RETIREMENT PLANS FOR SMALL BUSINESSES (2017 Edition)

Researched and Written by:
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CHAPTER 1

IDENTIFYING A SMALL BUSINESS

Overview

Small businesses constitute an essential element of the U.S. economy. Approximately 30 million small businesses operate in the United States, making up the vast majority of employer firms in the country. Collectively, these small businesses employ nearly 80 million workers or approximately half of all private sector employees.

In this chapter, we will examine the variety of ways that “small” is defined and used in Small Business Administration (SBA) rules, which defines “small” with a broader brush.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- How to identify a small business;
- The various business entity forms;
- The growth of business entities over time; and
- The small business market opportunity.

Background

For decades, the tax law has included specific rules to provide various benefits or incentives to small businesses or to exclude them from a burdensome rule. However, the federal tax law has no single, uniform definition of small business. Instead, as recently illustrated by the Small Business Jobs Act of 2010, such businesses may be defined based on gross receipts, assets, capital, entity type, number of shareholders or amount of some outlay, such as start-up expenditures. Even with the same base, such as gross receipts, small is defined with varying dollar amounts. We frequently hear elected officials talk about helping small businesses with no reference point or measure offered to define the term.

How to Identify a Small Business

The standard of what constitutes a small business in the U.S. for data collection purposes varies depending upon the use of the data. For example, there are different definitions of
small businesses for federal contracting purposes and federal tax purposes. There is no uniform and consistent definition; rather, different definitions may be based on:

- Number of employees;
- Business receipts; or
- Business assets.

In the United States, the legal definition of a small business is determined by the U.S. Small Business Administration (SBA), which sets the criteria to be used by the SBA in making small business determinations.

According to the SBA, a small business concern is one that is independently owned and operated, is organized for profit, and is not dominant in its field. Depending on the industry, size standard eligibility is based on the average number of employees for the preceding twelve months or on sales volume averaged over a three-year period.

Examples of SBA general size standards include the following:

- Manufacturing: Maximum number of employees may range from 500 to 1500, depending on the type of product manufactured;
- Wholesaling: Maximum number of employees may range from 100 to 500 depending on the particular product being provided;
- Services: Annual receipts may not exceed $2.5 to $21.5 million, depending on the particular service being provided;
- Retailing: Annual receipts may not exceed $5.0 to $21.0 million, depending on the particular product being provided;
- General and Heavy Construction: General construction annual receipts may not exceed $13.5 to $17 million, depending on the type of construction;
- Special Trade Construction: Annual receipts may not exceed $7 million; and
- Agriculture: Annual receipts may not exceed $0.5 to $9.0 million, depending on the agricultural product.

However, there is no standard or official definition of "small" business. The SBA and the tax law each define "small" differently. As shown above, the SBA definitions vary among industries with the parameters usually based on either number of employees or gross receipts (SBA, Size Standards). The tax law generally applies the same definitions to all industries, but varies the measure in terms of dollars and the base (gross receipts, number of shareholders, capitalization, assets, etc.).

In August 2011, the U.S. Treasury Department's Office of Tax Analysis (OTA) released a report: Methodology to Identify Small Businesses and Their Owners. The impetus for the report was a desire for improving the approach for defining and identifying small businesses to understand the impact of the tax law on the business and the owner.

The report by OTA described the following steps in defining small businesses and their owners:
• **Step 1:** Start with the broad set of possible business filers. This comprises six types of returns or schedules:
  - Schedule C (PDF) — Sole proprietorship
  - Schedule E-Part 1 — Rental real estate
  - Schedule F (PDF) — Farming
  - Form 1065 (PDF) — Partnerships
  - Form 1120 (PDF) — C Corporations
  - Form 1120-S (PDF) — S Corporations

• **Step 2:** Identify and remove non-business activities from the Step 1 group using a two-part test. The test is based on IRC § 183 guidance distinguishing a hobby from a business. After examining these rules, OTA came up with a two-part test to identify which returns indicate "substantial" operations carried out in a "businesslike" manner:
  - **De Minimis Test:** Are total income or total deductions greater than $10,000 or is their sum greater than $15,000? Income includes gross receipts, rents, dividends, capital gains, royalties and interest. If a loss from the sale of an asset is reported, its absolute value is used in this test. Deductions are defined similarly for each test. The dollar amounts are intended to serve as the minimum level of business activity that indicates whether significant time and effort is required by the owner. OTA notes that amounts below these thresholds may indicate a hobby.
  - **Business Activity Test:** This test is based on the premise that a business has outlays for depreciation, inventories, rents and employees. OTA set a threshold that a business must have deductions in excess of $5,000 to "operate in a 'businesslike' manner." Entities that primarily generate income from labor services are likely to be eliminated under this test.
    - Total deductions include wages, interest expense, goods and services purchased from others, rent, repairs, taxes, advertising, bad debt expense, depreciation and miscellaneous deductions. To treat corporations similarly to sole proprietorships and partnerships for this test, officer compensation is not included in measuring deductions for corporations. For some entities that primarily report investment income, interest expense might be ignored for this test.
    - **Modifications:** OTA makes various modifications to the tests to address certain entity features that may indicate the entity is not a typical business. For example, to address the possibility of misclassified employees and possible personal element of some sole proprietor expenses, only 50 percent of car-truck and travel, meals and entertainment expenses on Schedule C are considered. To attempt to capture only business-like real estate rentals of individuals, OTA excludes depreciation and mortgage interest from Schedule E deductions. Thus, rental owners must have other expenses such as maintenance and advertising to pass the business test.

• **Step 3:** Apply a $10 million total income and deduction threshold to determine which business entities are small. Total income includes the entity's gross receipts, rents and portfolio income. In addition, the entity's total deductions must not exceed $10 million (on the premise that "deductions can reflect the scale of operations").
• **Step 4:** Identify the individuals that own the entities that meet OTA's small business definition. OTA observes that "newly accessible data" from the IRS enables a better match of individual returns with partnership and S corporation returns. OTA noted that in some situations, it might not be appropriate to label an individual as a small business owner merely because they owned a small business. For example, what if an individual also owned a large business, the individual had a passive interest in his small business or income from the small business was not a material part of the individual's return. OTA's approach to resolving these issues was to have both broad and narrow definitions of small business owner.

The new OTA approach to identifying small businesses and their owners will enable Treasury and others to better answer questions about the effect of tax rate changes on small business owners (under both broad and narrow definitions). The approach might also lead Congress to fine-tune tax preferences offered to small businesses (by carving out what the Treasury calls "non-businesses").

The IRS, for classification purposes, defines small businesses as those entities with less than $10 million of assets.

**Data on Small Businesses in the U.S.A.**

Federal income tax returns filed by businesses provide a wealth of information about businesses operating in the United States. Some of this information is presented below. In order to assure the confidentiality of information contained on administrative tax returns, however, data items in the Public Use File are rounded and often masked or blurred to prevent identification. As such, each individual tax record is only suggestive of an actual tax return filed.

Business organization can take several forms – the choice of business form affects both the application of the federal income tax system as well as the application of state laws relating to the liability of business owners. Among the possible business forms that can be used are the following:

• **Sole Proprietorships.** A sole proprietorship is a business that has one owner and does not have stock.

• **Partnerships.** A partnership is a group of entities (e.g., individuals or businesses) that organize to do business together. Each partner contributes money, property, labor, or skill and shares in the profits of the business.

• **C Corporations.** C Corporations are formed when prospective shareholders exchange money, property, or both in exchange for capital stock of the corporation. The return on a shareholder's investment in a C Corporation is paid either through dividends, or through capital gains realized when the shareholder sells his or her stock in the corporation.
- **S Corporations.** S Corporations are small business corporations that are afforded the benefits of limited liability like C Corporations, but can elect to be treated as a pass-through entity for federal income tax purposes.
- **Limited Liability Company (LLC).** Limited liability companies are authorized under state law. Owners of an LLC, like a corporation, have limited personal liability, but other features of an LLC function more like a partnership, such as the flow-through treatment of LLC owner income. Most LLCs are treated as partnerships for federal tax purposes, although a very small percentage of LLCs are treated as sole proprietorships.

The most prevalent form of business in the United States is the sole proprietorship. For tax year 2013 (latest data available), there were approximately 24.1 million individual tax returns that reported nonfarm sole proprietorship activity, a 2.2 percent increase from 2012. This compared to 1.6 million C Corporations, 4.3 million S Corporations, and 3.2 million Partnerships (including returns of LLCs) for a total of 33.4 million nonfarm business returns filed.

Using the threshold of $10 million in gross receipts, 30 million of the 33.2 million returns filed in 2013 constituted nonfarm small businesses; these returns represented more than 90 percent of all business tax returns. Table 1.1 shows the breakdown of businesses by entity type in the United States for 2013 (latest data available).

### Table 1.1
**Number of Small Businesses by Entity Type, 2013**

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>C Corporation</td>
<td>1.6 million</td>
</tr>
<tr>
<td>S Corporation</td>
<td>4.3 million</td>
</tr>
<tr>
<td>Partnership (including LLC)</td>
<td>3.2 million</td>
</tr>
<tr>
<td>Nonfarm Sole Proprietorship</td>
<td>24.1 million</td>
</tr>
<tr>
<td>Total Nonfarm Small Businesses</td>
<td>33.2 million</td>
</tr>
</tbody>
</table>

Source IRS Statistics of Income (SOI)

Table 1.2 below shows the percentage distribution of businesses by entity type for 2013, based on 33.2 million tax returns filed with the IRS. Sole proprietorships account for 72 percent of all small businesses in the United States.
Growth of Businesses by Entity Type over Time

Since 1995, the number of business tax returns filed by C Corporations and farms has declined. On the other hand, there has been significant growth in the number of sole proprietorships, limited liability companies, and S Corporations filing business tax returns. Table 1.3 shows the changes in the number of businesses in the United States by entity type since 1995.

Table 1.3
Number of Businesses by Entity Type, 1995-2014 (in thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Sole Proprietorships</th>
<th>C Corporations</th>
<th>S Corporations</th>
<th>Partnerships</th>
<th>LLCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>16,424</td>
<td>2,321</td>
<td>2,153</td>
<td>1,462</td>
<td>119</td>
</tr>
<tr>
<td>1996</td>
<td>16,955</td>
<td>2,327</td>
<td>2,304</td>
<td>1,433</td>
<td>221</td>
</tr>
<tr>
<td>1997</td>
<td>17,176</td>
<td>2,258</td>
<td>2,452</td>
<td>1,410</td>
<td>349</td>
</tr>
<tr>
<td>1998</td>
<td>17,398</td>
<td>2,261</td>
<td>2,588</td>
<td>1,359</td>
<td>496</td>
</tr>
<tr>
<td>1999</td>
<td>17,576</td>
<td>2,210</td>
<td>2,726</td>
<td>1,306</td>
<td>632</td>
</tr>
<tr>
<td>2000</td>
<td>17,903</td>
<td>2,185</td>
<td>2,860</td>
<td>1,287</td>
<td>771</td>
</tr>
<tr>
<td>2001</td>
<td>18,338</td>
<td>2,149</td>
<td>2,986</td>
<td>1,254</td>
<td>878</td>
</tr>
<tr>
<td>2002</td>
<td>18,926</td>
<td>1,907</td>
<td>3,154</td>
<td>1,208</td>
<td>1,034</td>
</tr>
<tr>
<td>2003</td>
<td>19,710</td>
<td>1,857</td>
<td>3,342</td>
<td>1,283</td>
<td>1,092</td>
</tr>
<tr>
<td>2004</td>
<td>20,591</td>
<td>1,834</td>
<td>3,518</td>
<td>1,188</td>
<td>1,359</td>
</tr>
<tr>
<td>2005</td>
<td>21,468</td>
<td>1,799</td>
<td>3,684</td>
<td>1,143</td>
<td>1,569</td>
</tr>
<tr>
<td>2006</td>
<td>22,074</td>
<td>1,791</td>
<td>3,872</td>
<td>1,151</td>
<td>1,630</td>
</tr>
<tr>
<td>2007</td>
<td>23,123</td>
<td>1,846</td>
<td>3,990</td>
<td>1,020</td>
<td>1,818</td>
</tr>
<tr>
<td>2008</td>
<td>22,614</td>
<td>1,762</td>
<td>4,049</td>
<td>1,081</td>
<td>1,898</td>
</tr>
<tr>
<td>2009</td>
<td>22,660</td>
<td>1,695</td>
<td>4,094</td>
<td>1,021</td>
<td>1,969</td>
</tr>
<tr>
<td>2010</td>
<td>23,003</td>
<td>1,649</td>
<td>4,127</td>
<td>965</td>
<td>2,090</td>
</tr>
<tr>
<td>2011</td>
<td>23,427</td>
<td>1,625</td>
<td>4,158</td>
<td>980</td>
<td>2,111</td>
</tr>
<tr>
<td>2012</td>
<td>23,554</td>
<td>1,618</td>
<td>4,205</td>
<td>980</td>
<td>2,211</td>
</tr>
<tr>
<td>2013</td>
<td>24,075</td>
<td>1,583</td>
<td>4,258</td>
<td>980</td>
<td>2,285</td>
</tr>
<tr>
<td>2014</td>
<td>24,632</td>
<td>N/A</td>
<td>N/A</td>
<td>989</td>
<td>2,432</td>
</tr>
</tbody>
</table>

Source: IRS Statistics of Income
The number of LLCs and S Corporations showed significant increases, from 119,000 to 2.4 million in the case of LLCs and from 2,153 million to 4,258 million in the case of S Corporations. These increases are primarily attributable to changes in the law that made these forms of organization more attractive. The growth in LLCs can be attributed to changes in state laws that allowed the formation of limited liability companies and modifications to federal law to allow these entities to operate as pass-through entities like partnerships for federal income tax purposes. The increase in the number of S Corporation returns is partly attributable to changes in the law that increased the number of S Corporation shareholders and otherwise made it easier for corporations to qualify for S Corporation status.

**Small Business Gross Receipts Data**

While sole proprietorships are the dominant form of business in the United States, most sole proprietorships are very small. IRS data for 2004 (latest data available) shows the distribution of business entities by gross receipts (see Table 1.4). Of the 15.9 million small business returns with receipts less than $25,000, 13.3 million (84 percent) were sole proprietorships. In fact, non-farm sole proprietorships with gross receipts of less than $25,000 represented 48.7 percent of all U.S. small businesses in 2004.

**Table 1.4**

<table>
<thead>
<tr>
<th>Size of Gross Business Receipts</th>
<th>All Small Businesses</th>
<th>Corporations</th>
<th>Non-Corporate Businesses</th>
<th>Nonfarm Sole Prop.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $25,000</td>
<td>15,872,235</td>
<td>450,597</td>
<td>829,112</td>
<td>1,284,396</td>
</tr>
<tr>
<td>$25,001 to $100,000</td>
<td>5,521,119</td>
<td>307,399</td>
<td>561,043</td>
<td>397,461</td>
</tr>
<tr>
<td>$100,001 to $250,000</td>
<td>2,578,962</td>
<td>328,012</td>
<td>601,851</td>
<td>262,423</td>
</tr>
<tr>
<td>$250,001 to $500,000</td>
<td>1,331,692</td>
<td>268,188</td>
<td>451,424</td>
<td>147,948</td>
</tr>
<tr>
<td>$500,001 to $1 m</td>
<td>932,913</td>
<td>247,385</td>
<td>375,165</td>
<td>110,698</td>
</tr>
<tr>
<td>$1 m to $2.5 m</td>
<td>686,257</td>
<td>229,634</td>
<td>291,775</td>
<td>89,675</td>
</tr>
<tr>
<td>$2.5m to $5 m</td>
<td>263,212</td>
<td>103,484</td>
<td>107,685</td>
<td>36,829</td>
</tr>
<tr>
<td>$5m to $10,000,000m</td>
<td>143,693</td>
<td>57,788</td>
<td>60,895</td>
<td>20,925</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>27,330,082</strong></td>
<td><strong>1,987,171</strong></td>
<td><strong>3,684,086</strong></td>
<td><strong>2,350,355</strong></td>
</tr>
</tbody>
</table>

Also, Table 1.4 shows that about 58 percent of small businesses filing federal income tax returns in 2004 had gross receipts of less than $25,000. Almost 88 percent of all small business tax returns filed in 2004 had gross receipts of no more than $250,000. By contrast, only one-half of one percent of small businesses had gross receipts of more than $5 million in 2004, and only 2.8 percent of these entities were sole proprietorships.

