant identification.

[a] Participant Consent and Involuntary Distributions

Any distribution of a participant's benefit before normal retirement age or age 62 (whichever is later) requires the written consent of the participant. An exception applies where the participant's vested accrued benefit is no more than $5,000. An accrued benefit with a present value of $5,000 or less can be distributed in a lump sum without participant consent, under IRC Section 411(a)(11). This is often referred to as a "cashout."

EGTRRA made two significant changes to the involuntary distribution rules. First, EGTRRA allowed a plan to value a participant's benefit (for purposes of determining whether the $5,000 threshold is exceeded) without regard to any eligible rollover contributions the participant has made to the plan. This allows a plan to distribute large benefits without participant consent, where most of the funds are attributable to incoming rollovers.

Second, EGTRRA provided that benefits valued between $1,000 and $5,000 must be rolled over automatically to an IRA in lieu of paying a lump sum, where the participant does not affirmatively elect either a distribution in cash or a direct rollover to another qualified plan. Benefits valued below $1,000 can still be distributed in a single lump sum. In practice, many plans elected to reduce their automatic cashout threshold to $1,000 to avoid this IRA rollover requirement.

To determine the present value of a participant's benefit in a defined benefit plan, prescribed actuarial assumptions must be utilized. IRC Section 417(e)(3), as amended by GATT, requires that all present value calculations, for purposes of determining lump sum values, must utilize the 30-year Treasury bond rate and the 1983 Group Annuity Mortality Table (male/female blend). This mortality table was later replaced by an updated 1994 group annuity table in Revenue Procedure 2001-62, for annuity starting dates after the 2002 plan year. In recent years, the Treasury Department has raised the possibility that it will discontinue publishing the 30-year T-bill rates, and plan administrators have anxiously awaited a legislative replacement.

[b] Qualified Joint and Survivor Annuities

All defined benefit plans and any money purchase plans must provide a qualified joint and survivor annuity (QJSA) as the normal form of benefit for married participants, unless another benefit is elected with the written consent of the participant's spouse. This QJSA requirement generally does not apply to any defined contribution plan other than a money purchase plan. However, some 401(k) plans will offer such annuities voluntarily, or will be required to offer a QJSA due to a prior transfer of assets and liabilities from a money purchase plan.

IRC Section 417(a) requires that a plan notify a participant of the right to waive the QJSA. This QJSA notice must be distributed between 30-90 days before the annuity starting date. A participant may commence a distribution in fewer than 30 days after receipt of this notice, so long as the participant is advised that a 30-day election period is available. In any event, there must be at least a 7-day after issuance of the QJSA notice before a check is cut.

The QJSA notice must explain the QJSA, its relative value compared to other benefit forms, the right of the spouse to withhold consent to a waiver of the QJSA, and the participant's right to revoke the waiver. In 2003, the Treasury Department expanded these requirements, out of concern that some forms of benefit were subsidized but were not selected by participants because these subsidies were not apparent. Accordingly, plan administrators now must supply additional detail for each optional form of benefit available, either in generic form or as specific examples tailored to each participant. This supplemental information must include a description of each optional form, its eligibility conditions, the financial effect of electing the benefit, and any other material factors. These relative value regulations generally became effective for benefits commencing on or after February 1, 2006, with an earlier effective date (October 1, 2004) for lump sums and level income benefits.

[c] Retroactive Annuity Starting Date

In some cases, a retroactive annuity starting date (RASD) can be used. To understand this rule, it is important to note that a participant's benefit may be calculated "as of" one date (the annuity starting date), but may not be paid until some time later. Beginning in 2004, plans became able to offer an annuity starting date that occurred even *before* the QJSA notice is provided. The participant must affirmatively consent where a RASD is applies, and the plan must pay interest to the participant to compensate for the delay in payment. This RASD provision provides a mechanism for correcting mishaps such as, for example, a failure to pay distributions to a participant in a timely manner.

[d] Qualified Preretirement Survivor Benefits

In addition, plans that must provide joint and survivor annuities must also provide a qualified preretirement survivor annuity (QPSA) to the spouse of a deceased married participant. If an employer subsidizes the cost of a QPSA, no notices must be given to the participants. If an employer does not subsidize the cost of providing a QPSA, the cost of this benefit is borne by the participants and they must receive notice of their right to waive this benefit with the consent of the participant's spouse. Because the decision to subsidize the QPSA may be determined based on cost factors, controllers may be involved in this decision.

Note that not all plans are required to provide a qualified preretirement survivor annuity. Exempt plans, such as 401(k) plans, must provide that a married participant's balance be distributed to his or her surviving spouse unless waived.

[e] Withholding

Upon the distribution of benefits, withholding of taxes will be required. A distribution may be subject to state and local income tax withholding. Moreover, all eligible rollover distributions are subject to automatic 20% federal income tax withholding.

Generally speaking, all taxable distributions from qualified plans or 403(b) annuities are "eligible rollover distributions" that can be rolled over into another qualified plan or IRS except: (1) installments for a period spanning 10 years or more; (2) annuity payments paid over a life expectancy; and (3) required minimum distributions (generally, distributions triggered by the later of age 70½ or retirement).

A qualified plan must provide employees with a direct rollover option under IRC Section 401(a)(31). A direct rollover option must provide the distributee the opportunity to choose to have the eligible rollover distribution paid directly to an IRA or to a qualified plan that accepts such a distribution. The direct rollover is in addition to the regular rollover options, which allow a distributee to roll over the distribution to an eligible retirement plan.

[f] 402(f) Notices

To better educate participants about their distribution options and the tax consequences of a distribution (as opposed to a rollover), employers are required to issue a "402(f) notice" prior to commencing a benefit. This written explanation must be issued within a reasonable amount of time before making an eligible rollover distribution. It must explain (1) the availability of the direct rollover option; (2) the rules regarding mandatory income tax withholding on eligible distributions; (3) the rules under which a distributee may roll over the distribution within 60 days; and (4) if applicable, other special tax rules.

[g] Required Minimum Distributions

A qualified plan must begin to distribute benefits to a participant after he or she attains age 70½. These minimum distributions must begin no later than April 1 following the close of the calendar year in which the participant reaches age 70½. A plan can permit these minimum distributions to be delayed until April 1 following the year in which the participant retires from the employer sponsoring the plan, if later. If the participant dies before distributions begin, IRC Section 401(a)(9) and its regulations provide specific rules about distribution to beneficiaries.

[11] Anti-alienation Provisions and Qualified Domestic Relations Orders

A qualified plan must provide that benefits may not be assigned or alienated. A major exception to this general rule is provided for qualified domestic relations order (QDROs). A QDRO is a domestic relations order that creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable to a plan participant. A typical QDRO is issued upon divorce and provides that a spouse is entitled to receive 50% of a participant's vested plan benefits either immediately or at some time in the future, based on accruals that accumulated during the marriage. A QDRO can also be established for a child or other dependent.