Another interesting aspect of these IRS Statistics of Income (SOI) figures is that, for the smallest size class, the percentage of small businesses by entity type declines from sole proprietorship to partnership to S Corporation to C Corporation. The reverse is also true; C Corporations and S Corporations constitute a larger percentage of small businesses with gross receipts between $5 million and $10 million, while sole proprietorships constitute a small percentage of these businesses. IRS SOI shows that C Corporations
constitute 2.8 percent of small businesses with gross receipts under $25,000, while they constitute 40.2 percent of small businesses with gross receipts between $5 million and $10 million. Sole proprietorships constitute 83.9 percent of small businesses with gross receipts of less than $25,000 and only 2.8 percent of small businesses with gross receipts between $5 million and $10 million. Sole proprietorships become a consistently smaller percentage of small businesses as the gross receipts class increases and C Corporations and S Corporations become a consistently larger percentage of the total.

Small Businesses by Employment Levels

While this study defines small businesses solely by reference to total receipts (i.e., total annual gross receipts of less than $10 million), another way of looking at small businesses is by looking at employment size. Census survey data provides information on business size, total employment, and annual payroll, which is summarized in Table 1.5. This data includes businesses with at least one paid employee, but excludes self-employed individuals with no paid employees, employees of private households, railroad employees, agricultural production workers, and most government employees.

Table 1.5
Employment Size of Firms, 2014

<table>
<thead>
<tr>
<th>Employment Size</th>
<th># of Firms</th>
<th># Of Establishments</th>
<th>Employment</th>
<th>Annual Payroll ($10,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>5,825,458</td>
<td>7,563,084</td>
<td>121,069,944</td>
<td>5,940,186,911</td>
</tr>
<tr>
<td>0 to 4 employees</td>
<td>3,598,185</td>
<td>3,603,935</td>
<td>5,940,248</td>
<td>251,757,114</td>
</tr>
<tr>
<td>5 to 9 employees</td>
<td>998,953</td>
<td>1,010,467</td>
<td>6,570,776</td>
<td>235,546,762</td>
</tr>
<tr>
<td>10 to 19 employees</td>
<td>399,765</td>
<td>641,096</td>
<td>8,176,519</td>
<td>309,924,445</td>
</tr>
<tr>
<td>20 to 99 employees</td>
<td>208,737</td>
<td>690,583</td>
<td>20,687,543</td>
<td>797,228,321</td>
</tr>
<tr>
<td>100 to 499 employees</td>
<td>5,205,640</td>
<td>360,894</td>
<td>20,121,588</td>
<td>803,652,747</td>
</tr>
<tr>
<td>500+ employees</td>
<td>19,076</td>
<td>1,256,109</td>
<td>57,894,592</td>
<td>3,500,900,011</td>
</tr>
</tbody>
</table>


Note: An establishment is a single physical location of a business. A single firm may have one or more establishments. The data include all operating establishments with one or more paid employees. The series excludes data on self-employed individuals, employees of private households, railroad employees, agricultural production employees, and most government employees.

Table 1.6 below shows that there were approximately 7.5 million establishments with employees in the United States in 2014 (latest data available) with 86 percent of all establishments had fewer than 20 employees. Furthermore, 99.30 percent of all establishments had fewer than 500 employees.
Table 1.6
Distribution of Establishments by Size, 2014

<table>
<thead>
<tr>
<th>Employment Size of Establishment</th>
<th>Number of Establishments</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 4 employees</td>
<td>4,121,512</td>
</tr>
<tr>
<td>5 to 9 employees</td>
<td>1,405,860</td>
</tr>
<tr>
<td>10 to 19 employees</td>
<td>964,582</td>
</tr>
<tr>
<td>20 to 49 employees</td>
<td>665,899</td>
</tr>
<tr>
<td>50 to 99 employees</td>
<td>224,802</td>
</tr>
<tr>
<td>100 to 249 employees</td>
<td>128,244</td>
</tr>
<tr>
<td>250 to 499 employees</td>
<td>32,743</td>
</tr>
<tr>
<td>500 to 999</td>
<td>12,100</td>
</tr>
<tr>
<td>1,000 +</td>
<td>7,343</td>
</tr>
<tr>
<td>All establishments</td>
<td>7,563,085</td>
</tr>
</tbody>
</table>


In addition to the data concerning establishments by employment size, there are also a large number of U.S. businesses that are referred to as non-employer entities; most of these entities are sole proprietorships. For 2013, approximately 23 million U.S. businesses did not have employees. These businesses had more than $970 billion of receipts. Table 1.7 shows the number of establishments in the United States without employees for 2011 by business form.

Table 1.7
Non-Employer Businesses in the United States, Entity Form, Number of Entities, Receipts ($million)

<table>
<thead>
<tr>
<th>Entity Form</th>
<th>Number of Entities</th>
<th>Receipts ($millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All establishments</td>
<td>23,005,620</td>
<td>$1,052,025</td>
</tr>
<tr>
<td>Corporations</td>
<td>1,442,732</td>
<td>155,283</td>
</tr>
<tr>
<td>Sole Proprietorships</td>
<td>19,438,914</td>
<td>615,426</td>
</tr>
<tr>
<td>Partnerships</td>
<td>1,609,434</td>
<td>218,920</td>
</tr>
</tbody>
</table>

Source: [source: censtats.census.gov/cgi-bin/nonemployer/nonsect.pl]

Statistics of Income (SOI) data from the IRS enable a closer look at the types of business forms to glean additional information about businesses in the United States.

Importance of Small Businesses in the U.S.A

So as you can see, based on the data above, there is no wonder that small businesses are often mentioned as being the real job creators. Thus, lawmakers are likely to focus their attention on small businesses in designing approaches to both stimulate the economy and encourage growth. In fact, in this past election how many times did you hear politicians
mentioning “the importance of small businesses to our economy”? Small businesses often express concern about the competitive disadvantages they may face in accessing capital, obtaining government contracts and dealing with regulations, as well as taxation. Thus, proposals are often made with the intent of reducing these disadvantages.

So how important are small businesses in America? Here are some facts:

- Represent 99.7 percent of all employer firms;
- Small businesses employ about 64 percent of all private sector workers;
- Small businesses with employee’s start-up at a rate of over 500,000 per year;
- Four years after start-up, half of all small businesses with employees remain open;
- Pay 45 percent of total U.S. private payroll;
- Have generated 60 to 80 percent of net new jobs annually over the last decade;
- Create more than 50 percent of nonfarm private gross domestic product (GDP);
- The 33.3 million small businesses in the United States are located in virtually every neighborhood;
- Home-based businesses account for 53 percent of all small businesses; and
- Small businesses are employers of 41 percent of high tech workers (such as scientists, engineers, and computer workers).

Sources: U.S. Bureau of the Census; Advocacy-funded research by Joel Popkin and Company (Research Summary #211); U.S. Department of Commerce, International Trade Administration.

**Small Business Marketing Opportunity**

What kind of marketing and sales opportunities can be suggested for financial and insurance professionals, given the trend of the business data portrayed here by the IRS and DOL? Owners of closely held business enterprises provide an excellent marketing opportunity for financial and insurance professionals.

These owners have family protection needs, business continuation needs, retirement planning needs, and estate creation and asset protection needs. Those financial needs often can be covered with life insurance and annuity contracts.

Small business owners often wish to use their business cash flow to finance this personal protection, wealth accumulation and wealth preservation needs. Whether funding a plan to cover business debt, a qualified or non-qualified retirement plan, a buy-sell business continuation plan, a plan to offset long-term care costs, the cash flow of the business is the source of funds small business owners want to tap to pay ongoing retirement plan contributions and insurance premiums to finance these important financial objectives.

Every town and city in the U.S. has successful “Main Street America” business owners who operate under a Sole Proprietorship, C Corp, S Corp or LLC legal status. And as was stated earlier, one of the first questions to ask when approaching a small business owner is, “What is the tax status of your business, Sole Proprietorship, C Corp, S Corp or
LLC. The answer to this question will provide certain cash flow possibilities to fund various solutions for your small business owner client.

In our next chapter, we will examine and differentiate the various business structures, their features, benefits and tax ramifications.
Chapter 1
Review Questions

1. Which of the following organizations in the United States has set the legal definition of a small business?

( ) A. Department of Labor
( ) B. Small Business Administration
( ) C. Chamber of Commerce
( ) D. Department of Defense

2. For classification purposes, the IRS defines small businesses as those with less than what amount of assets?

( ) A. $5 million
( ) B. $1 million
( ) C. $10 million
( ) D. $25 million

3. What is the most prevalent form of business in the United States?

( ) A. General Partnership
( ) B. Sole Proprietorship
( ) C. C Corporation
( ) D. S Corporation

4. According to the U.S. Bureau of the Census, what percentage of all small businesses are home-based?

( ) A. 35%
( ) B. 45%
( ) C. 50%
( ) D. 53%

5. According to the Bureau of Labor Statistics, small businesses pay what percent of total U.S. private payroll?

( ) A. 45%
( ) B. 35%
( ) C. 20%
( ) D. 65%
CHAPTER 2

BUSINESS STRUCTURES

Overview

As was discussed in Chapter 1, small businesses may operate within several different business structures, as set forth by the Internal Revenue Service (IRS). In order for you, as the financial and insurance professional, to help a small business owner with his or her personal and business planning, it is very important that you have an understanding of the business structure in which the business operates in, as well as its tax status, before you provide any assistance.

In this chapter, we will examine the four common types of business structures. Then we will review each structure's advantage and disadvantages, as well as their tax structure and how they differ.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The four common business structures;
- The advantages and disadvantages of a Sole Proprietorship;
- Tax structure of a Sole Proprietorship;
- The various types of Partnerships and their advantages and disadvantages;
- The tax structure of Partnerships;
- The various types of Corporations and their advantages and disadvantages;
- Corporate tax structure;
- The benefits of an S Corporation and its tax structure;
- The benefits of an LLC and its tax structure; and
- Benefits and tax structure of a Personal Services Corporation.

Basic Business Structures

The four basic forms of business structures are:

- Sole proprietorships;
- Partnerships (general and limited);
- Corporations (C and S); and
- Limited liability companies.
The Internal Revenue Service (IRS) and the U. S. tax laws codified in the Internal Revenue Code (IRC) treats each of these entities in significantly different ways. Generally, taxpayers who own their businesses alone can form any one of these types of businesses except partnerships. Multiple owners of a business may form any type of business except, a Sole Proprietorship.

**Sole Proprietorship**

The sole proprietorship is the oldest, simplest and most common form of business entity. For tax year 2014, there were approximately 24.6 million individual income tax returns that reported non-farm sole proprietorship activity, a 2.3 percent increase from 2013. Non-farm sole proprietorship businesses represent over 72% of all active businesses in America.

A sole proprietor is someone who owns an unincorporated business by himself or herself and the success or failure of that business rests on the owner’s efforts and talents. The owner is personally responsible for all debts of the firm. Profits are considered as personal income and taxed accordingly (see Tables 2.1 through 2.4).

Sole proprietors are also unique because they are completely independently run. A sole proprietor makes his or her own decisions and they do not have to report to a board of directors, partners or stockholders.

**Sole Proprietorship Data for 2014**

Below is information reported by the IRS:

- Profits for the 24.6 million returns with sole proprietorship activity for Tax Year 2014 increased 4.9 percent increase from $302.3 billion for 2013 to $317.1 billion for 2014;
- The professional, scientific and technical services sector reported the largest percentage of total profits of all nonfarm sole proprietorships, with 24.7 percent ($78.2 billion), and had a 6.5 percent increase in profits for 2014;
- For all sole proprietorships, receipts increased 2.2 percent to 24.1 million. The largest sector in terms of number of returns was the professional, scientific, and technical services sector.
- Between 2013 and 2014, the number of individual income tax returns reporting nonfarm sole proprietorship activity increased 2.3 percent to 24.6 million.
- The transportation and warehousing sector had the largest percentage increase in number of returns among all sectors, increasing 9.8 percent. The largest sector in terms of number of returns was the professional, scientific, and technical service sector. The number of returns in this sector rose to 3.3 million, an increase of 1.7 percent from 2013. The second largest sector based on returns was the other services sector which is mainly comprised of personal and laundry services. This sector had a 3.0-percent increase in number of returns to 3.3 million.
Total business receipts (the sum of “income from sales and operations” and “other business income”) for all nonfarm sole proprietorship industries increased 3.9 percent, from $1,341.6 billion to $1,393.9 billion.

You can view this data at: https://www.irs.gov/pub/irs-soi/soi-a-inpr-id1614.pdf

**Advantages of Sole Proprietorship**

The principal advantage of the sole proprietorship form of business is its simplicity. There are normally no special papers or legal documents which have to be filed. Once established, the operation of the business is very flexible. The sole proprietor is the boss and makes all of the business decisions. The owner does not have to deal with a board of directors or shareholders, as would a corporation. The sole proprietorship also does not have to routinely prepare formal accountings and state filings, in the same complicated manner that is required of a corporation.

Another advantage of a sole proprietorship is that the business owner has the ability to run the business as he/she chooses. The sole proprietor does not have to answer to a boss and has the authority to control all aspects of the business. The sole proprietor also enjoys all of the business profits and is usually the only one to be concerned about business losses! In other business organizations, profits and losses must be shared with partners or shareholders.

**Disadvantages of a Sole Proprietorship**

The principle disadvantage of sole a proprietorship is its unlimited liability. As discussed above, the sole proprietor is exposed to full liability for all losses and indebtedness incurred by the business. Since there is little if any distinction between personal and business liabilities, the sole proprietor’s personal and business assets are subject to the claims of creditors. Business creditors can attach personal assets for payment of business liabilities.

Another disadvantage is the fact that the sole proprietor is the only boss. All business decisions belong solely to the proprietor, and he or she bears the burden of living with the outcome of those decisions. An entrepreneur who is rich with product knowledge may be poor on business operation abilities, but is faced with handling all aspects of running a business despite any preferences or weaknesses.

Also, another disadvantage of sole proprietorship is that you may have to pay high income taxes. You cannot take any tax deduction for your health or life insurance whilst operating as a sole proprietor. A full deduction for your health insurance and a deduction of life insurance policy are offered to corporations, so long as all employees of the corporation are offered the insurance.

Generally, the sole proprietor has limited working capital. Since there is little distinction between personal assets and business assets, business capital usually takes the form of personal capital. Thus, limited capital is also a disadvantage of a sole proprietorship.
Another serious disadvantage is the fact what when the sole proprietor dies, the business also dies. A sole proprietorship has no legal entity apart from its owner. Upon death of the owner, business assets and liabilities become part of the deceased’s estate along with any other personal assets and liabilities. Accordingly, even a very profitable business faces an end due to the death of the sole proprietor. After death, all assets and liabilities are treated the same—they are all subject to the claims of business creditors or personal creditors.

Registering a Sole Proprietorship

Establishing a sole proprietorship is cheap and uncomplicated, but there is one legal procedure that must be completed: registering the company with the state, usually through the county in which the owner lives. It only costs a few dollars, though specific costs vary with states. If the business is under a name different from the owner, usually it is required that the name of the business must be registered—known as fictitious business name—with the county.

Note: A great prospecting tool is to go to the county and/or get a copy of your local business newspaper and review the registered and fictitious business names in your community.

Taxation of Sole Proprietorships

A sole proprietor must report all business income or losses on their personal income tax return (see Table 2.1 thru Table 2.4); the business itself is not taxed separately. (The IRS calls this “pass-through” taxation, because business profits pass through the business and are taxed on their personal tax return).

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $18,650</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $18,650 but not over $75,900</td>
<td>$1,865 plus 15% of the excess over $18,650</td>
</tr>
<tr>
<td>Over $75,900 but not over $153,100</td>
<td>$10,452.50 plus 25% of the excess over $75,900</td>
</tr>
<tr>
<td>Over $153,100 but not over $233,350</td>
<td>$29,517.50 plus 28% of the excess over $153,100</td>
</tr>
<tr>
<td>Over $233,350 but not over $413,350</td>
<td>$52,222.50 plus 33% of the excess over $233,350</td>
</tr>
<tr>
<td>Over $416,700 but not over $470,700</td>
<td>$112,728 plus 35% of the excess over $416,700</td>
</tr>
<tr>
<td>Over $470,700</td>
<td>$131,628 plus 39.6% of the excess over $470,700</td>
</tr>
</tbody>
</table>
Table 2.2
Head of Households, 2017

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $13,350</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $13,350 but not over $50,400</td>
<td>$1,335 plus 15% of the excess over $13,350</td>
</tr>
<tr>
<td>Over $50,800 but not over $131,200</td>
<td>$6,952.50 plus 25% of the excess over $50,800</td>
</tr>
<tr>
<td>Over $131,200 but not over $212,500</td>
<td>$27,052.50 plus 28% of the excess over $131,200</td>
</tr>
<tr>
<td>Over $212,500 but not over $416,700</td>
<td>$49,816.50 plus 33% of the excess over $212,500</td>
</tr>
<tr>
<td>Over $416,700 but not over $444,550</td>
<td>$117,202.50 plus 35% of the excess over $416,700</td>
</tr>
<tr>
<td>Over $444,550</td>
<td>$126,950 plus 39.6% of the excess over $444,550</td>
</tr>
</tbody>
</table>

Table 2.3
Single Taxpayers 2017
(Other than Surviving Spouse and Heads of Households)

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $9,325</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $9,325 but not over $37,950</td>
<td>$932.50 plus 15% of the excess over $9,325</td>
</tr>
<tr>
<td>Over $37,950 but not over $91,150</td>
<td>$5,226.25 plus 25% of the excess over $37,950</td>
</tr>
<tr>
<td>Over $91,150 but not over $191,650</td>
<td>$18,713.75 plus 28% of the excess over $91,150</td>
</tr>
<tr>
<td>Over $191,650 but not over $416,700</td>
<td>$46,643.75 plus 33% of the excess over $191,650</td>
</tr>
<tr>
<td>Over $413,350 but not over $418,400</td>
<td>$120,910.25 plus 35% of the excess over $416,700</td>
</tr>
<tr>
<td>Over $418,400</td>
<td>$121,505.25 plus 39.6% of the excess over $418,400</td>
</tr>
</tbody>
</table>

Table 2.4
Married Individuals Filing Separately, 2017

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $9,325</td>
<td>10% of the taxable income</td>
</tr>
<tr>
<td>Over $9,325 but not over $37,950</td>
<td>$932.50 plus 15% of the excess over $9,325</td>
</tr>
<tr>
<td>Over $37,950 but not over $76,550</td>
<td>$5,226.25 plus 25% of the excess over $37,950</td>
</tr>
<tr>
<td>Over $75,950 but not over $116,675</td>
<td>$14,876.25 plus 28% of the excess over $76,550</td>
</tr>
<tr>
<td>Over $115,725 but not over $208,350</td>
<td>$26,111.25 plus 33% of the excess over $116,675</td>
</tr>
<tr>
<td>Over $206,675 but not over $235,350</td>
<td>$56,364 plus 35% of the excess over $208,350</td>
</tr>
<tr>
<td>Over $235,350</td>
<td>$65,814 plus 39.6% of the excess over $235,350</td>
</tr>
</tbody>
</table>

The only difference between reporting income from a sole proprietorship vs. reporting wages from a job is that the sole proprietor must list their business’ profit or loss information on Schedule C (Profit or Loss from a Business), which must be submitted to the IRS along with Form 1040.

Note: Sole-proprietor farmers use Schedule F.

The sole proprietor is taxed on all profits of the business — that’s total sales minus expenses — regardless of how much money he/she actually withdraws from the business. In other words, even if you leave money in the company’s bank account at the end of the year — for instance, to cover future expenses or expand the business — you must pay taxes on that money.
You can deduct business expenses in the same manner as any other type of business. You are allowed to write off any money you spend in pursuit of profit, including start-up costs, operating expenses and product and advertising costs, as well as business-related meals, travel and entertainment expenses.

In addition, sole proprietors must pay self-employment tax, which is higher than the tax paid by employees. Sole proprietors must make contributions to the Social Security and Medicare systems; taken together, these contributions are called “self-employment taxes.” Self-employment taxes are equivalent to the payroll tax for employees of a business. However, while regular employees make contributions to these two programs through deductions from their paychecks, sole proprietors must make their contributions when paying their other income taxes.

Another important difference between employees and sole proprietors is that employees only have to pay half as much into these programs because their contributions are matched by their employers. Sole proprietors must pay the entire amount themselves.

For 2017, the self-employment tax rate is 15.3 percent of the first $127,200 of income plus 2.9 percent on everything over $127,200 to pay for the Medicare portion of Social Security tax. In addition, certain high income earners will pay an additional 0.9 percent Medicare contribution tax on earnings in excess of the following thresholds:

- Single $200,000
- Married filing jointly $250,000
- Married filing separately $125,000
- Head of Household (with qualifying child) $200,000
- Qualifying widow(er) $200,000

For self-employed taxpayers over the threshold, the combined Medicare tax in 2017 is 3.8%.

Self-employment taxes are reported on Schedule SE, which a sole proprietor submits each year with his 1040 income tax return and Schedule C. For further information about the taxation of Sole Proprietors (individuals who use Schedule C or C-EZ), see IRS Publication 334, (www.irs.gov/publications/p334/index.html).

**Partnerships**

A partnership is the relationship between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor, skill with the expectation of sharing in the profits and losses of the business, regardless of whether a formal partnership agreement was made.

A partner(s) can be individuals, corporations, other partnerships, or any other legal entity. Partners are classified as either:
- General partners; or
- Limited partners

General Partners are those who assume liability for the partnership’s debts and losses. Limited partners partnership has a least one general partner and one or more limited partners.

**Formation of Partnerships**

The partnership is relatively easy to create. The partnership’s existence is usually formalized through preparation of a *partnership agreement*. Although many partnerships operate without a written agreement, it makes smart business sense to formally draft a formal agreement. Formal partnership agreements should be prepared by, or at least reviewed by, an attorney.

In general, partnership agreements outline each partner’s share of income, gain, loss, deductions, credits, and methods to dissolve the partnership under various situations including death of one or more partners.

### Partnership Data for 2014

- The number of partnerships grew 4.4 percent (from 3,460,699 to 3,611,255) between 2013 and 2014. Since 2005, the number of partnerships has grown at an average annual rate of 2.6 percent. Partnerships classified as limited liability companies (LLCs) accounted for the majority of this growth.
- For 2014 partnerships filed more than 3.6 million tax returns, a 2.1 percent increase over the number filed for 2013. These returns represented 27 million partners, up 8.5 percent from the previous year. The number of partners has grown each of the last 10 years, increasing 8.5 percent.
- Domestic limited liability companies (LLCs) made up the majority (67.4 percent) of all partnerships, surpassing all other entity types for the 13th consecutive year.
- Domestic limited partnerships represented only 11.5 percent of all partnerships but reported the most profits (32.2 percent), and the largest share of the partners (44.2 percent).
- Real estate and rental and leasing accounted for about half (50.3 percent) of all partnerships and just over a quarter (28.5 percent) of all partners. The finance and insurance sector reported the largest shares of total net income (loss) (41.4 percent), total assets (56.4 percent), and total receipts (23.4 percent) in 2013
- Total assets increased 8.1 percent between 2013 and 2014, from $24.2 trillion to $26.1 trillion. All 20 industrial sectors reported an increase.
- Receipts totaled $7.5 trillion for 2014, up 5.6 percent from the amount reported for 2013. Business receipts made up the majority of total receipts (69.4 percent), rising 2.3 percent for the year.
- Total net income (loss), or profit, decreased 8.9 percent, from $768.8 billion for 2013 to $837.4 billion for 2014. Ordinary business income accounted for the majority of this increase.
Between 2013 and 2014, total income (loss) minus total deductions available for allocation increased from $1,478.5 billion to $1,722.5 billion. Partners classified as partnerships received the largest share of income (loss) allocated to partners, $586.3 billion.

You can view this data at: https://www.irs.gov/pub/irs-soi/soi-a-copa-id1612.pdf

**Partnerships by Entity Types**

Partnerships classify their business structures as one of six entity types:

- Domestic general partnership;
- Domestic limited partnership;
- Domestic limited liability company;
- Domestic limited liability partnership;
- Foreign partnership; or
- “Other” Partnership

Limited liability companies (LLCs) made up the majority (66 percent) of all partnerships, surpassing all other entity types for the 12th consecutive year increasing almost 125 percent during this period. The number of LLCs rose 2.2 million after increasing 4.8 percent between 2011 and 2012. Partners associated with LLCs increased 6.1 percent (from 8.7 million to 9.2 million), while LLC profits increased 62.1 percent (from $149.6 billion to $242.5 billion). LLCs still represented 31.2 percent of the overall profits for all partnerships for 2012, an increase from 25.8 percent in 2011.

LLCs remained the most prevalent type of partnership, yet limited partnerships represented only 12 percent of all partnerships, reported the most profits (32.4 percent), and the largest share of partners (45.2 percent). Over the last 10 years, the number of limited partnerships increased only 7.4 percent, while the number of partners associated with those partnerships rose 71.7 percent. The total net income (loss) for limited partnerships increased $71.5 billion (from $188.4 billion to $259.9 billion) between 2011 and 2012.

Prior to 2002, domestic general partnerships were consistently the most common type of partnership and have ranked second since that time. With the exception of a slight increase for 2005, the number of domestic general partnerships has declined 23 percent over the past 10 years. This type of partnership accounted for 17.2 percent (0.6 million) of all partnerships for Tax Year 2013, following a decrease of less than 1 percent between 2011 and 2012.

**Taxation of Partnerships**

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level (IRC § 701). Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into
account in computing the tax of the partners (based on the partnership’s method of accounting and regardless of whether the income is distributed to the partners). A partner’s deduction for partnership losses is limited to the amount of the partner’s adjusted basis in his or her partnership interest. To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner’s basis in the partnership interest generally equals the sum of:

- Such partner’s capital contribution to the partnership;
- The partner’s distributive share of partnership income; and
- The partner’s share of partnership liabilities, less:
  - Such partner’s distributive share of losses allowed as a deduction and nondeductible expenditures not properly chargeable to capital account; and
  - Any partnership distributions.

Partnerships provide partners with a significant amount of flexibility to vary respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.

For reporting purposes, every partnership that engages in a trade or business, or has income from sources in the United States must file an annual information return, IRS Form 1065, *U.S. Partnership Return of Income*, or IRS Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*, with the Internal Revenue Service. A partnership does not pay tax on its income but “passes through” any profits and losses to its partners, who must include those profits and losses on their income tax returns. The partnership return must show names and addresses of each partner and each partner’s distributive share of taxable income. The return must be signed by a general partner. (See IRS Pub 541).

**Advantages of a General Partnership**

Below are the advantages of a General Partnership:

- Shared financial commitment;
- Ease of formation, few formalities;
- Ease of formation (mostly applicable licenses), operation and termination (lack of corporate formalities);
- Pass through tax treatment (single level taxation);
- Broader management base; general partners have unlimited management control; and
- Ability to shift income and appreciation to others.
Disadvantages of a General Partnership

Below are the disadvantages of a General Partnership:

- Unlimited liability of general partners (joint and several liability);
- Divided authority in decision-making;
- Difficulty in disposing of partnership interests;
- Lack of continuity—that is, when a partner leaves, partnership dissolves unless agreed upon otherwise;
- Lack of ability to use tax advantages of certain benefits, such as group health, life and disability; and
- Difficult to attract investors.

Under the general partnership law of most states, each and every partner is *jointly and severally liable* for all of the partnership’s debts, liabilities and obligations. Thus, even if a partner was not involved in any wrongdoing, his or her personal assets would still be at risk to pay damages arising from mistakes (claims) occurring in connection with another partner. Worse yet, under joint and several liability principles, an injured plaintiff could choose to sue only one of the partners and recover the entire judgment solely from that partner. A plaintiff might sue all of the partners, but because one or more of the partners is financially insolvent or “judgment proof,” the solvent partners would be responsible for the entire amount of the judgment. Of course, the paying partners would have a right of reimbursement (on a pro rata basis) from the non-paying partners. If the nonpaying partners are insolvent, however, the paying partners would still end up “holding the bag.” This is because a third party is generally not bound by the partners’ internal agreement regarding the sharing of losses or liabilities.

Limited Partnership

A *limited partnership (LP)* differs from a general partnership in the role and responsibilities of the partners. The limited partners typically provide capital and help arrange while not taking an active role in running the business. They do, however, receive a share of the profits for their involvement as limited partners.

The general partner in a limited partnership runs the operations of the business.

Most states have statutes that regulate and define the obligations and responsibilities of partners in this type of business arrangement. LPs are required to file with the secretary of state and must also file various reports.

The key to this LP partnership agreement is found in the area of liability, which falls on the general partners, and typically not on the limited partners. For this reason, individuals are reluctant to be general partners. The general partner of a limited partnership can itself be a corporation or LLC to mitigate liability issues to the promoters of the limited partnership. This, however, does not mean that a limited partner cannot be part of, or have a vote in, key decisions that affect the partnership.
A limited partnership can be attractive for a limited partner who can provide funding but not expertise and does not have the time to devote to being a hands-on part of the business. Taking on the financial risk of his or her investment but not the liability risk, is also more attractive to a limited partner. For tax purposes, a limited partnership typically works like a general partnership in that it is a pass through operation with profits passing through to the partners who then include their allocated income on their personal tax returns. Limited partnerships are often formed to acquire, operate and hold real estate.

Before the Tax Reform Act of 1986, limited partnerships were very popular in connection with certain tax shelter investments. The 1986 Act substantially eliminated the “shelter” element of passive investments and generally designated limited partnership interests as passive.

**Advantages of a Limited Partnership**

Below are the advantages of a Limited Partnership:

- Much easier to attract investors as limited partners;
- Allows for general partners to use their expertise, make key decisions and manage the business; and
- Limited partners can leave the business or be replaced without the need for the limited partnership to be dissolved

**Disadvantages of a Limited Partnership**

Below are the disadvantages of a Limited Partnership:

- There are more filings, formalities and state requirements with limited partnerships; and
- General partners assume personal liability

An interesting aspect of the limited partnership is that partners are able to allocate profits, losses, and gains as they see fit, regardless of the equity interest of a specific partner; subject to compliance with tax laws. This too can be attractive to prospective investors.

**Limited Liability Partnership (Professional Partnerships)**

Many states have now authorized special partnerships known as “limited liability partnerships,” or LLPs. Often, these LLPs are available only to certain professional practices, such as attorneys, medical practitioners and certified public accountants. To qualify as an LLP, all of the partners must be properly licensed to practice in their specialty or profession. The LLP merges the features of a general partnership with a corporation’s shield of limited liability. The primary distinction between general partnerships and LLPs is that the general partners belonging to an LLP are not vicariously liable for the acts of the other partners.
For example, if a physician were to be sued for medical malpractice, the other partners (physicians) in the LLP would not be held responsible for the mistake of one physician. The limited liability aspect of the partnership protects the remaining partners, but the partner who made the mistake will still have to answer to the lawsuit.

**Uniform Partnership Act**

Partnership law in the United States has been derived from only one source—the Uniform Partnership Act (UPA), originally promulgated in 1914 by the National Conference of Commissioners on Uniform State Laws, and subsequently enacted in 49 states. Under UPA, these states have adopted legislative acts that designate partnerships as being entities distinct from the partners. In such a case, the changing or death of a partner will not necessarily dissolve the partnership. If a partner desires to withdraw from a partnership, a state enacted uniform partnership act can enable the partnership to continue as a going concern without being forced into dissolution. The withdrawing partner can leave or sell his or her interest in the business without the old partner, or may bring in a new partner to take the place of the departing partner.