To be certified as a QDRO, a domestic relations order must meet certain requirements. It must specify the name of the plan affected, the parties involved, and the amount of benefits being assigned to the alternate payee. In addition, certain requirements exist to protect the plan. A QDRO cannot provide benefits of a type of form beyond what is permitted by the plan. Nor can it require payments of increased actuarial value, or payments that are promised to another alternate payee under a separate QDRO. Often a QDRO will divide the participant's benefit into two portions, with an independent "separate interest" assigned to the alternate payee. In 2005, the DOL began to allow plans to charge a participant for the cost of processing a QDRO involving the participant's benefit.

Upon receipt by a plan of a domestic relations order, the plan administrator is required to notify the participant and each alternate payee of the receipt of such order. The plan administrator must also notify these individuals of the plan's procedures for determining if an order satisfies all the statutory requirements to be a QDRO. While this determination is being made, the plan administrator must freeze the funds which might be payable to the alternate payee. In other words, these funds will be unavailable for distribution to the participant until a distribution is made, which can take up to 18 months. In 2005, the DOL began to allow plans to charge participants for the cost of processing a QDRO.

A plan must have procedures in place to address the receipt of QDROs and the plan's response. Although it is unlikely that a controller would be involved in evaluating the domestic relations order directly, it is advisable for the controller to ensure that the necessary administrative procedures exist.

Other exceptions to the anti-alienation rules relate to criminal activity, and to bankruptcy. TRA 1997 amended ERISA and the IRC to allow attachment of a participant's retirement benefit in two situations: (1) where he or she is convicted of a crime involving a violation against the plan, or (2) where there is a civil judgment by a court, or a settlement agreement between the participant and the DOL or PBGC, with regard to a participant's fiduciary breach. In the second scenario, the court order or settlement agreement must provide specifically for the offset.

Prior to 2005, litigation often addressed whether ERISA's anti-alienation principles protected a participant's qualified plan assets from the reach of creditors in bankruptcy. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 appears to have resolved this issue by excluding retirement plan assets from bankruptcy court claims.

[12] Rules for Top-Heavy Plans

Special rules apply to plans that are determined to be "top-heavy." A defined benefit plan is top-heavy if, as of the applicable determination date, the present value of accrued benefits of all key employees exceeds 60% of the value of the accrued benefits of all employees. A defined contribution plan is top-heavy if, as of the applicable determination date, the total of the accounts of all key employees exceeds 60% of the total of the accounts of all participants. In applying these tests, a key employee must be distinguished from the definition of highly compensated employee that is utilized for purposes of applying the nondiscrimination tests.

A key employee generally includes any employee who is in one of the following categories at any time during the plan year being tested or the preceding plan year:

- An officer of the employer having annual compensation greater than $130,000 (indexed after 2002 in $5,000 increments)

- A 5% owner of the employer
- A 1% owner of the employer having an annual compensation from the employer of more than $150,000, as indexed

The top-heavy rules require the aggregation of all plans maintained by related employers, if these employers are treated as a single employer for pension plan purposes under IRC Section 414. This includes each plan in the controlled group: (1) in which a key employee is a participant, and (2) that enables any plan to satisfy the coverage and nondiscrimination rules. A plan sponsor may also elect to permissively aggregate any plans, if the affected plans will continue to satisfy the coverage and discrimination rules.

Once a plan or group of plans is determined to be top-heavy, certain special qualification requirements must be satisfied. These include:

- *Minimum vesting*. A top heavy plan must utilize either a three-year vesting schedule or a six-year graded vesting schedule (similar to the vesting schedule for 401(k) matching contributions, as amended by EGTRRA). Under the three-year vesting schedule, employees who complete at least three years of service with the employer must be eligible to participate in a plan and are 100% vested in their benefit. The six-year graded vesting schedule provides that employees must become vested as follows:

Year of Service	*Vested Percentage*
2	20
3	40
4	60
5	80
6	100

- *Minimum benefits*. Under a top-heavy defined benefit plan, the annual retirement benefit for a non-key employee must not be less than the employee's average compensation multiplied by the lesser of: (1) 2% multiplied by the employee's years of service or (2) 20%. For a top-heavy defined contribution plan, the employer's contribution for each non-key employee must not be less than 3% of the employee's compensation. If the highest contribution percentage rate for key employees is less than 3% of compensation, however, the 3% minimum contribution rate is reduced to the rate that applies to the key employees.
- *Compensation limitation*. For any plan year in which a plan is determined to be top-heavy, an employee's compensation will be considered only up to the limit of IRC Section 401(a)(17) ($220,000 for 2006) in determining contributions or benefits.

F1.07 FIDUCIARY RESPONSIBILITIES

Controllers must not only be knowledgeable of the general provisions of a qualified plan, they must also be familiar with the general fiduciary rules relating to such plans. In recent years, fiduciary litigation has become more prevalent and potential liability has therefore increased. ERISA established standards for plan investments and transactions and imposed additional restrictions and responsibilities on plan fiduciaries.

[1] Definition of a Fiduciary

The threshold question is: Who is a fiduciary? Under ERISA, the definition of a fiduciary is functional in nature. That is, an individual will be a fiduciary if he or she performs the duties of a fiduciary, regardless of whether a plan document or contract applies this label.

A fiduciary is defined to include any person who (1) exercises any discretionary authority or discretionary control over the management of a plan or over the management or disposition of the assets of the plan; (2) renders investment advice (direct or indirect) to the plan for a fee or other compensation or has the authority or responsibility to do so; or (3) has any discretionary authority or discretionary responsibility in the administration of the plan. In general, attorneys, accountants, and consultants are not fiduciaries. An examination of the facts and circumstances of each situation is required, however, to make this determination.

Every employee benefit plan is required to have at least one "named fiduciary" designated in the plan document as being responsible for operating the plan. If the employer is designated as the named fiduciary, it is recommended that a committee be established by the employer to perform designated activities.

[2] General Fiduciary Duties

A fiduciary's general responsibilities include acting solely in the interest of participants and beneficiaries and diversifying investments to minimize the risk of large losses, unless it is clearly not prudent to do so. These rules may be more specifically identified to include the following:

- *Exclusive Benefit Rule*: To act for the exclusive purpose of providing benefits to participants and beneficiaries, and defraying reasonable administration expenses;
- *Prudence*: To act with the care, skill, prudence, and diligence that a prudent man would exercise;
- *Diversification*: To minimize the risk of large losses by diversifying the investment of a plan, unless it is clearly prudent not to do so under certain circumstances; and
- *Operational Compliance*: To follow the terms of a plan.