In a state that has adopted a uniform partnership act, the partners do not individually own partnership property and assets or have any interest in specific items of property belonging to the partnership. This is because the partnership is considered to be a separate legal entity. Each partner is free to assign their interest in the partnership to another person. The assignment of a partnership interest will not result in the dissolution of the partnership, but the assignee will not become a partner as a result of the assignment. To avoid unwanted assignments and the involvement of outside persons, many partnership agreements will limit the ability of the individual partners to assign away their interest in the partnership.

For a partnership, acting in a state with a uniform partnership act, it is crucial for the partnership to have provisions in the partnership agreement dealing with the death or withdrawal of a partner. If the majority of the remaining partners agree to continue the partnership, then the death or withdrawal will not result in the dissolution of the partnership. The agreement must set out the method for dealing with the disposition of the out-going partner’s interest if the partnership is going to survive the death or withdrawal. In such cases, a buy-out arrangement with an agreed upon valuation formula will be essential to the continuation of the partnership beyond the death or withdrawal or the out-going partner.

**Revised Uniform Partnership Act (RUPA)**

The Revised Uniform Partnership Act (RUPA) was approved by the Conference in 1994, bringing the law of partnerships in line with modern business practices and trends while retaining many of the valuable provisions in the original act. It was amended in 1997 to provide limited liability for partners in a limited liability partnership.
Adopted with the newest amendments in 21 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands, and without the limited liability partnership amendments in four additional states, RUPA is the only revision since the original was promulgated. It governs the relations among general partners and between the partners and the partnerships.

RUPA makes basic revisions to several subjects in the Uniform Partnership Act. For example, it clearly expresses the primacy of the partnership agreement. That agreement is any agreement between the partners, whether written, oral or implied, concerning the partnership. An important concept of RUPA is that it operates, for the most part, as a default statute for matters that are not covered by the partnership agreement.

An important feature of the Revised Uniform Partnership Act is that it moves away from the aggregate approach to partnership law, and instead adopts an entity approach. RUPA states that a partnership is an entity distinct from its partners—thus achieving greater partnership stability under this more modern approach. A partnership may sue and be sued in the partnership name; property may be acquired in the partnership name as well.

The partner's interest is viewed as a separate group of rights and liabilities associated with participation in the partnership. No partner has an interest in specific property of the partnership. Creditors of a partner may attach the interest of a partner, but may not attach specific partnership property.

RUPA also changes the rule on the dissolution of a partnership. Partnership breakups under RUPA do not require dissolution every time a partner leaves. In most cases, a partnership may buy out the interests of a partner who leaves. A term partnership will not dissolve so long as one-half of the partners choose to remain. RUPA also establishes and defines the scope of the partners' duties of care and loyalty, and the obligation of good faith and fair dealing.

The 1997 amendments to the Uniform Partnership Act provide greater protection to general partners of a registered limited liability partnership than is the case under most of the existing state limited liability partnership statutes.

Corporations

The corporation is the most prominent form of business structure in this country, in terms of total assets. Although a corporation consists of people, just like a sole proprietorship or partnership, it is usually considered an artificial entity in the eyes of the law. By definition, a corporation might be described as an artificial person that employs one or more individuals in a for-profit or non-profit business entity. It exists as a separate entity and provides a level of protection against personal liability.

According to Wikipedia, the free encyclopedia,
“A corporation is a separate legal entity, usually used to conduct business. Corporations exist as a product of corporate law, and their rules balance the interests of shareholders that invest their capital and the employees who contribute their labor. People work together in corporations to produce.”

The corporation has the power to make contracts, borrow money, buy and sell property in its own name, issue notes, and to do other acts incidental to the business for which it was organized. The obligations of the business are its own debts; it can sue and be sued in the corporate name.

**Limited Liability of Shareholders**

All assets and liabilities are owned by the corporation, not the individuals who own or manage it. Thus, the owners of the corporation have *limited liability*, in contrast to the partnership or the sole proprietor where the business owners have unlimited liability.

Corporations are owned by *stockholders*. If a corporation goes out of business, the risk to the stockholders is only the loss of their investment. The shareholder’s personal assets cannot be attached by creditors of the business, unlike the situation for partnerships or sole proprietors. Thus, limited liability is one of the key factors which cause individuals to incorporate their business ventures as opposed to an unincorporated business situation.

**Corporation Data for 2013**

- The number of active corporate tax returns filed increase approximately 0.8 percent between 2012 and 2013 (latest data available). Approximately 4,080,293 corporations filed tax returns electronically in 2012. This number rose 8 percent in 2013, reaching an all-time high of 4,404,316 returns filed electronically;
- Total assets reported for active corporations increased approximately 4 percent, from $85 trillion in 2012 to $88 trillion in 2013. By sector, Management of Holding Companies experienced the largest net decrease, down 4.8 percent from $15.2 trillion in 2012 to $14.5 trillion in 2013. In contrast, the Wholesale Trade sector shows the largest percentage increase of 12.76 percent from $2.5 trillion in 2012 to $2.9 trillion in 2013;
- Total receipts from operations and investments increased 2.7 percent, from $29.4 trillion in 2012 to $30.2 trillion the following year. Corporate pretax profits, also known as net income (less deficit), increased 8.7 percent, from $1.8 trillion to $1.9 trillion. When excluding pass-through entities from the total, pretax profits increased from $1.1 trillion in 2012 to $1.2 trillion in 2013. In 2013, S Corporations pass-through entities reported $381 billion in pretax profits, regulated investment companies (RICs) reported $322 billion and REITs reported $65 billion;
- Of the 5.9 million active corporations for Tax Year 2013, approximately 4.3 million were pass-through entities These entities include RICs, REITs and S corporations. Pass-through entities pay little or no Federal income tax at the
corporate level. By law, they are required to pass any profits or losses to their shareholders, where they are taxed at the individual rate. Pretax profits for pass-through entities increased 6.3 percent (or $46 billion) during 2013; and

- The remaining 1.6 million corporate returns reported total receipts of $23 trillion, an increase of 1.8 percent from 2012 to 2013.

You can view this data at: http://www.irs.gov/pub/irs-soi/13coccr.pdf

Advantages of Corporation

Below are the advantages of a Corporation:

- Perpetual life; the corporation need not be dissolved because of the death of one or more stockholders;
- Corporate owners generally are not personally liable for corporate debts, the most that can be lost is the investment made in the company; and
- Ease of gathering investors.

Disadvantages of Corporation

Below are the disadvantages of a Corporation:

- More complicated and expensive to set up a corporation than other forms of business structures. The corporation is governed by the laws of the state in which it is organized and by the federal government:
  - Articles of incorporation must be filed;
  - Corporate by-laws must be prepared;
  - Records must be kept;
  - Annual reports must be filed with state officials; and
- Tax disadvantages: double taxation (dividends).

C Corporation

The most commonly found type of corporation is the C Corporation, which is a for-profit, state incorporated business. These are the regular type of corporations that are organized as small closely held corporations or large corporations that are traded on the national and international stock exchanges.

C Corporations are organized based on state law under the rules and regulations of the individual state’s Department of Corporations and the Secretary of State’s office. Corporations file articles of incorporation with, or secure a charter from, the State. A corporation only has the powers granted by statute of its charter, plus any implied powers necessary to carry out its normal functions. Thus, a corporation’s powers are more limited than those of an unincorporated business. Articles of incorporation are filed, and appropriate fees are paid to set up a corporation.
The C Corporation is established as a unique business entity, which takes on a distinctly separate business and tax identity from that of the owners (the shareholders). Separate income taxes are filed (IRS form 1120), and corporate taxes are paid regularly for the business. In return, the business owners are typically removed from personal liability for debt incurred by the corporation.

Should the business go bankrupt, or be faced with a lawsuit, the owner’s personal assets are protected. This is the most significant reason why many business owners choose to incorporate. Additionally, as a separate entity, a corporation can own property, make business dealings or even sue another business independently of the shareholders.

To establish a corporation, there are several requirements and formalities that need to be addressed. For example, a corporation needs to issue shares to stockholders. In addition, state requirements usually include minutes be taken at shareholder and Board of Director meetings, appointment of officers and maintaining specific records as outlined by the state in which the incorporation documents are filed.

The shareholders have ownership in the corporation, the Board of Directors governs the business and elected officers manage the day-to-day activities. Corporations must adhere to corporate tax laws and file corporate taxes regularly. While corporate taxes can be higher, initially they may be lower than that of a sole proprietor who is paying a 28% rate on his or her personal income tax. The first $50,000 is taxed at a rate of 15%.

Advantages of a C Corporation

Below are the advantages of a C corporation:

- The corporation is a separate legal entity, and if it is adequately capitalized and proper corporate formalities are followed, the shareholders should generally have liability protection from the debts and obligations of the corporation;
- Corporations can utilize corporate benefit health plans, which often offer better retirement options and benefits than those offered by non-corporate plans;
- 100% deductible health insurance for all employees as well as group term life insurance up to a specified amount per employee;
- If a stockholder dies or wishes to sell out, the corporation continues;
- Easier to raise capital as a corporation than as a sole proprietorship or partnership; and
- Can offer employee incentive stock plans.

Disadvantages of a C Corporation

Below are the disadvantages of a C corporation:

- "Double taxation." This means that besides paying corporate income taxes, any dividends to shareholders are taxed again at the applicable tax rate;
• Formalities and regulations must be followed closely in conjunction with the laws regarding incorporating in a specific state. Failure to do so can create a situation where shareholders may be held liable;
• Costlier to start than a sole proprietorship or partnership; and
• More time and effort to maintain.

While the idea of double taxation is very troublesome to many new business owners, it is not usually significant for small businesses, where it is unlikely that there will be large dividend payouts. Rather, the money is paid out in the form of salaries and benefits. As the owner, you can pay yourself a reasonable salary and handle any number of duties in the corporation. By incorporating, you have the luxury of leaving some money in the corporation if you foresee significant personal income from other sources. This way you can reduce your own personal income tax payments.

Taking the time, making the effort and paying the additional expenses to incorporate are usually considered worthwhile by a business that foresees potential liabilities and/or seeks investors.

Taxation of C Corporation

A C Corporation is taxed as a separate entity under the tax laws. Income earned by a corporation is normally taxed at the corporate level using the corporate income tax rates shown in Table 2.5 below, and the corporation must file IRS Form 1120 each year to report this income.

<table>
<thead>
<tr>
<th>Taxable Income Over</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $50,000</td>
<td>15% of the Taxable Income</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>$7,500 plus 25% of the excess over $50,000</td>
</tr>
<tr>
<td>Over $75,000 but not over $100,000</td>
<td>$13,750 plus 34% of the excess over $75,000</td>
</tr>
<tr>
<td>Over $100,000 but not over $335,000</td>
<td>$22,250 plus 39% of the excess over $100,000</td>
</tr>
<tr>
<td>Over $335,000 but not over $10,000,000</td>
<td>$113,900 plus 34% of the excess over $335,000</td>
</tr>
<tr>
<td>Over $10,000,000 but not over $15,000,000</td>
<td>$3,400,000 plus 35% of the excess over $10,000,000</td>
</tr>
<tr>
<td>Over $15,000,000 but not over $18,333,333</td>
<td>$5,150,000 + 38% of the excess over $15,000,000</td>
</tr>
<tr>
<td>Over $18,333,333</td>
<td>35% of the excess over $18,333,333</td>
</tr>
</tbody>
</table>
After the corporate income tax is paid on the business income, any distributions made to stockholders are taxed again at the stockholders' tax rates as dividends. Because of these two levels of tax, a regular corporation may be a less desirable form of business than the other business entities (sole proprietorships, partnerships, limited liability companies, or S Corporations). This may be true even though regular corporations are taxed at lower tax rates on their first $75,000 in income.

Because the taxation of income to sole proprietorships and partnerships is determined by the tax bracket that applies to each individual owner, a comparison of tax rates that apply to corporations and to individuals can give you some idea of which form of business would save taxes at a particular income level.

In comparing the tax advantages of operating as a partnership or sole proprietorship rather than as a corporation, remember that not all of the corporate profits will be subject to double taxation. The operators of the corporation may withdraw reasonable salaries, which are deductible by the corporation. These salaries are therefore free from tax at the corporate level (though the recipients will have to pay income tax, and both recipients and the business will have to pay FICA tax, on them). In some cases, the entire net profit may be offset by salaries to the owners so that no corporate income tax is due.

**Accumulated Earnings Tax**

A corporation can accumulate its earnings for a possible expansion or other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business it may be subject to an accumulated earnings tax of 15%. If the accumulated earnings tax applies, interest applies to the tax from the date the corporate return was originally due, without extensions.

To determine if the corporation is subject to this tax, first treat an accumulation of $250,000 (or less) generally as within the reasonable needs of most businesses. Treat an accumulation of $150,000 or less as within the reasonable needs of a business whose principal function is performing services in the fields of account, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts (IRC § 531).

Reasonable needs of the business include the following.

- Specific, definite, and feasible plans for use of the earnings accumulation in the business; and
- The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, if the amount does not exceed the reasonably anticipated total estate and inheritance taxes and funeral and administration expenses incurred by the shareholder's estate.

The absence of a bona fide business reason for a corporation's accumulated earnings may be indicated by many different circumstances, such as a lack of regular distributions to its
shareholders or withdrawals by the shareholders classified as personal loans. However, actual moves to expand the business generally qualify as a bona fide use of the accumulations.

The fact that a corporation has an unreasonable accumulation of earnings is sufficient to establish liability for the accumulated earnings tax unless the corporation can show the earnings were not accumulated to allow its individual shareholders to avoid income tax.

**Note:** This tax does not apply to LLCs.

**S Corporation**

An S Corporation gets its name from the subchapter of the Internal Revenue Code that determined it is not a taxpaying entity, but is a conduit (pass-through) that passes gains and losses on to its shareholders. It is a separate legal entity in terms of providing liability protection to its owners from business creditors. This best-of-both-worlds aspect is why an S-corporation is chosen for some businesses instead of the other business structures. However, to make an election to be treated as an S Corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity and number of its shareholders.

**Formation**

To be eligible to elect S Corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock (IRC § 1361). Only individuals (other than non-resident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S Corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock (IRC § 1362).

Although there are limitations on the types of shareholders and stock structure an S Corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C Corporation or partnership). Certain corporations may not elect S Corporation status including financial institutions using the reserve method of accounting for bad debts and insurance companies subject to tax under subchapter L.

State laws specify formalities in order to form a corporation. At minimum, articles of incorporation must be filed with the secretary of state. In some states, the articles must also be recorded with the register of deeds in the county in which the corporation is located. Once the business has incorporated, the owners may decide to file as an S Corporation, within approximately 75 days of incorporating. To do so, they need to file an IRS form 2553. This does not create a separate type of corporation, but changes the tax structure of the corporation.
Taxation of S Corporation

The S Corporation has shareholders and is taxed like a sole proprietorship or a partnership rather than a C Corporation, which is taxed as a separate business entity. Income is passed through to the shareholders who report their pro rata income, or losses, on their individual tax returns. Pass-through entities accounted for 73 percent (4.3 million) of all active corporate tax returns filed in 2013.

The S Corporation still files a federal tax return (IRS Form 1120S) and possibly a state return as well, if required by individual state law. The S Corporation shows profits and losses as they pass through to the shareholders and the corporation generally does not pay federal income tax as a separate entity. Some states, however, do tax S Corporations in the same manner as C Corporations. Check your state tax laws before electing S Corporation status.

Advantages of an S Corporation

Below are some advantages of an S Corporation:

- Corporate losses can be passed through to the shareholders, and as the owner (and shareholder) you may be able to take the loss against income that appears on your personal return;
- You can have the protection of limited personal liability without having to pay corporate taxes;
- You can minimize self-employment tax and FICA tax. Profits, as a shareholder, are not taxed in this manner; and
- It is easier to raise capital as a corporation than as a sole proprietorship or partnership.

Disadvantages of an S Corporation

Below are some disadvantages of an S Corporation:

- Numerous regulations and requirements that must be upheld by an S Corporation including a limit on the number of shareholders;
- Like a C Corporation, it can be costly to set up and follow formalities;
- Scrutiny by the IRS of shareholder-employees, who must receive reasonable compensation (subject to employment taxes) before any non-wage distributions may be made to that shareholder-employee; and
- Other regulations imposed on S Corporations include:
  - All shareholders must be U.S. citizens;
  - All shareholders must vote in favor of the S Corporation; and
  - Benefits such as health or accident insurance for employee shareholders (with at least 2 percent partnership) may not be deducted by the corporation.
A corporation that plans to pass through dividends regularly to shareholders may want to elect S Corporation tax status. Also, a business owner who may want to take business losses on his or her own personal tax return, possibly to offset income earned by his or her spouse may opt for this type of corporation. It is worth noting that if you do set up an S corporation and later decide that there is a better alternative for your business, you can vote to drop S Corporation status.

Like other corporations, the S Corporation can limit the personal liability of the owners. Creditors can go after the assets of the corporation and not the owners if there are outstanding debts. It is necessary that the owner keeps his or her personal financial records and those of the S Corporation totally separate to avoid legal entanglements.

**Life Span**

Because a corporation is a separate legal entity, it has a “perpetual life”—that is, there is no specific time limit on how long the corporation can exist. Also, there is no responsibility between the life of a corporation and the lives of its owners. For example, the death of the sole owner of a corporation does not result in its dissolution.

**Sale or Transfer of Ownership**

Shares of stock can easily be transferred in an S Corporation during the lifetime of an owner or at the owner’s death. However, there are restrictions that limit the transferability of stock. An S Corporation can have no more than 75 shareholders. Also, shareholders can only be individuals, estates, certain tax-exempt organizations and certain trusts.

**Management Responsibility**

A corporation consists of shareholders and a board of directors. The directors usually employ officers and other employees to oversee the day-to-day operation of the business. In a small business, there is often little distinction between the shareholders, the board and the officers. Frequently, these roles and responsibilities are carried out by the same people.

**The Limited Liability Company (LLC)**

A limited liability corporation (LLC) is a separate legal entity that is a hybrid between a partnership and a corporation which combines the limited liability advantage of a corporation with the tax status of a sole proprietor or partnership (see IRS Pub 3402).

A limited liability company (LLC) is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for Federal income tax purposes as if it were a sole proprietorship (referred to as an entity disregarded as separate from its owner), a partnership, or a corporation. If the LLC has only one owner,
(see IRS Publication 555, on community property states), it will automatically be treated as if it were a sole proprietorship (a “disregarded entity”), unless an election is made for it to be treated as a corporation. If the LLC has two or more owners, it will automatically be treated as a partnership unless an election is made for it to be treated as a corporation. If the LLC does not make a classification election, a default classification of partnership (multi-member LLC) or disregarded entity (single-member LLC) will apply. The election referred to is made using the Form 8832 (PDF), Entity Classification Election. If a taxpayer does not file Form 8832 (PDF), a default classification will apply.

**The Growth of LLCs**

The growth of LLCs was made possible by a 1988 IRS revenue ruling that treated Wyoming’s LLCs as partnerships for tax purposes and by the subsequent adoption of LLC rules in all U.S. states. Most LLCs elect to be taxed as partnerships for Federal reporting purposes, and their numbers are counted among the partnership data. Since 1990, we have seen the rapid growth of LLCs relative to other forms of business organization that are taxed as partnerships.

**Ownership of an LLC**

LLCs are owned by members. An ownership interest in an LLC confers on a member the right to a designated share of the profits and losses of an LLC, the right to vote, and the right to receive distributions from the LLC.

There are no limits on the number of members an LLC may have. However, most authorities agree that a one-member LLC cannot be considered a partnership for federal tax purposes (since a partnership refers to a business with at least two co-owners) and so may be taxed as a corporation.

**Formation of LLC**

An LLC is formed by filing the articles of organization with the Secretary of State or designated official of the state in which the LLC is established. Typical provisions in the articles include the name and address of the LLC, the name of the company’s registered agent, and, if determined the date the LLC will be dissolved.

Although not required by law, members of LLCs should also enter into operating agreements with one another. These are documents created to establish internal governance rules for the operation of the business. Similar to a shareholders’ agreement, the operating agreement may, among other things, control how profits, losses, distributions, and management powers are distributed among the members. If an operating agreement is not prepared, the rules of operation set forth in the LLC’s home state will apply by default.

Also, an Employer Identification Number (EIN) will now be required. A social security number will no longer suffice (see IRS Pub. 1635) for further details.
Management of an LLC

LLCs can be managed by their members, or the management responsibility can be delegated. A manager may be an individual, a partnership, a corporation, or even another LLC. Managers may also appoint (such as a president, treasurer, etc.) to help run the LLC. Unless limited by the LLC’s articles of organization, managers and officers are able to bind the LLC to contractual obligations.

Although LLCs work beautifully for most common types of businesses, they also work well in more-complex structures. Joint ventures, investment groups, international partnerships, high-technology ventures, real estate developers, and professionals are some of the businesses that may profit from forming an LLC.

Advantages of an LLC

Below are some advantages of a Limited Liability Corporation (LLC):

- Limited Liability protection;
- Pass through tax treatment (the IRS does not tax LLC's, income and expenses are filed on Form 1040, Schedule C);
- Flexibility in structuring managerial responsibility and in allocating priority cash flows and tax benefits;
- Several states do not tax LLC's; and
- The initial application process and annual paperwork for the LLC is dramatically less complicated and less expensive than a corporation.

Disadvantages of an LLC

On the other hand, there are some disadvantages, but they are dependent on the state in which the business resides, state tax laws and certain scenarios for raising capital:

- Some states do tax the LLC;
- Some commercial lenders are reluctant to consider an LLC any different than a sole proprietor, and that is due more to ignorance of legal business structures;
- In some states the LLC must make contributions to unemployment compensation funds, even if it is a sole proprietorship;
- Most venture capitalists shy away from the LLC as it does not designate percentage ownership if more than one person and/or entity eventually comprises its owners; and
- Though not significant compared to corporations, the LLC does have to submit annual reports and fees in many states.

**Taxation of LLCs**

Back in 1988, the Service ruled that an LLC organized under the Wyoming LLC statute could be treated as a partnership for Federal tax purposes, applying the four-factor test of the prior entity classification regulations then in effect. All 50 States have enacted LLC statutes. Over the years following the 1988 revenue ruling, the Service issued a series of revenue rulings on a State-by-State basis, eventually addressing the issue for many of the States, concluding that LLCs organized under each such State’s laws could be classified as a partnership for Federal tax purposes. No further such rulings have been issued since December 17, 1996, when the final check-the-box regulations was issued; those regulations generally make classification of an entity as a partnership for Federal tax purposes elective.

**Note:** California does not allow professionals to operate as LLCs.

**Personal Service Corporation (PSC)**

A personal service corporation, also called a professional service corporation, is a corporate entity formed by individuals who provide personal services for their clients. Examples of this type of business include accountants, actuaries, architect, attorneys, chiropodists, chiropractors, medical doctors, dentists, engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians.

The U.S. Treasury’s exposure to service corporations had its beginnings in the late 1960s and the early 1970s when the IRS refused to recognize as taxable entities those corporations being formed under professional corporation statues of various states. Finally, in the early 1970s the IRS acquiesced to the cases it lost and formally recognized professional corporations. The IRS stipulates that a company’s owner must personally perform at least 20 percent of the services to qualify for this status.

There are several advantages to forming a personal services corporation, as opposed to operating as a sole proprietorship or partnership. The most notable are:

- Limited Liability;
- Tax Advantages; and
- Perpetuity

**Limited Liability**

A major advantage to owning a personal service corporation is the benefit of limited liability the structure provides. If a company structured as a sole proprietorship fails to pay a vendor for services rendered, the owner is personally responsible for the debt. His assets, such as his home or automobile, may be seized to repay the arrears. Personal service corporations are considered by the government to be independent entities, separate from their owners. As a result, an owner is not personally responsible for any
debts or claims brought against it. His personal credit is not affected as a result of any delinquent debt or lawsuits brought against his company.

**Tax Advantages**

There are a variety of tax advantages afforded to personal service corporations. The law allows personal service corporations to deduct salaries, bonuses, and to provide employees with tax-free healthcare benefits and life insurance. Moreover, fringe and supplemental benefits offered by the company, including disability insurance and dependent care are tax deductible. Business expenses, such as the procurement of business equipment or travel, are also tax deductible. In addition, personal service corporations can design employee retirement plans, such as a 401(K), with higher contribution limits than unincorporated businesses are allowed.

Also, as discussed above, the personal services corporation is allowed to retain profits in the amount of $150,000 per year from being distributed to shareholders to pay for company improvements and other business transactions.

**Perpetuity**

A sole proprietorship or partnership legally dissolves when its owner dies or otherwise leaves the organization. A personal service corporation, on the other hand, exists in perpetuity. Thus, the company remains intact if ownership is transferred or shares are sold. This is especially beneficial to an owner who wishes to partially retire or focus on other ventures. As long as she meets the requirement of performing 20 percent of the services provided by the business, she is free to remain otherwise uninvolved in its operation.

**Disadvantage of PSC**

One of the disadvantages of operating professional service corporations is that they don’t get the favorable tax rates like regular corporations do. The IRS taxes profits from professional service corporations at a flat rate of 35 percent regardless of the amount. For example, regular corporation are taxed just 15 percent on the first $50,000 in profits while professional corporations are taxed 20 percent more on the same amount. The 35 percent flat rate is generally higher than what LLC owners pay on their share of profits. In fact, in 2016, LLC owners (married filing jointly) with $50,000 in income, pay only 15 percent in federal income taxes.

**Applicable Federal Income Tax Rates**

Table 2.6 below illustrates the summary of applicable Federal income tax rates to small businesses.
Table 2.6
Summary of Application of Federal Income Taxes to Small Businesses

<table>
<thead>
<tr>
<th>Forms of Business</th>
<th>Individual Income Tax</th>
<th>Corporate Income Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>Applies</td>
<td>Does not apply</td>
</tr>
<tr>
<td>Qualified Joint Venture (married couple)</td>
<td>Applies to each spouse’s share of income</td>
<td>Does not apply</td>
</tr>
<tr>
<td>Partnership</td>
<td>Applies to each partner’s share of partnership income</td>
<td>Does not apply</td>
</tr>
<tr>
<td>Corporation</td>
<td>Applies to shareholder’s share of S Corporation income</td>
<td>Does not apply unless S Corporation elects to be taxed as a corporation</td>
</tr>
<tr>
<td>Limited Liability Company (LLC)</td>
<td>Applies to member’s share of LLC income</td>
<td>Does not apply unless LLC elects to be taxed as a corporation</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Applies to dividends paid to shareholders</td>
<td>Applies</td>
</tr>
</tbody>
</table>
Chapter 2
Review Questions

1. Which of the following is the simplest and the most common form of business entity?
   ( ) A. Sole Proprietorship
   ( ) B. Partnership
   ( ) C. Corporation
   ( ) D. S Corporation

2. Which of the following is the most commonly found type of corporation?
   ( ) A. S Corporation
   ( ) B. C Corporation
   ( ) C. Personal Services Corporation
   ( ) D. Limited Liability Corporation

3. Corporations are owned by______________.
   ( ) A. Stockholders
   ( ) B. Members
   ( ) C. Beneficiaries
   ( ) D. Trusts

4. What is the flat Federal tax rate that applies to the first dollar of taxable income of a qualified personal services corporation (PSC)?
   ( ) A. 10%
   ( ) B. 15%
   ( ) C. 25%
   ( ) D. 35%

5. To be eligible to elect S Corporation status, a corporation may not have more than how many shareholders?
   ( ) A. 10
   ( ) B. 20
   ( ) C. 100
   ( ) D. 50
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CHAPTER 3

EMPLOYER SPONSORED QUALIFIED RETIREMENT PLANS

Overview

Historically, the ideal retirement plan for many Americans was likely to come from three main sources: Social Security, Employer Sponsored Pension Plans and Personal Savings. This was typically illustrated graphically with the picture of a three legged stool.

In this chapter, we will examine the second leg of the stool: Employer sponsored “qualified” retirement plans (QRPs).

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The definition of a qualified retirement plan (QRP);
- The basic features, benefits and eligibility requirements of employer sponsored QRPs;
- The types of employer-sponsored QRPs: Defined Benefit (DB) and Defined Contribution (DC) plans;
- The differences between a defined benefit plan (DB) and a defined contribution (DC) plans;
- The changing retirement landscape of employee-sponsored QRPs; and
- A comparative analysis of QRPs.

Let’s first define a qualified retirement.

Qualified Retirement Plan (QRP) Defined

What is a qualified retirement plan (QRP)? A QRP is a plan that meets the requirements of IRC § 401(a) and the Employee Retirement Income Security Act (ERISA) of 1974 (see Chapter 4 for a full review of ERISA) and is thus eligible for favorable tax treatment.
Basic Characteristics of Employer-Sponsored QRPs

Employer sponsored retirement plans provide value to employers and their employees. They give employers a distinct advantage in attracting and retaining quality employees, and they provide employees with a source of retirement income. More importantly, employer sponsored plans offer participating employers significant tax advantages.

Eligibility Requirements

To be eligible for “qualified” plan status, and to be able to receive certain tax advantages, and a qualified retirement plan must comply with the following:

- The plan must be in written form and established by an employer (corporation, partnership or sole proprietor). The plan must be a formal, written document which reflects its permanent nature and the basic provisions governing the plan;
- The plan must be communicated to the employees. Typically, this is accomplished by means of providing the employees with a written summary of the plans;
- The plan must benefit the employees and/or their dependents and beneficiaries. The plan cannot be exclusively for the benefit of the employer or other key personnel;
- The plan must be permanent. The plan must be intended to stay in place indefinitely for the benefit of the employees. This implies that the plan cannot have a specific termination date established by the employer;
- The plan cannot discriminate. All employees who are eligible to participate in the plan must be included (unless an employee signs a waiver indicating he or she does not wish to participate). It is discriminatory to purposely keep employees out of the plan who would otherwise be eligible;
- The plan must be filed and approved by the IRS. Required forms and information must be supplied to the IRS and Department of Labor for plan approval. Requirement under the Internal Revenue Code (IRC) include criteria governing eligibility, vesting and distribution rules; and
- The employer is deemed to be a plan fiduciary. That is, the employer is placed in a position of financial trust with regard to the plan and its participants, and is held to a higher level of legal responsibility. Other individuals may also be considered fiduciaries, such as the plan administrator.

A full spectrum of these requirements for employers and their employees can be found in IRC § 401 through 420.

Tax Advantages

If a plan satisfies the above requirements, it will be considered a qualified retirement plan and both the employer and the employees will be able to enjoy specific tax advantages. These advantages include:
• The employer is allowed a current tax deduction for plan contributions as business expenses;
• Amount contributed by the employer on behalf of the participants are not currently taxable to the employees under income tax rules;
• Investment earnings on the plan contributions are tax deferred. They will only be taxed upon receipt by the employee; and
• Lump sum benefit payments may be rolled into another qualified retirement plan (such as an IRA) and current income taxation will continue to be deferred.

Needless to say, the principal advantage of an employer sponsored qualified retirement plan is its favorable tax advantages. The employer enjoys a tax deduction for all contributions, and the employees have the advantage of no current taxation on the amounts contributed or on the investment growth of the contributions.

Types of Employer-Sponsored QRPs

Under IRC § 414 it provides that there are two main types of retirement plans:

• Defined Benefit plans [IRC § 414(j)]; and
• Defined Contribution plans [IRC § 414(i)].

Let’s first begin with a review of defined benefit plans.