A related general restriction is that most defined benefit plans and money purchase plans are not permitted to have more than 10% of the fair market value of the plan assets invested in a combination of "qualifying employer securities" and "qualifying employer real property" as defined in Section 407 of ERISA and IRC Section 4975(e). This rule generally does not exist for eligible individual account plans (such as 401(k) plans), that can invest in excess of the 10% limit without violating the diversification or prudence rules.

[3] Prohibited Transactions

Under ERISA, a plan fiduciary is prohibited from engaging in certain specific transactions with a party-in-interest. A party-in-interest is defined as any fiduciary or employee of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee association whose members are covered by the plan, a person who owns 50% or more of such an employer or employee association, or relatives of any of the persons described previously. For purposes of the Code, the term "disqualified person" is utilized in lieu of the term "party-in-interest," although the terms are virtually identical.

The following transactions between a plan and a party-in-interest are prohibited under Section 406 of ERISA and IRC Section 4975(c).

- The sale, exchange, or leasing of property
- A loan or other extension of credit
- The furnishing of goods, services, or facilities, except as otherwise provided
- A transfer of plan assets to a party-in-interest for the use or benefit of a party-in-interest
- An acquisition for the plan of any employer securities or real property, except as otherwise provided

In addition to the prohibited transactions listed previously, fiduciaries are also restricted from engaging in certain actions. Fiduciaries are prohibited from (1) dealing with the assets of the plan in their own interests or for their own accounts; (2) receiving consideration for their own accounts, from any party dealing with the plan, in connection with the transactions involving the plan's assets; and/or (3) acting in any transactions involving a plan on behalf of a party whose interests are adverse to that of the plan, its participants, or beneficiaries. For example, an employer cannot invest plan assets in the purchase of real estate owned by an employee.

[a] Exemptions From Prohibited Transaction Rules

Even though certain transactions are prohibited, exemptions from the general prohibited transaction rule do exist. Both the IRC and ERISA specifically exclude certain transactions from the prohibited transaction rules. The most common exceptions are:

- Any loan made to a party in interest (or disqualified person) if such loan is available to all participants, is adequately secured, bears a reasonable rate of interest, and is not available to highly compensated employees in an amount greater than that available to other employees. This would cover loans uniformly available under a 401(k) plan.
- Any contract or reasonable arrangement with a party in interest (or disqualified person) for office space or legal, accounting, or other necessary services if no more than reasonable compensation is paid.

In addition to the specific transactions that are permitted, the Code and ERISA contain a procedure whereby either specific exemptions or class exemptions may be granted. The authority for granting such exemptions exists with DOL.

[b] Penalties for Prohibited Transactions.

Under ERISA, any fiduciary who engages in a nonexempt prohibited transaction is personally liable to the plan for any losses incurred by a plan resulting from such breach. A fiduciary must also restore to the plan any profits that the fiduciary obtains as a result of a breach of his fiduciary duty.

The IRC also imposes a tax on certain enumerated prohibited transactions. Under Section 4975 of the IRC, as amended by TRA 97, a 15% excise tax is imposed on the amount involved in a prohibited transaction for each year, or part thereof, during which a prohibited transaction remains uncorrected. This tax is imposed on any disqualified person who participates in the transaction. In addition, if the initial 15% excise tax is imposed and such transaction is not corrected within the same taxable period, the IRC imposes an additional tax of 100% of the amount involved.

A fiduciary breach is also subject to a civil penalty of up to 20%, imposed by the DOL, under Section 502(l) of ERISA.

If a prohibited transaction occurs, it is important to determine the amount involved and to correct the transactions as soon as possible. To report the transaction, and pay the applicable tax, IRS Form 5330, "Return of Excise Taxes Related to Employee Benefit Plans," should be completed.

Other exceptions and rules are described in ERISA, the IRC, and other regulations and rulings. The controller should obtain advice of legal counsel when investigating a possible prohibited transaction, breach of fiduciary duty, or any exemptions thereto.

[4] ERISA Section 404(c) Regulations

The DOL has issued regulations under Section 404(c) of ERISA that deal with participant-directed investments in individual account plans. If a transaction meets the requirements of ERISA Section 404(c), fiduciaries are relieved from liability for losses on investment decisions *to the extent* that participants exercise control over the investment of their accounts. The regulations propose a number of conditions that a plan must meet if its fiduciaries are to be relieved from liability. If a plan permits participants to direct the investment of their account, controllers must make sure that each investment decision independently meets the requirements.

In order to exercise control over his or her accounts, a participant must be given sufficient investment information without having to make a request. This includes all of the following:

- An explanation that the plan is intended to be a 404(c) plan.
- A description of the investment alternatives available under the plan, and the risk and return of each alternative.
- Identification of the investment managers.
- An explanation of when and how investment instructions may be made, and any limitations or restrictions.
- A description of transaction fees and expenses.
- The name, address and phone number of the plan fiduciary who will provide more information on request.
- If employer securities are provided, a description of the procedures for securing confidentiality of purchase/sale transactions and voting rights.
- A prospectus, immediately prior to or following investment in any assets subject to the Securities Act of 1933.
- Description of voting rights.

Additional information must be available upon request.

In addition, the regulations require that the plan offer a broad range of investment alternatives. The plan must offer at least three diversified categories of investments, and each category must have material differences in its risk and return characteristics.

[5] Plan Assets

Section 403(a) of ERISA provides generally that all qualified plan assets must be held in trust. An additional rule applies for retirement plans in which the employee makes contributions, either after-tax or on a salary reduction basis. These employee contributions must be treated as plan assets—and transferred to the trust—as soon as practicable after they are contributed by the employee, in accordance with DOL regulations. In no event can this transfer occur later than 15 business days after the end of the month of contribution. In practice, the DOL frequently expects this transfer to occur much earlier.

A controller should understand which funds qualify as "plan assets" subject to the fiduciary rules. Of concern is whether an investment by the plan will result in the underlying assets of the *investment* becoming plan assets as well. For many investments, this "look-through" treatment is not the case. For example, investment in publicly traded securities and investment in debt instruments is not subject to this look-through rule. Neither is investment in a venture capital operating company, or a real estate operating company, so long as these VCOCs and REOCs meet certain requirements.

[6] Payment of Plan Expenses

ERISA permits the use of plan assets for the exclusive purpose of providing benefits to participants and beneficiaries, and to defray reasonable expenses of administering the plan. The DOL has ruled that it is a prohibited transaction for the plan to pay settlor expenses. This includes decisions by the employer regarding significant design issues facing the plan, such as the decision to terminate a plan.