Defined Benefit Plan

A defined benefit (DB) plan specifies a formula for computing benefits that will be received during retirement, typically in the form of an annuity over the lifetime of the retiree and spouse. In the private sector such plans when offered, are almost always fully funded by the employer, with employees automatically enrolled in the plan after completing an initial eligibility period, such as one year. Such plans are funded as a single account by the employer; to meet certain tax standards, the employer must contribute sufficient funds to pay future benefits promised by the plan, taking into account various actuarial assumptions about the work-life, salary, and life expectancy of the participants. The employer assumes the risk of varying investment returns (see Chapter 5 for a full review of Defined Benefit Plans).

Defined Contribution Plan

A Defined Contribution (DC) plan has certain features, such as which party is assuming risk, which can be looked at as the opposite of DB plans. In these plans, the amount contributed to the plan—often by both the employee and the employer—is specified while the future value of the plan is unknown. Funds are placed into individual accounts for each employee, with periodic contributions added to the account. The employee assumes the risk of investment gains and losses. When employees retire (or otherwise
leave employment), provided they have met any vesting requirements imposed in employer funds, they receive the value of their account (See Chapter 6).

History of DB and DC Plans

The first pension plans in the United States were sponsored by colonial militias and the U.S. military, many of which predated our country’s independence. The history of the private DB plan in America goes back 125 years. American Express Company, a railroad freight forwarder, introduced in 1875 the very first U.S. private sector pension plan in an effort to promote a stable, career-oriented workforce. For the remainder of the 20th century, most of the major railroad companies, and many of the country’s private employers all introduced pension plans. For example, AT&T introduced a pension plan to its employees in 1906. By 1920, pension plans had become a fairly normal part of an employment contract with a large employer.

The 1930s and 1940s helped shape the structure of the modern defined benefit plan. Ironically, the Great Depression had an overall positive impact on private pension plans. While the disastrous economic conditions of the year led to many corporate pension failures, the government’s reaction to the depression resulted in much higher tax rates, particularly among the highest earners in the country. Consequently, the tax benefit enjoyed by corporations that contributed to pension plans was enhanced. Further, the adoption of Social Security reduced the demand for high benefits from labor, facilitating the payment of modest benefits. As a result, the number of pension plans grew significantly, particularly among smaller employers.

Resulting from the legislative foundation made during the Great Depression, between 1945 and 1970 participation in pension plans by the private workforce increased from 19% to 45%, according to the Bureau of Labor Statistics. While the pension plan had become much more institutionalized during these decades, several well-publicized failures (e.g., Studebaker) resulted in increased pension legislation throughout the period, culminating in the adoption of the Employee Retirement Income Security Act (ERISA) in 1974 (see Chapter 4).

The history of DC plans is more recent. Prior to 1978, many companies offered profit-sharing plans or various other types of deferred compensation plans to employees, where employees could defer a portion of their non-salaried compensation into a plan. In 1981, Johnson Companies designed the first 401(k) plan whereby employees could defer a portion of their own salary pretax. A couple of months after this first salary reduction 401(k) plan, the Internal Revenue Service (IRS) issued proposed regulations on 401(k) plans that sanctioned the use of employee salary reductions as a source of 401(k) contributions. With IRS approval, most companies with preexisting deferred compensation plans added 401(k) components to the plans, turning their DC plans overnight into viable, tax-advantaged retirement vehicles.
Over the course of the next 20 years, the popularity of 401(k) plans grew rapidly, particularly among smaller employers that were burdened by the increasing liability and costs associated with sponsoring a defined benefit plan. Generally speaking, many firms with existing DB plans adopted 401(k) plans to supplement retirement benefits, or “froze” their DB plans and offered new employees only a 401(k) plan as a primary retirement savings vehicle. Most new firms, or those without a DB plan previous to the 401(k) regulations, chose to offer only a 401(k) plan to employees as a primary retirement savings vehicle.

Changing Landscape of Employer–Sponsored QRP Benefits

In the past two decades, the changing landscape of employer-sponsored retirement plans has changed significantly. According to the Investment Company Institute (ICI), retirement assets in the United States increased from $2.4 trillion in 1985 to $24.5 trillion by the end of the second quarter of 2016.

Of the $24.5 trillion held in retirement accounts, $7.0 trillion was held in all employer-based DC retirement plans of which included $4.9 trillion in 401(k) plans, while private DB plans held $2.8 trillion in assets, ICI reported (See Table 3.1).

Table 3.1
Total U.S. Retirement Market
(Trillions of dollars, end of period, selected years)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1994</th>
<th>2000</th>
<th>2016 (2Q)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRAs</td>
<td>$0.2</td>
<td>$1.1</td>
<td>$2.6</td>
<td>$7.5</td>
</tr>
<tr>
<td>Private DC Plans</td>
<td>$0.6</td>
<td>$1.1</td>
<td>$3.0</td>
<td>$7.0</td>
</tr>
<tr>
<td>Government DB plan</td>
<td>$0.4</td>
<td>$1.6</td>
<td>$3.0</td>
<td>$5.2</td>
</tr>
<tr>
<td>Private DB Plans</td>
<td>$0.8</td>
<td>$1.2</td>
<td>$2.0</td>
<td>$2.8</td>
</tr>
<tr>
<td>Annuities</td>
<td>$0.4</td>
<td>$0.8</td>
<td>$1.0</td>
<td>$2.0</td>
</tr>
<tr>
<td>Total</td>
<td>$2.4 trillion</td>
<td>$5.7 trillion</td>
<td>$11.6 trillion</td>
<td>$24.5 trillion</td>
</tr>
</tbody>
</table>

https://www.ici.org/research/stats/retirement/ret_16_q2

Retirement assets accounted for 34 percent of all household financial assets in the United States at the end of the second quarter of 2016, according to the Investment Company Institute (ICI).

This dramatic increase in America’s savings is unsurprising, given the expected retirement income needs of the baby boomer generation, in which 8,000 a day began to turn 65 in 2011, and will continue over the next 16 years.
**Benefit Incidence**

While all retirement savings vehicles shown in Table 3.1 above have experienced growth over the 29 year time period, it is noteworthy that the assets of private DC plans have increased nearly fivefold, while the assets of DB plans have increased only twofold.

Table 3.2 displays the trends in private pension plans (DB vs. DC) from 1975 to 2014 (latest data available). For private employers, we have seen a significant increase in the number of pension plans from 632,135 in 1985 to 685,203 in 2014, an 8 percent increase, according to the Department of Labor (DOL). The overall increase has stemmed from a large increase in the number of DC plans from 461,963 in 1985 to 640,334 in 2014, an increase of 39% (largely 401(k) plans), while at the same time period we saw a 74 percent decrease in DB plans.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Plans</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>632,135</td>
<td>170,172</td>
<td>461,963</td>
</tr>
<tr>
<td>1990</td>
<td>712,308</td>
<td>113,062</td>
<td>599,245</td>
</tr>
<tr>
<td>1995</td>
<td>693,404</td>
<td>69,492</td>
<td>623,912</td>
</tr>
<tr>
<td>2000</td>
<td>735,651</td>
<td>48,773</td>
<td>686,878</td>
</tr>
<tr>
<td>2005</td>
<td>679,095</td>
<td>47,614</td>
<td>631,481</td>
</tr>
<tr>
<td>2006</td>
<td>701,012</td>
<td>48,579</td>
<td>645,971</td>
</tr>
<tr>
<td>2007</td>
<td>683,647</td>
<td>48,982</td>
<td>658,805</td>
</tr>
<tr>
<td>2008</td>
<td>676,689</td>
<td>48,375</td>
<td>669,157</td>
</tr>
<tr>
<td>2009</td>
<td>706,667</td>
<td>47,137</td>
<td>659,530</td>
</tr>
<tr>
<td>2010</td>
<td>701,012</td>
<td>46,543</td>
<td>654,469</td>
</tr>
<tr>
<td>2011</td>
<td>683,647</td>
<td>45,256</td>
<td>638,390</td>
</tr>
<tr>
<td>2012</td>
<td>676,689</td>
<td>43,718</td>
<td>632,970</td>
</tr>
<tr>
<td>2013</td>
<td>681,154</td>
<td>44,163</td>
<td>636,991</td>
</tr>
<tr>
<td>2014</td>
<td>685,203</td>
<td>44,869</td>
<td>640,334</td>
</tr>
</tbody>
</table>


Table 3.3 shows the number of pension plans with fewer than 100 participants from 1975 to 2014. It also shows the significant increase in total pension plans during that time period, but also the significant decline of DB plans vs. the significant growth of DC plans.
### Table 3.3
Number of Pension Plans with Fewer Than 100 Participants, 1975-2014

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Plans</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>583,476</td>
<td>145,430</td>
<td>438,046</td>
</tr>
<tr>
<td>1990</td>
<td>659,144</td>
<td>93,821</td>
<td>565,323</td>
</tr>
<tr>
<td>1995</td>
<td>631,117</td>
<td>52,405</td>
<td>578,712</td>
</tr>
<tr>
<td>2000</td>
<td>664,458</td>
<td>35,214</td>
<td>629,245</td>
</tr>
<tr>
<td>2005</td>
<td>600,264</td>
<td>36,058</td>
<td>564,205</td>
</tr>
<tr>
<td>2006</td>
<td>615,436</td>
<td>36,388</td>
<td>579,049</td>
</tr>
<tr>
<td>2007</td>
<td>626,068</td>
<td>37,953</td>
<td>588,115</td>
</tr>
<tr>
<td>2008</td>
<td>635,005</td>
<td>37,765</td>
<td>597,240</td>
</tr>
<tr>
<td>2009</td>
<td>621,007</td>
<td>39,963</td>
<td>588,115</td>
</tr>
<tr>
<td>2010</td>
<td>615,436</td>
<td>36,388</td>
<td>579,049</td>
</tr>
<tr>
<td>2011</td>
<td>598,488</td>
<td>35,418</td>
<td>563,070</td>
</tr>
<tr>
<td>2012</td>
<td>590,825</td>
<td>34,175</td>
<td>556,650</td>
</tr>
<tr>
<td>2013</td>
<td>594,939</td>
<td>34,839</td>
<td>560,099</td>
</tr>
<tr>
<td>2014</td>
<td>598,094</td>
<td>35,875</td>
<td>562,219</td>
</tr>
</tbody>
</table>


Table 3.4 displays the growth of pension plan assets from 1985 to 2014. Pension plan assets have grown from $1.25 billion in 1985 to $8.3 trillion by 2014. DC plan assets made up 64 percent of pension plan assets at the end of 2014, according to the DOL.

### Table 3.4
Pension Plan Assets by Type of Plan, 1985-2014
(amounts in millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Plans</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>1,252,739</td>
<td>826,117</td>
<td>426,622</td>
</tr>
<tr>
<td>1990</td>
<td>1,674,139</td>
<td>961,904</td>
<td>712,236</td>
</tr>
<tr>
<td>1995</td>
<td>2,723,735</td>
<td>1,402,079</td>
<td>1,321,651</td>
</tr>
<tr>
<td>2000</td>
<td>4,202,672</td>
<td>1,986,177</td>
<td>2,216,495</td>
</tr>
<tr>
<td>2005</td>
<td>5,061,622</td>
<td>2,254,032</td>
<td>2,807,590</td>
</tr>
<tr>
<td>2006</td>
<td>6,281,749</td>
<td>2,448,361</td>
<td>3,833,388</td>
</tr>
<tr>
<td>2007</td>
<td>6,009,473</td>
<td>2,646,603</td>
<td>3,443,870</td>
</tr>
<tr>
<td>2008</td>
<td>4,703,498</td>
<td>2,040,961</td>
<td>2,662,537</td>
</tr>
<tr>
<td>2009</td>
<td>5,511,060</td>
<td>2,193,983</td>
<td>3,317,076</td>
</tr>
<tr>
<td>2010</td>
<td>6,281,749</td>
<td>2,448,361</td>
<td>3,833,388</td>
</tr>
<tr>
<td>2011</td>
<td>6,345,595</td>
<td>2,516,109</td>
<td>3,829,487</td>
</tr>
<tr>
<td>2012</td>
<td>6,978,887</td>
<td>2,716,167</td>
<td>4,262,720</td>
</tr>
<tr>
<td>2013</td>
<td>7,870,897</td>
<td>2,866,392</td>
<td>5,004,505</td>
</tr>
<tr>
<td>2014</td>
<td>8,307,434</td>
<td>2,985,476</td>
<td>5,321,958</td>
</tr>
</tbody>
</table>

Table 3.5 displays the number of active participants in pension plans with fewer than 100 active employees by type of plan from 1985 to 2014. According to the DOL, the growth of participants in DC plans increased to 96%.

### Table 3.5

**Number of Active Participants in Pension Plans with Fewer Than 100 Active Participants by Type of Plan, 1985-2014**  
(numbers in thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Plans</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>7,023</td>
<td>1,751</td>
<td>5,272</td>
</tr>
<tr>
<td>1990</td>
<td>7,659</td>
<td>1,024</td>
<td>6,635</td>
</tr>
<tr>
<td>1995</td>
<td>8,397</td>
<td>670</td>
<td>7,727</td>
</tr>
<tr>
<td>2000</td>
<td>9,996</td>
<td>511</td>
<td>9,485</td>
</tr>
<tr>
<td>2005</td>
<td>10,328</td>
<td>462</td>
<td>9,866</td>
</tr>
<tr>
<td>2006</td>
<td>10,653</td>
<td>466</td>
<td>10,187</td>
</tr>
<tr>
<td>2007</td>
<td>10,848</td>
<td>454</td>
<td>10,394</td>
</tr>
<tr>
<td>2008</td>
<td>10,884</td>
<td>436</td>
<td>10,448</td>
</tr>
<tr>
<td>2009</td>
<td>12,081</td>
<td>490</td>
<td>11,591</td>
</tr>
<tr>
<td>2010</td>
<td>12,301</td>
<td>536</td>
<td>11,764</td>
</tr>
<tr>
<td>2011</td>
<td>12,051</td>
<td>526</td>
<td>11,525</td>
</tr>
<tr>
<td>2012</td>
<td>12,060</td>
<td>520</td>
<td>11,540</td>
</tr>
<tr>
<td>2013</td>
<td>12,160</td>
<td>527</td>
<td>11,633</td>
</tr>
<tr>
<td>2014</td>
<td>10,022</td>
<td>382</td>
<td>9,640</td>
</tr>
</tbody>
</table>


Table 3.6 displays the pension plan assets of plans with fewer than 100 participants by plan type. DC plans hold 93% of pension plan assets for plans with fewer than 100 participants.

### Table 3.6

**Pension Plan Assets of Plans with Fewer than 100 Participants by plan type, 1985-2014 (amounts in millions)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Plans</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>211,665</td>
<td>67,745</td>
<td>143,920</td>
</tr>
<tr>
<td>1990</td>
<td>242,068</td>
<td>44,192</td>
<td>197,876</td>
</tr>
<tr>
<td>1995</td>
<td>323,751</td>
<td>26,455</td>
<td>297,295</td>
</tr>
<tr>
<td>2000</td>
<td>454,082</td>
<td>29,056</td>
<td>425,028</td>
</tr>
<tr>
<td>2005</td>
<td>526,373</td>
<td>31,946</td>
<td>494,427</td>
</tr>
<tr>
<td>2010</td>
<td>641,844</td>
<td>42,764</td>
<td>599,080</td>
</tr>
<tr>
<td>2011</td>
<td>624,446</td>
<td>40,921</td>
<td>583,525</td>
</tr>
<tr>
<td>2012</td>
<td>670,356</td>
<td>42,306</td>
<td>628,050</td>
</tr>
<tr>
<td>2013</td>
<td>766,854</td>
<td>46,524</td>
<td>720,329</td>
</tr>
<tr>
<td>2014</td>
<td>800,097</td>
<td>49,480</td>
<td>750,617</td>
</tr>
</tbody>
</table>

Table 3.7 displays that 66 percent of workers in private industry had access to a retirement plan as of March 2016. According to the Bureau of Labor Statistics, only 18 percent of workers in private industry had access to a defined benefit (DB) plan, while 61 percent had access to a defined contribution (DC) plan.

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>All Retirement Benefits</th>
<th>DB Plan</th>
<th>DC Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Workers</td>
<td>66</td>
<td>18</td>
<td>61</td>
</tr>
<tr>
<td>Union</td>
<td>91</td>
<td>72</td>
<td>56</td>
</tr>
<tr>
<td>Nonunion</td>
<td>64</td>
<td>13</td>
<td>62</td>
</tr>
<tr>
<td>Lowest 10(^{th}) percentile of wages</td>
<td>33</td>
<td>4</td>
<td>28</td>
</tr>
<tr>
<td>Highest 10(^{th}) percentile of wages</td>
<td>88</td>
<td>36</td>
<td>85</td>
</tr>
<tr>
<td>Establishments with fewer than 100 workers</td>
<td>52</td>
<td>8</td>
<td>48</td>
</tr>
<tr>
<td>Establishments with 100 workers or more</td>
<td>83</td>
<td>30</td>
<td>77</td>
</tr>
<tr>
<td>Establishments with 500 workers or more</td>
<td>90</td>
<td>43</td>
<td>82</td>
</tr>
</tbody>
</table>

Footnotes:
(1) The percent of workers with access to both a defined benefit and a defined contribution plan is calculated as the sum of the percent of workers with separate access to a defined benefit plan and a defined contribution plan minus the percent with access to any retirement plan.
(2) Data for defined contribution plans with no employer contribution are not included in the "all retirement" data.

Comparative Analysis of Qualified Retirement Plans

The first, and probably most important, constituent of a qualified retirement plan is the employee. From an employee’s perspective, a qualified retirement plan serves the primary purpose of enabling him or her to save and invest effectively for retirement. In determining the efficacy of a qualified retirement plan, one has to evaluate the plan’s ability to maximize the amount of savings that the employee can set aside, the tax advantages of saving and investing, and the efficacy of the investment of the employee’s savings.

Defined benefit plans appear to have a distinct advantage over defined contribution plans in maximizing retirement savings. This advantage stems from the fact that defined contribution plans (largely 401(k) plans), for the most part, require employees to voluntarily set assets aside. Also, defined contribution plans often allow the participant to borrow money from the plan under certain situations and to cash out the plan provided a tax penalty is paid. Because many participants to take advantage of the liquidation provisions of defined contribution plans, the plans ultimately do not fulfill their purpose of providing retirement savings for many.
Generally, defined contribution plans require employees to invest their own retirement assets. As one might expect, many participants produce strong results, while others will ultimately produce weak investment results. On the whole, most evidence shows that the average investor in DC plans produces investment results worse than the average return generated by DB plans (see discussion below).

Qualified retirement plans also serve a valuable purpose for employers. First, employers utilize retirement plans as a valued benefit with which to attract and retain personnel. Retirement plans also enable profitable companies to set aside money without paying taxes on it. Thus, retirement plans can be a tax-advantaged benefit.

It is unclear which employees’ value more; a defined benefit plan or a defined contribution plan. Anecdotally, younger employees tend to prefer DC plans (especially 401(k) plans), which are portable, often have liquidity provisions, create personal accounts that make the benefit more tangible and allow participants to control the investment of their assets. Older employees, by contrast, often prefer defined benefit plans, which are frequently structured to provide better benefits to older workers with longer tenure.

Qualified retirement plans also serve a valuable economic purpose, by providing a significant source of domestic savings for our economy and by reducing the burden on the government of providing retirement income for seniors.

Defined benefit plans require employers to invest assets for decades, to support the promised benefit for employees. Defined contribution plans, by contrast, generally allow participants to remove their assets before retirement, or to borrow money from their plans under certain conditions. Thus, DC plans do not provide the same degree of stability in the country’s retirement savings pool. Assuming that the bulk of government pension plans (federal, state and local) assets are in DB plans. In 1985, DB plans comprised 58% of total retirement assets in America. The decline in the prominence of DB plan assets was partly due to the rise of DC plans and IRAs.

**Empirical Evidence on the Efficacy of DB Plans and DC Plans**

There have been several empirical studies that have attempted to compare the investment returns of DB plans to the average return generated by DC plan (401(k) plan) participants. The bulk of these studies have shown that DB plans generally produce higher returns than 401(k) plans. This result likely stems from the fact that DB plans, as perpetual investment pools, can truly be managed for the long term, with higher allocations to long-term assets like equities. Further DB plans are generally directed by trustees who hire professional advisors that are able to make prudent investment decisions than the average 401(k) participant. Finally, they usually have lower operating costs.
In fact, a recent research report prepared by Towers Watson found that the median investment return for DB plans was 2.74 percent in 2011, while DC plans had median returns of -0.22 percent. According to the report, the nearly 3-percentage-point difference is the widest margin by which DB plans outperformed DC plans since 1995, when Towers Watson first analyzed the rates of returns for both types of plans.

The report also found that despite the large performance difference in 2011, the gap between DB and DC plans narrowed during the previous five-year period. Since 1995, DB plans have outperformed DC plans by 76 basis points annually, but in the last five years in which data is available, the difference shrank by about half, to 39 basis points. The smaller gap is mostly due to the strong market performance in 2009, when DC plans returned 20.86 percent while DB plans gained 15.46 percent. DB plans actually realized higher returns than DC plans in all other years between 2007 and 2011.

The research analysis notes that performance in some DB plans was helped by sponsors shifting assets from equities to long-duration bonds in an effort to match the value of plan liabilities with respect to interest rate changes. That move proved to be successful from a total investment return perspective, as the performance of long-duration bonds far outpaced that of equity markets during 2011.

The Towers Watson research analysis was based on Form 500 financial and pension disclosure data through 2011, as released by the DOL. The analysis only looked at companies that sponsor only one DB plan and one 401(k) plan, each with at least 100 participants.

**Highlights of Business Structures**

While the operation of a DB or DC retirement plan does not change because of business structure, the tax deductibility and method of income calculation for contribution purposes do vary somewhat.

- **Sole Proprietorships, Partnerships and LLCs:**
  - Contributions are based on net Schedule C income after contribution minus the ½ Self-employment tax deduction;
  - Deduction is taken as a Keogh plan contribution on Form 1040;
  - Self-Employment tax is based on both the net Schedule C and the contribution;
  - Loans are available to plan sponsors and their employees. When applicable, participant loans are available to the lesser of 50% of their (PVAB) plan assets (at the time of the loan) or $50,000. Loans are not available for participants of IRC § 412(e) plans;
  - Potential required contributions in excess of Net Schedule C income may not be deductible; and
  - Sole proprietorships and partnerships cannot take losses to fund the pension plan.
- Corporations and Sub-S Corporations:
  - Contributions are based on actual W2 income taken from the corporation;
  - Contributions are deducted on the corporate tax return and therefore never appear on the participant's 1040;
  - Contributions are not subject to FICA or Self Employment taxes;
  - Loans are available to plan sponsors and their employees. When applicable, participant loans are available to the lesser of 50% of their (PVAB) plan assets (at the time of the loan) or $50,000. Loans are not available to participants of IRC § 412(e) plans; and
  - All required contributions are deductible; corporations may take a loss to fund the retirement plan.

### Table 3.8
**Traditional Defined Benefit Plan and Traditional Defined Contribution Plan**

<table>
<thead>
<tr>
<th>Employees Attracted and/or Most Benefited</th>
<th>Defined Benefit (DB) Plan</th>
<th>Defined Contribution (DC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Longer tenure and/or older employees</td>
<td>Shorter tenure and/or younger employees</td>
<td></td>
</tr>
</tbody>
</table>

| Job Tenure Patterns Encouraged | Longer tenure because employees receive greatest benefit accruals at end of long-time service. May lock people into jobs they would otherwise leave. | Although employees receive benefits based on salary, not tenure, may encourage employees to change jobs in order to receive access to lump-sum distribution from retirement accounts. |

| Influence on Retirement Patterns | Can be designed to encourage early retirement; may financially penalize workers for working additional years beyond the NRA. May pressure workers who would not otherwise retire to do so. | Cannot be designed to encourage early retirement but instead rewards employees for working additional years. |

| Cost variability/risk | Employer assumes investment and possibly pre-retirement inflation risk, and therefore, annual plan costs are less predictable. While costs might be higher than anticipated, pension costs in a booming stock market may be zero because investment returns on past contributions. | Employer assumes none of the investment risk on retirement fund assets. As a result, annual costs are more predictable although the employer cannot take advantage of high stock market or other investment returns on retirement plans assets. |

<p>| Annual funding flexibility | However, there tends to be more flexibility as to when an employer may meet these costs contributions in DB plans | However, some types of profit sharing plans have less flexibility in when those costs are to be paid. In addition, defined contribution accounts can be designed to entail no employer contributions at all, |</p>
<table>
<thead>
<tr>
<th><strong>Termination benefits</strong></th>
<th>Termination benefits are usually small for employees with less job tenure</th>
<th>Termination benefits equal account balances, when vested, based on both salary and years of plan participation. Tend to be larger than those for DB plans, cet. par.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Plan termination</strong></td>
<td>Can be very costly if plan is under-funded.</td>
<td>Not applicable, because DC plans are by definition never under-funded.</td>
</tr>
<tr>
<td><strong>Administrative costs</strong></td>
<td>Managing a large pool of funds is less expensive than managing individual accounts, but may be more expensive because of the provision of annuities (which can be relatively complex to administer) and the need for professional actuarial and investment advice to ensure compliance with regulations.</td>
<td>While actuarial services are not required to the extent necessary for defined benefit plans, the provision of participant investment education and the cost of administering many individual funds for loans, hardship, and/or retirement benefits may make DC plans more expensive. However DC plans generally are less expensive to administer, especially for smaller employers.</td>
</tr>
<tr>
<td><strong>Integration with Social Security Benefits</strong></td>
<td>Employers fulfill a specific retirement income objective (e.g., to replace 60 percent of pre-retirement income with Social Security and pension benefits), and therefore, Social Security integration is accomplished more efficiently under defined benefit plans.</td>
<td>Integration can be accomplished, but the process focuses on disparity in contributions and does not attempt to target a specific replacement ratio.</td>
</tr>
<tr>
<td><strong>Providing Substantial Benefits Over a Short Time Period</strong></td>
<td>Employees can be grandfathered into a new DB system so as to provide special benefits that are not possible under a DC approach (e.g., the quick accumulation of benefits to participants who have not participated in the system for a substantial period of time).</td>
<td>Unless grandfathered into a defined benefit plan, shorter tenure workers leave service with more substantial benefits under a DC arrangement.</td>
</tr>
<tr>
<td><strong>Flexible Benefit Retirement Plan Provision</strong></td>
<td>DB plans cannot be part of a flexible benefit package.</td>
<td>Some types of DC plans (401(k) and PS) may be included in a flexible benefit package.</td>
</tr>
<tr>
<td><strong>Linking Benefits with Company Performance</strong></td>
<td>Investment of pension assets in company stock is prohibited</td>
<td>Employer contributions may be in the form of employer contributions.</td>
</tr>
<tr>
<td>Investment risk given to participants</td>
<td>Employer absorbs investment risk in exchange for investment control.</td>
<td>Employees absorb investment risk in exchange for potential investment rewards.</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Inflation risk given to participants</td>
<td>COLAS may be provided and are often done so for public plans. Employer may share responsibility for inflation after retirement if ad hoc COLAS are used in private plans. Employer assumes pre-retirement risk if DB formula is based on final averages.</td>
<td>No room in plan design for COLA adjustments. Employees assume risk for inflation both prior to and after retirement.</td>
</tr>
<tr>
<td>Opportunities given to participants</td>
<td>No pre-retirement access to accounts is usually provided.</td>
<td>Pre-retirement access to accounts is often provided.</td>
</tr>
<tr>
<td>Benefit provided at retirement</td>
<td>Benefits are <em>usually</em> paid in the form of life annuities.</td>
<td>Benefits are usually paid in the form of lump-sum distributions, with which the employee may spend as they please.</td>
</tr>
<tr>
<td>Automatic enrollment</td>
<td>Enrollment is automatic.</td>
<td>Enrollment usually is not automatic.</td>
</tr>
<tr>
<td>Investment Horizons and Expected Impact on Investment Income</td>
<td>A DB plan allows the burden of retirement security (including the attendant investment risk) to be spread over a long period of time. In theory, DB plans may be expected to hold a larger percentage of more risky (and higher yielding) investments since their relevant investment horizon spans several decades if the plan is assumed to be an ongoing operation.</td>
<td>A DC plan usually requires employees to invest for their retirement on an individual basis. This may cause them to increase their asset allocation in less risky (and lower yielding) investments to mitigate the impact of market downturns near retirement age.</td>
</tr>
<tr>
<td>Tax Advantages</td>
<td>In DB plans, only employer contributions are given tax-favored status.</td>
<td>In DC plans, both employer and employee contributions may be given tax-favored status.</td>
</tr>
<tr>
<td>Approach to Informational Parity</td>
<td>Investment expertise means that those buying and selling pension investment services have informational parity.</td>
<td>Employers sometimes offer participant education to increase informational parity between investors and investment services.</td>
</tr>
</tbody>
</table>
Chapter 3
Review Questions

1. A qualified retirement plan is a plan that meets which section of the Internal Revenue Code (IRC)?

   ( ) A. IRC § 408
   ( ) B. IRC § 457(b)
   ( ) C. IRC § 401(a)
   ( ) D. IRC § 408A

2. Which of the following companies was the first to introduce the very first U.S. private section pension plan?

   ( ) A. Metropolitan Life Insurance Company
   ( ) B. American Express
   ( ) C. Montgomery Ward
   ( ) D. The Prudential Life Insurance Company

3. Which of the following statements about a Defined Benefit Plan is FALSE?

   ( ) A. When offered, are almost always fully funded by the employee.
   ( ) B. Such plans are funded as a single account by the employer.
   ( ) C. Employer assumes investment risk.
   ( ) D. A defined benefit (DB) plan specifies a formula for computing benefits that will be received during retirement.

4. Which of the following characteristics of a Defined Contribution plan is FALSE?

   ( ) A. Attracts shorter tenured / younger employees
   ( ) B. Financial liabilities are placed on the employee
   ( ) C. Higher fees
   ( ) D. Does not allow for portability

5. What is the percent of government (federal, state and local) pension plans assets that are in defined benefit plans?

   ( ) A. 75%
   ( ) B. 50%
   ( ) C. 10%
   ( ) D. 21%
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CHAPTER 4

PENSION PLAN LEGISLATION AND ERISA

Overview

It is very important for you, as the advisor, to have an understanding of the pension legislation and tax laws regulating qualified retirement plans, when presenting them to any business, large or small.

In this chapter, we will examine the federal law which established minimum standards for pension plans in private industry and provided for extensive rules on the federal income tax effects of transactions associated with employee benefit plans, known as the Employee Retirement Income Security Act (ERISA) of 1974. In addition, we will also review some of the changes enacted by the Pension Protection Act of 2006 (PPA) (P.L. 109-280) and the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA)

P.L. 110-455, made several technical corrections to the Pension Protection Act of 2006 (P.L. 109-280), and contains provisions designed to help pension plans and plan participants weather the current economic downturn.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The background and purpose of the Employee Retirement Income Security Act of (ERISA) 1974;
- The four titles that make up ERISA;
- The required employee disclosures as set forth by Title I of ERISA;
- The required employer reporting requirements to Governmental agencies as set forth in Title I of ERISA;
- The participation and vesting requirements as set forth by Title I of ERISA;
- The benefit protection for spouses as set forth by Title I of ERISA;
- The fiduciary responsibilities as set forth by Title I of ERISA;
- The limits on plan contributions and benefits as set forth by Title III of ERISA;
- The coverage and nondiscrimination rules as set forth by Title III of ERISA; and
- The Pension Benefit Guaranty Corporation as set forth by Title IV of ERISA.
ERISA

The Employee Retirement Income Security Act of 1974 (ERISA) (Pub. L. No. 93-406, codified in part at 29 USCS § 1002 et seq.) was enacted on September 2, 1974 and signed into law by President Gerald Ford. ERISA is a federal law establishing minimum standards for pension plans in private industry. It also provides extensive rules on federal income tax effects of transactions associated with employee benefit plans.