Conversely, the payment of administrative and fiduciary expenses by plan assets is considered permissible. The DOL has interpreted this to include expenses necessary to keep the plan tax-qualified, such as the costs of implementing a plan termination. This might include, for example, the cost of preparing a plan amendment to terminate the plan, as well as the cost of submitting a request for a determination letter upon termination with the IRS.

In 2003, the DOL issued additional guidance on the payment of plan expenses from defined contribution plans. In Field Assistance Bulletin 2003-3, the DOL authorized the allocation of general plan expenses to participants, pro rata based on account balances. It also permitted a per capita allocation of general administrative plan expenses. This Bulletin also allowed a plan to charge a specific participant for the reasonable cost of individual transactions such as hardship withdrawals, QDROs and distributions.

It is frequently difficult to distinguish a settlor expense from an administrative or fiduciary one. Accordingly, a controller should proceed with caution when paying plan expenses from plan assets, to avoid an inadvertent prohibited transaction.

[7] DOL Voluntary Fiduciary Correction Program

The DOL has established a program under which plan officials can voluntarily correct a transaction that may be considered a breach of fiduciary responsibilities. After correction is made under the Voluntary Fiduciary Correction (VFC) program, the DOL will issue a no-action letter as to the breach. The VFC program is limited to the transactions listed below:

- Delinquent participant contributions, including 401(k) plan contributions.
- Fair market interest rate loan to party in interest.
- Below-market interest rate loan to a person who is not a party in interest.
- Below-market interest rate loan solely because of delay in perfecting security interest.
- Purchase of an asset (including real property) by a plan from a party in interest.
- Sale of an asset (including real property) by a plan to a party in interest.
- Sale and leaseback of real property to a sponsoring employer.
- Purchase of an asset (including real property) by a plan from a non-party in interest at other than fair market value.
- Payment of benefits without properly valuing plan assets on which payment is based.
- Payment of duplicative, excessive or unnecessary compensation.
- Payment of dual compensation to plan fiduciaries.

In addition, for the asterisked transactions above, the IRS will provide relief from the prohibited transaction excise taxes, so long as the transactions are conducted at fair market value or fair rental value, as applicable.

The DOL requires that any correction under the VFC program involve a notice to plan participants regarding the failure.

[8] Bonding of Plan Fiduciaries

Bonding is required with respect to each fiduciary or plan official responsible for handling plan funds. The purpose of bonding is to protect the plan against any loss that might result from fraud or dishonesty by plan officials. Bonding serves a different purpose than fiduciary liability insurance, which is intended to protect the fiduciary rather than the plan.

F1.08 REPORTING REQUIREMENTS

Various reports must be prepared and filed on behalf of qualified plans with the IRS, the DOL and the PBGC, while other notices must be furnished to plan participants and beneficiaries. The plan administrator is required to file an annual report on behalf of most plans with the DOL which, in turn, provides a copy to the IRS and PBGC. This annual report includes financial statements and schedules, an actuarial statement certified by an enrolled actuary (for defined benefit plans), and other information.

This chapter does not provide an exhaustive summary of all reporting and disclosure requirements, but it does, however, outline the following requirements for pension plans:

- The Annual Report/Return – Form 5500 Series + Schedules
- Audit Requirement
- Financial Statement Requirement

Reporting requirements for welfare benefit plans are addressed in the separate chapter on Health and Welfare Benefit Plans.

[1] Annual Report/Return—Form 5500 Series

The most significant report to the controller is the annual report (Form 5500). All administrators of plans covered by ERISA (i.e., defined benefit, defined contribution, and welfare benefit plans) generally must file annual reports with the DOL. These reports must be filed for all plans whether or not they are tax qualified, including plans that have ceased to accrue benefits (i.e., frozen plans) and plans to which contributions have been discontinued (i.e., wasting trusts). If the controller is not directly responsible for filing the reports, he should be sure that they are filed timely, with the correct forms and applicable schedules.

For plans with 100 or more participants, the annual report must contain, with certain exceptions, financial statements (with footnotes), separate schedules, and an independent public accountant’s report. Smaller plans may be eligible for simplified reporting rules.

Most one-participant pension plans for owners of a trade or business with more than $100,000 in assets are only required to file Form 5500EZ. The Form instructions specify which type of plans may not qualify for the Form EZ filing. Such a plan with assets below $100,000 for a plan year may be exempt from filing entirely, although a filing may be desirable in order to commence the statute of limitations for that plan year via Schedule P.

[2] Exemptions From Filing

Below are the filing exemptions applicable to pension benefit plans.

[a] Top-Hat Plans

These are unfunded pension benefit plans maintained by an employer to provide benefits to a select group of management or highly compensated employees. These plans generally are permitted to file a one-time registration statement with the DOL, within 120 days of adoption, in lieu of an annual filing requirement.

[b] Excess Benefit Plans

These are unfunded excess benefit plans that provide benefits in excess of the IRC Section 415 limitations.

[c] Fully Insured Plans

A limited exemption applies to certain large plans with 100 or more participants that qualify as fully insured pension plans. A fully insured pension plan is one whose benefits are provided exclusively through insurance contracts or policies, and whose assets are held solely in the general account of an insurance company. These insured plans are not required to file the financial statements, schedules, or the accountant's report as required in Schedules G, H and I. However, these plans must still file an annual report and any remaining schedules (such as Schedules A & B).

[d] Annuity or Custodial Arrangements

Annuity or custodial arrangements under IRC Section 403(b)(1) or (7) not established or maintained by an employer under DOL Reg. Section 2510.3-2(f).

[e] SIMPLE IRAs

These are Savings Incentive Match Plans for Employees of Small Employers that involve SIMPLE IRAs under IRC Section 408(p).

[f] SEPs

These are Simplified Employee Pensions or salary reduction SEPs described in IRC Section 408(k) that conform to the alternative method of compliance in DOL Reg. Section 2520.104-48 or -49.

[g] Foreign Plans

Plans maintained outside the United States primarily for the benefit of nonresidents are required to file a Form 5500 only.

[3] Where and When to File

The Form 5500 reports must be filed with the DOL within seven months after the plan's year end. For example, a plan with a December 31 year-end must file with the DOL no later than July 31 of the following year. An extension of this due date of up to 2½ months may be obtained by filing Form 5558 (Application for Extension of Time to File Certain Employee Plan Returns). Alternatively, a plan may rely on an automatic extension until the due date of the plan sponsor's federal income tax return, if certain conditions are met (including attachment of the extension request for the income tax return to the Form 5500).

The controller should make sure that the applicable Form 5500 is filed prior to its due date. Figure F1.2 below summarizes the specific filing requirements for employees and plan administrators.

[4] Penalties for Failure to File

Plan administrators are subject to a penalty of up to $1,100 a day, up to a maximum of $30,000, for failing timely to file returns with the DOL, unless reasonable cause for delinquency is shown. Additional penalties apply for a failure to submit the actuarial statement ($1,000) or a failure to submit Schedule SSA ($1 per day, per participant).

In 1995, the DOL introduced the Delinquent Filer Voluntary Compliance Program (DFVC). This program facilitates voluntary compliance by plan administrators who are delinquent in filing annual reports by permitting the administrators to pay significantly reduced penalties. Plans are not eligible if they have already been notified by the DOL of the delinquency. The reduced penalty is $50 per day, with caps ranging from $1,000 to $5,000 depending on the delay at issue.

In addition, willful violation of ERISA reporting requirements or knowing misrepresentation may be subject to criminal penalties and substantial monetary sanctions.

[5] Final Return

A final return is required for a pension plan that has terminated and distributed all assets, or that has legally transferred all assets to the control of another plan. For example, a plan that has merged in its entirety into another plan should file a final Form 5500 for the plan year that ends when all plan assets are transferred to the successor plan.

FIGURE F1.2
Summary of Filing Requirements for Employers and Plan Administrators

Applicable Form	Large Pension Plan	Small Pension Plan
Form 5500-EZ	Not required	Must complete if only one participant and spouse
Form 5500	Must complete	Must complete unless eligible for Form 5500-EZ
Schedule A (Insurance Information)	Must complete if plan has insurance contracts for benefits or investments	Must complete if plan has insurance contracts for benefits or investments
Schedule B (Actuarial Information)	Must complete if defined benefit plan and subject to minimum funding standards; also certain money purchase plans	Must complete if defined benefit plan and subject to minimum funding standards; also certain money purchase plans
Schedule C (Form 5500)	Must complete if service provider was paid $5,000 or more and/or an accountant or actuary was terminated	Not required
Schedule D (DFE/Participating Plan Information)	Must complete Part I if plan participated in a CCA, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participated in a CCA, PSA, MTIA, or 103-12 IE.
Schedule E (ESOP Annual Information)	Must complete if ESOP	Must complete if ESOP
Schedule G (Financial Transaction Schedules)	Must complete if Schedule H, line 4b, 4c, or 4d is "Yes"	Not required
Schedule H (Financial Information)	Must complete	Not required
Schedule I (Financial Information — Small Plan)	Not required	Must complete
Schedule P (Annual Return of Fiduciary of Employee Benefit Trust)	Must file to start running of statute of limitations under Code Section 6501(a)	Must file to start running of statute of limitations under Code Section 6501(a)
Schedule R (Retirement Plan Information)	Must complete if defined benefit plan or money purchase plan	Must complete if defined benefit plan or money purchase plan
Schedule SSA (Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits) — *forwarded to Social Security*	Must complete if plan had separated participants with deferred vested benefits to report	Must complete if plan had separated participants with deferred vested
Accountant's report	Must attach	Not required unless Schedule I, line 4k is checked "No"

F1.09 AUDIT REQUIREMENTS

ERISA requires that independent auditors audit the financial statements of pension and welfare plans, which are generally prepared by the corporate controller. These auditors are required to submit a report summarizing their examination with the annual return.

DOL regulations generally do not require the accountant's opinion to encompass information pertaining to both custodial accounts and discretionary trust accounts that are certified by certain financial institutions (e.g., banks and insurance companies). This provision, however, does not eliminate the need for an auditor. An independent audit must be made of other transactions and information included in the financial statements of the plan.

Fully insured pension plans, as discussed above in Section F1.09(2), are not required to submit an auditor's report. A fully insured plan is a plan whose benefits are provided exclusively through insurance contracts or policies and whose assets are held solely in the general account of an insurance company.

Small plans used to be exempt automatically from the auditor's report requirement. Since 2002, however, small plans must satisfy certain requirements before this exemption applies. First, at least 95% of plan assets must constitute "qualifying plan assets". These include employer securities, participant loans, assets held by a bank or insurer, investment or annuity contracts, mutual funds, and participant-directed assets. If plan assets fail to satisfy this 95% threshold, a small plan may still qualify for the exemption if it obtains additional bonding in order to protect the plan. This bonding must equal the value of its qualifying plan assets. Second, a small plan must supply details about the bonding and the financial institutions associated with plan investments in its Summary Annual Report. Where a plan has between 80 and 120 participants at the beginning of the plan year, the plan administrator may elect to follow the same rules for the annual report that applied in the prior year (either the rules for plans with more than 100 participants, or fewer than 100 participants, as applicable).

[1] Sanctions for Failure to Obtain Audit

If a plan is required to have an audit and no audit is obtained, the DOL may reject the plan's annual report. The DOL may also reject an annual report if the accountant's opinion contains a material qualification. If a satisfactory revised report is not submitted within 45 days after such rejection, the DOL may take either of the following actions:

- Retain an independent qualified public accountant on behalf of the participants to perform an adequate audit, at the plan's expense.
- Bring a civil suit for appropriate relief.

[2] Financial Statement Requirements

As previously discussed, most plans are required to attach a financial statement and schedules to their annual return. DOL Regulation Section 2520.103-1 permits plans with 100 or more participants to elect between two methods of complying with this requirement. A plan can either submit its financial statement in accordance with Section 103 of ERISA (the "statutory method"), or it can submit its financial statement in accordance with the method set forth in the regulations (the "alternative method").

There are a number of significant differences between the statutory and alternative methods:

- The statutory method requires that the financial statements be prepared in accordance with generally accepted accounting principles (GAAP), whereas the alternative method does not (although differences from GAAP must be noted). Under the alternative method, a plan may prepare financial statements on a cash basis, accrual basis, or modified accrual basis.
- The alternative method requires the financial statements to be given in a comparative form, whereas the statutory method does not. (The statutory method does, however, require a comparative schedule of assets and liabilities.)
- The alternative method requires all assets and liabilities in the financial statements to be stated at their current value. Although this is not a statutory requirement, ERISA does require the assets and liabilities schedule to be stated on a current-value basis.

As a practical matter, a controller may prefer to follow the alternative method of reporting. Plans generally utilize the statutory method when unwilling to adopt current value as the primary asset valuation method.

[a] Statements Required

A pension plan must include two financial statements, regardless of whether the statutory method or the alternative method is used:

- Statement of assets and liabilities
- Statement of changes in net assets available for plan benefits

The defined benefit pension plan financial statements required by the Financial Accounting Standards Board Statement of Financial Accounting Standards 35 ("FAS 35") are acceptable to the DOL. This means that pension plans should be able to prepare a single set of financial statements in accordance with FAS 35.

[b] Footnote Disclosure

The following footnotes to the financial statements should be “considered” under the statutory method in accordance with Section 103(b)(2) of ERISA. These footnotes are required under the alternative method.

- A description of the plan, including any significant changes in the plan made during the period and the impact of such changes on benefits
- The funding of the plan, including policy with respect to prior service cost and any changes in such policy during the year
- A description of any significant changes in plan benefits made during the period
- A description of material lease commitments, other commitments, and contingent liabilities
- A description of agreements and transactions with persons known to be parties-in-interest
- A general description of priorities upon termination of the plan
- Information concerning whether a tax ruling or determination letter has been obtained
- Any other information required for a full and fair presentation

In addition, the alternative method requires a footnote giving a description of accounting principles and practices and, if applicable, variances from GAAP principles. While this requirement is not specified under the statutory method, it would be necessary under GAAP, even though it is not set forth as a separate item in the statutes.

The alternative method also requires an explanation of the differences, if any, between the information contained in the separate financial statements and the assets, liabilities, income, expenses and changes in any other matters necessary to fully and fairly present the financial condition of the plan.

[c] Schedules

Both the statutory method and the alternative method require certain schedules, usually prepared by the controller, to be attached to the financial statements. The statutory method requires two schedules not required by the alternative method: (1) comparative statements of assets and liabilities at current value and (2) statements of cash and disbursements. Both methods require the following additional items under ERISA § 103(b):

- A schedule of assets held for investments
- A schedule of each transaction involving a person known to be a party-in-interest
- A schedule of all loans or fixed-income obligations that were in default at the close of the plan fiscal year and were classified during the year as uncollectible
- A list of all leases that were in default or were classified during the year as uncollectible
- An annual statement of the assets and liabilities of any common or collective trust maintained by a bank or other institution or a separate account with an insurance company
- A schedule of transactions, or a related series of transactions involving an amount in excess of 5 percent of the current value of plan assets (for purposes of this disclosure, the current value of a transaction is compared with the current value of the plan assets at the beginning of the plan year)

[3] Form and Contents of Returns and Schedules

[a] Schedule of Assets Held for Investment

This schedule requires a detailed list of assets held for investment purposes at the end of the year. It should include:

- The identity of the issuer, borrower, lessor, or similar party
- A description of investments, including the trading date, rate of interest, collateral, and par or maturity value
- Cost
- Current value (and, for a loan, the payment schedule)

Similar information should be given on assets acquired and disposed of within the plan year, except as required below. DOL Regulation Section 2520.103-11 permits the exclusion from this schedule of certain assets which are not held at the end of the plan year, as follows:

- Debt obligations of the United States or any agency of the United States
- Interest paid by a company registered under the Investment Company Act of 1940
- Bank certificates of deposit with a maturity of not more than one year
- Commercial paper with maturity of not more than nine months if it is ranked in the highest rating category by at least two nationally recognized statistical rating services and is issued by a company required to file reports with the SEC under Section 13 of the Securities Exchange Act of 1934
- Participation in a bank common or collective trust
- Participation in an insurance company pooled separate account
- Securities purchased from a person registered as a broker-dealer under the Securities Exchange Act of 1934 and listed on a national securities exchange or quoted on NASDAQ

Cost information may be omitted for assets with respect to participant-directed transactions under an individual account plan.

The DOL also permits the exclusion of assets that are described on one of the separate schedules described in sections Sections F1.09[3][b], F1.09[3][c], F1.09[3][d] or F1.09[3][f] below.

[b] Schedule of Party-in-Interest Transactions

The controller must submit a schedule of each transaction involving a known party-in-interest, unless a statutory or administrative exemption applies under ERISA. This schedule must include:

- Identity of the party involved
- Relationship to the plan, the employer, or other party-of-interest
- Description of transactions, including maturity date, rate of interest, collateral, par, or maturity values
- Purchase price
- Selling price
- Leased rental
- Expense incurred in connection with transaction
- Cost of assets
- Current value of assets
- Net gain or loss on each transaction

[c] Schedule of Obligations in Default

A schedule is required of all loans or fixed-income obligations that were either: (1) in default at the end of the plan's fiscal year, or (2) classified as uncollectible during the year. This includes loans that were written off or renegotiated during the year. This schedule, prepared by the controller, must include:

- Identity and address of the borrower
- The original amount of the loan
- The amount of both principal and interest received during the year
- The unpaid balance at the end of the year
- A detailed description of the loan (including the date the loan was made, maturity date, interest rate, type and value of any collateral), as well as any renegotiation of the loan and such revised terms, and any other material items
- The principal and interest amount overdue (the schedule should also note any of the items due from individuals identified as parties-of-interest)
- An explanation of steps that have been taken or will be taken to collect the overdue amount

[d] Schedule of Leases in Default

The controller must also prepare a schedule of any leases that were either: (i) in default as of the end of the plan year, or (2) classified as uncollectible during the year. This schedule should include the following information relating to the lease transaction:

- The identity of the lessor or the lessee and its relationship to the plan, employer, employee organization, or any other party-in-interest
- The type of property leased and a description of that property, including the location and date it was purchased
- Terms relating to the rent, taxes, insurance, repairs, expenses, renewal options, and date the property was leased
- The original cost of the property, its current value at the time the lease was entered into, and the gross rental receipts during the year
- The expenses paid during the plan year, the net receipts, and the accrual in arrears
- The steps taken to collect the amount due or otherwise to remedy the default

[e] Collective Trusts' Rules

Many employee benefit plans invest in funds sponsored by banks and insurance companies. If these investments are in common or collective trusts of a bank or an insurance company's pooled separate account, DOL regulations do not require that the plan include in its annual report the statement of assets and liabilities of such trusts if the bank or interest carrier files a statement of assets and liabilities directly with the DOL. In such a case, the bank, in addition to filing with DOL, must give the plan administrator a copy of the annual statement of assets and liabilities of any common or collective trusts or pooled separate accounts in which any plan assets are held. The plan then must include in its annual report a certificate that the plan has received the statement from the bank or insurance carrier.

[f] Schedule of Reportable Transactions

The controller may find this schedule to be the most cumbersome one to prepare. It covers all reportable transactions, defined in DOL Regulation Section 2520.103-6 to include the following categories:

[i] Single transaction. A single transaction in excess of 5% of the current value of the plan assets. "Current value" is defined as the fair market value of assets at the beginning of the plan year (or as of the date of acquisition or disposition, if mid-year).

EXAMPLE:
Part-way through the year, Company A buys common stock in Company B in an amount equal to 6% of the value of plan assets, measured at the time of the transaction. This is a reportable transaction.

[ii] Series of non-securities transactions. A series of transactions with or in conjunction with the same person involving property, other than securities, which amount in the aggregate to more than 5% of the current value of the plan assets. For this purpose, a "person" includes an individual, partnership, joint venture, corporation, mutual company, joint stock company, trust estate, unincorporated organization, association, or employee organization.

[iii] Series of securities transactions. A series of transactions with respect to securities of the same issue, which amount in the aggregate to more than 5% of the current value of the plan assets. This covers a purchase, sale or exchange of securities.

[iv] Follow-on securities transaction. Any transaction with respect to securities, or with or in conjunction with a person, if a prior or subsequent single transaction with that person was a reportable transaction.

The schedule generally must contain both the identity of the parties and a description of the assets involved, including interest rates and maturity in the case of a loan. It must also include, where appropriate, the purchase price, selling price, lease rental, expenses incurred with the transaction, cost of the asset, current value of the asset on the transaction date, and the net gain or loss. It is not necessary to provide the identity of the parties where a transaction involved the purchase or sale of a security on the market through a registered broker-dealer. Where multiple transactions involve the same issue of a security, the controller may provide totals rather than information on individual transactions.

Reportable transactions do not include participant-directed transactions under an individual account plan.

F1.10 DISCLOSURES TO PARTICIPANTS

In addition to filing reports with the federal government, a plan is required to make certain information available to the participants. The controller should monitor the plan administrator to ensure compliance with these requirements.

[1] Summary of Annual Reports

Generally, plans that file annual reports must also distribute summary annual reports (SARs) to their participants and beneficiaries each year. A copy of the full annual report must be available upon request, although the plan sponsor may impose a reasonable copying charge for this information.

The purpose of the SAR is to summarize the annual report. The SAR provides basic information about the plan's financial condition, including the value of plan assets, plan expenses, and whether the plan has satisfied its minimum funding obligations. DOL Regulation Section 2520.104b-10 sets forth the format of the SAR for pension benefit plans, with detailed sample language.

Note that, where a significant percentage of the workforce is literate only in a non-English language, the plan administrator may be required to furnish a notice in that language offering assistance in reading the SAR.

SARs must be distributed to participants and beneficiaries within nine months after the plan's year-end, or two months after the end of an IRS-granted extension to file Form 5500.

[2] Summary Plan Description and Summary of Material Modifications

Section 104(b) of ERISA requires that a summary plan description (SPD) be published and distributed to each participant and each beneficiary receiving benefits under the plan. This SPD must be distributed within 90 days after the individual becomes a participant or, in the case of a beneficiary, within 90 days after he or she first receives benefits. (For a new plan, the SPD may be distributed within 120 days after the plan is subject to Part 2 of ERISA.)

The summary plan description must contain the following information, under Section 102(b) of ERISA and the regulations thereunder:

- The name of the plan, and how it is commonly known to participants
- The name and address of the sponsoring employer or union
- The employer identification number of the plan sponsor, and the plan number assigned by the plan sponsor
- The type of plan (such as 401(k), defined benefit, etc.)
- The type of administration of the plan (such as contract or insurer administration)
- The name, address and business telephone of the administrator
- The name and address of the person designated as agent for service of legal process
- The name, title, and principal place of business of any trustee
- A description of the relevant portions of any collective bargaining agreement
- The plan's requirement regarding eligibility for participation and benefits
- A statement describing the plan's normal retirement age, and a statement describing any conditions that must be met before a participant will be eligible to receive benefits
- A description of the QDRO procedures, or a statement that such procedures are available upon request from the plan administrator, free of charge
- A statement describing any joint and survivor benefits provided under the plan, including any requirement that an election be made as a condition to select or reject the joint and survivor annuity
- A description of the vesting requirements of the plan
- The circumstances that may result in disqualification, ineligibility, or denial or loss of benefits
- A summary of any plan provisions governing the authority of the plan sponsor to terminate the plan or to amend or eliminate benefits, including a summary of plan provisions governing rights upon plan termination and an explanation of the accrual and vesting of benefits upon plan termination
- A summary of any provisions that may result in the imposition of a fee or charge on the participant or beneficiary, or on an individual account

- A summary of the PBGC insurance provisions, if applicable, and a statement that further information is available upon request (model language is available). If pension benefits are not insured by the PBGC, a statement to that effect must be provided
- The source of contributions to the plan (such as employee or employer). Defined benefit plans can state simply that benefits are actuarially determined.
- The source of financing of the plan and the identity of any organization through which benefits are provided
- The date of the end of the plan year and whether the records of the plan are kept on a calendar or fiscal year basis
- The process to be followed in presenting claims for benefits under the plan and any remedies for redress of claims that are denied, any applicable time limits, and reference to assistance offered by the DOL
- A statement of ERISA rights, as described in DOL Regulation Section 2520.102-3(t) (model language is provided).

At least once every five years, the plan administrator must furnish an updated SPD that integrates all plan amendments made within the five-year period.

In addition, the plan administrator must furnish a summary of any material modification to the plan. This information must be distributed no later than 210 days after the end of the plan year in which the change was made.

Participant communications should be reviewed by corporate counsel before distribution to plan participants, to ensure that the content complies with applicable regulations. Recent case law has relied upon employee communications to create entitlements for participants. For example, numerous courts have held that, where the SPD and plan document differ, the participant is entitled to the more favorable interpretation. Accordingly, any SPD or other employee communication must be carefully reviewed by counsel prior to distribution, to ensure that all limitations and exclusions are clearly represented.

[3] Notice of Blackout Period

A plan administrator is required to issue advance notice to participants of any blackout period scheduled for a defined contribution plan. This requirement, imposed by SOX, defines “blackout period” as a period in which participants are unable to make investment decisions or other transactions regarding their accounts. Blackouts typically arise due to a plan merger or significant administrative change (such as a transfer to a new recordkeeper).

The DOL regulations require this notice to be distributed to participants between 30 and 60 days before the blackout commences. An exception to this advance notice requirement may apply where the blackout was unforeseeable, or beyond the reasonable control of the plan administrator. In this case, however, notice must be supplied as soon as administratively possible. An exception may also apply where a blackout results from a corporate transaction, such as a merger or acquisition.

Failure to issue a timely notice is subject to a civil penalty of $100 per day, per notice.

A controller may be involved in the decision to merge plans together, or the decision to outsource administrative functions such as recordkeeping. As a result, it is important to keep these notice requirements in mind.

[4] Notice of Reduction in Accruals

A defined benefit or money purchase plan cannot be amended to significantly reduce a participant’s future accruals, unless a notice is provided to participants under Section 204(h) of ERISA. This notice is discussed in more detail in F1.06(2)(c) above.

[5] Notice of Underfunding

The plan administrator of a defined benefit plan must notify participants and beneficiaries of any failure to meet minimum funding standards. This notice must inform participants of the plan’s funding status, and the limits on the PBGC’s guaranty. The notice must be distributed no later than two months after the deadline for filing the annual report for the previous plan year.

Failure to provide this notice can subject the plan administrator to penalties of up to $100 per day.

[6] How to Furnish Notice

Traditionally, notices to participants and beneficiaries were required to be delivered by in-hand or by first class mail (and occasionally, by posting). In recent years, the IRS and DOL have permitted plan administrators to deliver many notices electronically, subject to certain conditions. For example, this would allow distribution of certain notices via email (as an attachment), or by a hyperlink to the employer's website. A CD-ROM might also be permissible.

Covered notices include:

- SPDs, SMMs and SARs
- Individual benefit statements
- Investment-related information under Section 404(c) of ERISA
- QDRO notifications
- Documents requested by participants
- Information about plan loans
- Notices of benefit suspension under Section 203 of ERISA
- Information about the tax effect of distributions and rollovers under Section 402(f) of the IRC
- Notices of a reduction in future accruals under Section 204(h) of ERISA
- Notices relating to participant consent under IRC Section 411(a)(11)
- Notice to Interested Parties (regarding determination letter submission)

Numerous safeguards apply to electronic methods of distribution, particularly with regard to the participant's (and spouse's) ability to access the electronic medium.

F1.11 ADDITIONAL REPORTING OBLIGATIONS

[1] Withholding Requirements

Federal income taxes are required to be withheld on all eligible rollover distributions, whether or not an individual recipient elects to have any amount withheld. This mandatory withholding is at a flat 20% rate unless the distribution is rolled over into another qualified plan or IRA.

Each person receiving benefits from a qualified plan should be given IRS Form W-4P, or an appropriate substitute, in order to permit the individual to elect the desired amount of withholding, if applicable. Unless an individual elects otherwise, tax must be withheld on a periodic distribution as if the individual were married and claiming three withholding allowances.

With respect to all distributions, individuals may elect to do one of the following:

- Have no taxes withheld from a periodic pension or annuity payments.
- Have taxes withheld on periodic payments based on the number of allowances and marital status indicated.
- Have an additional amount withheld on periodic payments, if desired.
- Change a prior election for withholding on periodic distributions.
- Receive a qualified rollover distribution and have 20% automatically withheld.
- Have a qualified rollover distribution rolled directly into an alternate qualified plan or IRA to avoid 20% withholding, and pay regular income tax on such amounts upon distribution.

Since penalties exist for underpaying one's estimated taxes, individuals should be cautioned to accurately review their entire tax position prior to completion of their withholding forms. In addition, any recipient of a pension or annuity payment must be provided with Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, or Insurance Contracts, Etc.," regardless of whether any federal income tax was withheld. If taxes are withheld the controller should also consider the use of IRS Form 941, "Employer's Quarterly Federal Tax Return," to report the taxes withheld and to remit such taxes to the IRS.

[2] PBGC Reportable Events

The plan administrator of a defined benefit plan must notify the PBGC when certain "reportable events" occur. ERISA imposes this notice requirement because the reportable events listed below generally indicate that a plan is having financial difficulty; thus, the notice gives the PBGC a head's up that it may need to commence proceedings to terminate the plan. (This notice should not be confused with the schedule of reportable transactions previously addressed under the audit rules.)

Administrators generally must notify the PBGC within 30 days after they know or have reason to know of any of the events listed below. For plans that are maintained by non-publicly traded companies, and that are not fully funded, certain events may require notice 30 days *in advance*.

- The IRS issues a notice that a plan has ceased to be tax-qualified under the IRC.
- The DOL determines that a plan has failed to comply with Title I of ERISA.
- A plan amendment is adopted that may decrease benefits payable to any participant. This includes elimination of any type of retirement benefit, any decrease in the amount of any accrued benefit, or certain decreases in the amount of retirement benefits that would accrue in the future.
- The number of active participants declines by more than 20% during the plan year, or by more than 25% compared to the beginning of the previous year.
- The IRS determines that a termination or partial termination has occurred.
- A plan fails to meet the minimum funding standards of Section 412 of the IRC.
- A plan is unable to pay benefits when due.
- A distribution is made to a substantial owner under certain circumstances.
- A plan merges, consolidates, or transfers its assets.
- Bankruptcy, insolvency of employer or plan, or liquidation of employer.
- A member of the contributing sponsor's controlled group leaves the controlled group.
- A contributing sponsor or controlled group member is involved in a liquidation or dissolution.
- An extraordinary dividend or stock redemption is declared by a contributing sponsor or controlled group member.
- A transfer of plan liabilities outside the controlled group.

F1.12 IRS VOLUNTARY COMPLIANCE PROGRAMS

The tax consequences of plan disqualification are severe, including denial of deductions for the employer and immediate taxation of all deferred benefits for employees. In recognition of this fact, the IRS has introduced a voluntary compliance regime entitled the Employee Plans Compliance Resolution System (EPCRS), which consists of three separate administrative programs: (1) the Self Correction Program (SCP), (2) the Voluntary Correction Program (VCP), and (3) the Closing Agreement Program (CAP).

EPCRS provides procedures for correcting a range of failures, from one-time and relatively small infractions to significant and chronic mistakes. Some corrections (under VCP) involve the IRS and require its ultimate approval; other corrections (under SCP) can be done independently if certain conditions are met. At the same time, the IRS has toughened penalties (under CAP) for employees who decline to enter a voluntary compliance program but end up under audit by the IRS.

In general, each correction program requires full and complete correction of the failure at issue, for all taxable years, regardless of whether the statute of limitations has expired. The basic principles of correction underlying EPCRS include: (i) making participants and beneficiaries whole, (ii) keeping plan assets in the plan except where corrective distribution is required, and (iii) complying with similar correction methods presented in the Code for analogous failures, where no specific correction methodology is detailed in Revenue Procedure 2006-27.

The controller will need to be familiar with these programs and their varied costs. For SCP, there is no submission fee since the correction is handled internally at the plan sponsor without IRS involvement. However, the correction of the qualification defect generally carries some cost. For VCP, submission fees generally range from $750 to $25,000 depending on the number of plan participants. For CAP, there is no submission, but the plan sponsor would be required to pay a monetary sanction equal to a negotiated percentage of the maximum amount due if the plan were to be disqualified. The maximum amount is the sum (for all open taxable years) of the tax on the trust, the income tax due as a result of the lost employer deductions, and the income tax resulting from the lost deferral for plan participants.