ERISA was enacted to protect the interests of employee benefit plan participants and their beneficiaries by:

- Requiring the disclosure of financial and other information concerning the plan to beneficiaries;
- Establishing standards of conduct for plan fiduciaries; and
- Providing for appropriate remedies and access to the federal courts.

ERISA is sometimes used to refer to the full body of laws regulating employee benefit plans, which are found mainly in the Internal Revenue Code and ERISA itself.

Responsibility for the interpretation and enforcement of ERISA is divided among the Department of Labor, the Department of the Treasury (particularly the Internal Revenue Service), and the Pension Benefit Guaranty Corporation (PBGC).

ERISA consists of four titles. They are:

- **Title I.** Sets out specific protections of employee rights in pensions and welfare benefit plans;
- **Title II.** Specifies the requirements for plan qualification under the Internal Revenue Code (IRC);
- **Title III.** Assigns responsibilities for administration and enforcement to the Departments of Labor and Treasury; and
- **Title IV.** Establishes the Pension Benefit Guaranty Corporation.

In this chapter, we will review Title I, Title II and Title IV.

**Title I: Protection of Employee Benefit Rights**

Title I of ERISA covers employee pension and welfare benefit plans established or maintained by employers in the private sector. The law specifically exempts governmental plans and church plans. Plans that are maintained only for the purpose of complying with applicable workmen’s compensation laws, unemployment compensation, or disability insurance laws, as well as plans that are maintained outside of the United States (primarily for the benefit of persons who are nonresident aliens) are also exempted from ERISA’s Title I requirements.
Reporting and Disclosure

Section 2(b) of ERISA states that it is the policy of ERISA

“to protect ... the interests of plan participants and their beneficiaries by requiring disclosure and reporting of financial and other information.”

Both pension and welfare benefit plans can be subject to extensive reporting and disclosure requirements that can be found under Sections 101 through 111 of ERISA. These sections may require disclosure of information to plan participants and beneficiaries, as well as reporting of pension and welfare plan information to governmental agencies. Some of the reporting and disclosure requirements provide that certain materials must be disseminated or made available to participants at reasonable times and places. Other requirements arise only upon the written request of a plan participant, beneficiary, or upon the occurrence of a specific event.

Below is a list of documents that are required to be made available to employees that are participating in an employer sponsored pension:

- Summary Plan Description (SPD);
- Summary of Material Modification;
- Summary of Annual Report;
- Notice of Preretirement Survivor Benefit;
- Notice of Joint and Survivor Benefit;
- Notice of Terminated Vested Participants;
- Individual Accrual Benefit Statement; and
- Notice of Freedom to Divest Employer Securities

Plan disclosure documents keep participants informed about the basics of plan operation, alert them to changes in the plan's structure and operations, and provide them a chance to make decisions and take timely action about their accounts.

In addition, the Pension Protection Act of 2006 (PPA) made enhancements to the reporting and disclosure requirements, requiring the provision of statements of a participant’s total accrued benefits, an annual funding notice for single-employer plans, as well as a notice of eligibility to divest employer securities (see Table 4.1).

Summary Plan Description

As a mechanism for informing plan participants of the terms of the plan and its benefits, ERISA requires that plan administrators furnish to participants a summary plan description (SPD). A SPD is a written summary of the provisions of an employee benefit plan that contains the terms of the plan and the benefits offered. It must be written in a manner that can be understood by the average plan participant, be sufficiently accurate, and comprehensive, to reasonably apprise participants and beneficiaries of their rights and obligations under the plan.
Among other things, the SPD must include information about:

- When and how employees become eligible to participate in the profit sharing plan;
- The contributions to the plan;
- How long it takes to become vested;
- When employees are eligible to receive their benefits;
- How to file a claim for those benefits; and
- Basic rights and responsibilities participants have under the Federal retirement law, the Employee Retirement Income Security Act (ERISA).

**Summary of Material Modification**

Under Section 104(b)(1), a plan administrator must provide a summary of any material modification (SMM) in terms of the plan as well as any change in information required to be included in the SPD. This summary must be provided, in most cases, within 210 days after the close of the plan year in which the modification was adopted, and also must be furnished to the Labor Department upon request. Similar to the SPD, the materials must be written in a manner that can be understood by the average plan participant. While ERISA does not define “material modification” and does not specifically cover what changes warrant an SMM, courts have addressed this issue. Courts have held plan amendments such as the establishment and elimination of benefits are material modifications. However, as courts have also pointed out, not all plan amendments are material modifications.

**Individual Benefit Statements**

Under Section 105 of ERISA, plan administrators must periodically furnish an individual benefit statement (IBS) to participants and beneficiaries. For defined contribution plans, a pension benefit statement must be provided:

- Every calendar quarter to participants and beneficiaries who have the right to direct the investments of the account; or
- Once each calendar year for participants and beneficiaries who have accounts with the plan, but do not have control over the investment in the account.

ERISA Section 105 also provides that plan administrators of DB plans must furnish benefit statements to participants and beneficiaries at least once every three (3) years. This is required for individuals who have both a non-forfeitable accrued benefit and are employed by the employer maintaining the plan at the time the statement is furnished. Statements to participants in DB plans must also be provided upon request. Pension benefit statements must indicate information such as the amount of non-forfeitable benefits, accrued benefits, and the earliest date on which accrued benefits become non-forfeitable. Benefit statements must include the value of each investment in a participant or beneficiary’s account.
An individual benefit statement (IBS) shows the total plan benefits earned by a participant, vested benefits, the value of each investment in the account, information describing the ability to direct investments, and (for plans with participant direction) an explanation of the importance of a diversified portfolio.

As noted above, for plans that allow participants to direct the investments in their accounts, plan and investment information, including information about fees and expenses, must be provided to participants before they can first direct investments and periodically thereafter – primarily on an annual basis with information on the fees and expenses actually paid provided at least quarterly. The initial plan-related information may be distributed as part of the SPD provided when a participant joins the plan as long as it is provided before the participant can first direct investments. The information provided quarterly may be included with the IBS.

Summary Annual Report

Section 103 of ERISA provides that certain employee benefit plans must file an annual report with the Department of Labor. The annual report is considered to be a primary source of information concerning the operation, funding, assets, and investments of employee benefit plans. It is regarded as a compliance and research tool for the Labor Department, and a source of information and data for use by other federal agencies, Congress, and private groups in assessing employee benefit, tax, and economic trends and policies. While the annual report can also be an important disclosure document for plan participants, participants must request a copy from a plan administrator.

The annual report must include a detailed financial statement containing information on the plan’s assets and liabilities, an actuarial statement, as well as other information, depending on the type of plan and number of participants. Plan administrators must make copies of the annual report available at the principal office of the plan administrator, and other places, as may be necessary to make pertinent information readily available to plan participants.

The annual report must be filed within seven months after the close of a plan year, and extensions may be available under certain circumstances. The annual report is to be filed with the Department of Labor on Form 5500. In 2006, the DOL published a rule requiring electronic filing of Form 5500 annual reports for plan years beginning on or after January 1, 2008.

Blackout Period Notice

The Blackout Period Notice requires at least 30 days' (but not more than 60 days') advance notice before a 401(k) or profit sharing plan is closed to participant transactions. During blackout periods, participants (and beneficiaries) cannot direct investments, take loans, or request distributions. Typically, blackout periods occur when plans change.
Automatic Enrollment Notice

If a plan automatically enrolls employees, the *Automatic Enrollment Notice* (AEN) details the plan’s automatic enrollment process and participant’s rights. The notice must specify the deferral percentage, the participant’s right to change that percentage or not make automatic contributions, and the plan’s default investment. The participant generally must receive an initial notice at least 30 days before he or she is eligible to participate in the plan. Employers that provide for immediate eligibility can provide this initial notice on an employee’s first day of employment if they allow participants to withdraw contributions within 90 days of their first contribution. An annual notice also must be provided to participants at least 30 days prior to the beginning of each subsequent plan year.

Notice of Freedom to Divest Employer Securities

The PPA amended the disclosure provisions of ERISA to require plan administrators to provide participants with a notice of their eligibility; and to divest employer securities held in a defined contribution plan. Section 101(m) of ERISA requires plan administrators to provide this notice to applicable individuals at least 30 days before the date on which the individual is eligible to divest these securities. The notice must inform the participant that he or she has the right to direct divestment of the employer securities and informed of the importance of diversifying the investment of retirement account assets. The notice must be written in a manner that can be understood by the average plan participant. It may be delivered in written, electronic, or other appropriate form that is reasonably accessible to the recipient.

Annual Funding Notice

DB plan administrators must also provide an annual plan funding notice. While in previous years, funding notices have been furnished by multiemployer plans, single-employer plans must provide this notice beginning in 2008. The required annual notices include information about the plan’s funding policy, assets, and liabilities; a statement of the number of participants; and a general description of the benefits that are eligible to be guaranteed by the PBGC. The notice must be provided to the PBGC, plan participants and beneficiaries, labor organizations representing such participants or beneficiaries, and, in the case of a multiemployer plan, to each employer who has an obligation to contribute to the plan.

Reporting to Government Agencies

In addition to the disclosure documents that provide information to participants, plans must also report certain information to government entities.
Form 5500, Annual Return/Report of Employee Benefit Plans

The Form 5500 Annual Report is the primary source of information about the operations, funding and investments of approximately 800,000 retirement and welfare benefit plans. This Form must be filed with the U.S. Department of Labor and shared with the IRS and must be done electronically. These reports are made available to the public. You can go to: https://www.efast.dol.gov/portal/app/disseminate?execution=e1s this search engine identifies Form 5500 and 5500-SF filings received by EFAST2. You can also visit: http://freeerisa.benefitspro.com/

Depending on the number and type of participants covered, most profit sharing plans must file one of the following forms:

- Form 5500, Annual Return/Report of Employee Benefit Plan;
- Form 5500-SF, Short Form Annual Return/Report of Small Employee Benefit Plan; or
- Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan.

Most one-participant plans (sole proprietor and partnership plans) with total assets of $250,000 or less are exempt from the annual filing requirement. However, regardless of the value of the plan's assets, a final return/report must be filed when a plan is terminated.

**IRS Form 1099-R**

Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.* is used to report distributions (including rollovers) from a retirement plan. It is given to both the IRS and recipients of distributions from the plan during the year.

### Table 4.1
**Key Information Plan Administrator Must Provide Automatically**

<table>
<thead>
<tr>
<th>What</th>
<th>Description</th>
<th>When</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Summary Plan Description (SPD)</strong></td>
<td>A summary version of the plan document and other important plan information, in easier-to-understand language.</td>
<td>Within <strong>90 days</strong> of becoming a participant in the plan; and An updated copy every 10 years (5 years if the plan has been amended).</td>
</tr>
<tr>
<td><strong>Automatic Enrollment Notice</strong></td>
<td>For plans with automatic enrollment, a description of the automatic enrollment process, the percentage of salary being deferred, the default investment used for automatic contributions, your right to opt out of the plan, your right to change deferral percentage and investments, and how to find</td>
<td>Generally, at least <strong>30 days</strong> before you are eligible to participate; and 30 days before the beginning of each subsequent plan year.</td>
</tr>
<tr>
<td><strong>Individual Benefit Statement</strong></td>
<td>Statement providing information about your account balance and vested benefits. Depending on the type of plan you have, the statement may also include the value of the investments in the account and information describing your right to direct investments.</td>
<td>At least quarterly for participant-directed defined contribution plans; At least annually for non-participant-directed defined contribution plans; or At least every 3 years for defined benefit plans.</td>
</tr>
<tr>
<td><strong>Annual Funding Notice</strong></td>
<td>Basic information about the funding status and financial condition of the defined benefit pension plan, including the plan’s funding percentage; assets and liabilities; and a description of the benefits guaranteed by the PBGC.</td>
<td>Within 120 days of the end of the plan year.</td>
</tr>
<tr>
<td><strong>Plan and Investment Information for Participant-Directed Plans</strong></td>
<td>Plan and investment related information, including information about fees and expenses, so participants can make informed decisions to manage their individual accounts. The investment related information must be provided in a format, such as a chart, that allows for comparison among the plan’s investment options.</td>
<td>Before a participant can direct investments for the first time; At least annually thereafter; and At least quarterly for fees and expenses actually paid.</td>
</tr>
<tr>
<td><strong>Summary of Material Modifications</strong></td>
<td>A summary of significant plan changes or changes in the information required to be in the SPD.</td>
<td>Within 7 months of the end of the plan year in which the changes were made.</td>
</tr>
<tr>
<td><strong>Summary Annual Report</strong></td>
<td>A summary of financial information filed by the plan on its Form 5500 Annual Return/Report. If your plan is required to provide an annual funding notice, your plan is not required to provide this report.</td>
<td>Within 9 months after the end of the plan year or 2 months after the annual report filing deadline.</td>
</tr>
<tr>
<td><strong>Notice of Significant Reduction in Future Benefit Accruals</strong></td>
<td>Notice of any significant reduction in the rate of future benefit accruals, or the elimination of or significant reduction in an early retirement benefit or retirement-type subsidy. Applies to defined benefit plans and certain defined contribution plans.</td>
<td>At least 45 days before the effective date of the plan amendment.</td>
</tr>
<tr>
<td><strong>Blackout notice</strong></td>
<td>Notice of a period of more than 3 consecutive business days when there is a temporary suspension, limitation, or restriction on directing or diversifying plan assets, obtaining loans, or obtaining distributions. Applies to most 401(k) or other individual account plans.</td>
<td>Generally, at least 30 days before the blackout date.</td>
</tr>
<tr>
<td><strong>Notice to Participants of Underfunded Plan</strong></td>
<td>For defined benefit plans that are less than 80% funded, the notice of the funding level of the plan and information on PBGC guarantees.</td>
<td>Within 2 months after the due date for filing the annual report</td>
</tr>
</tbody>
</table>
**Plan Documents**

Documents that provide the terms of the plan, including collective bargaining agreements and trust agreements.

**Annual Report (Form 5500) – most recent report**

Financial information about the plan that most plans are required to file with the government within 7 months of the end of the plan year.

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**Participation Requirements**

ERISA restricts the amount of time an employee can be excluded from participating in a pension plan. Under ERISA Section 202(a)(1)(A), an employee can only be excluded from an ERISA pension plan on account of age or service if the employee is under age 21 or has not yet completed a year of service. The term “year of service” is defined as a 12-month period during which the employee has worked at least 1,000 hours.

Alternatively, in the case of a plan under which a participant’s benefits are 100% vested after no more than two years of service, a plan may require two years of service prior to participating in the plan. Plans maintained for employees of certain educational institutions which provide for 100% vesting after one year may condition participation on an employee’s becoming 26 years old or completing one year of service, whichever is later.

Once an employee becomes eligible to participate, a plan must enroll the employee no later than:

- The first day of the plan year; or
- Six months after the date of satisfaction of the participation requirements, whichever is earlier.

ERISA also prohibits pension plans from excluding employees from participation in the plan after an employee has attained a certain age.

**Benefit Accrual**

Section 204 of ERISA governs benefit accrual, which generally refers to the rate at which benefits are earned by a plan participant. An “accrued benefit” is defined differently for defined benefit and defined contribution plans. For defined benefit plans, accrued benefit means an individual’s benefit determined under the plan and expressed in the form of an annual benefit commencing at normal retirement age, subject to exceptions. ERISA provides three primary methods for benefit accrual under a defined benefit plan:

- Under the “133-1/3 rule,” generally, a later rate of accrual for one year of plan participation cannot be more than 133-1/3 percent of the rate for any other plan year;
• Under the “3% rule,” a participant must accrue at least 3% of the participant’s anticipated normal retirement benefit in each year of participation, up to a maximum of 33-1/3 years; and
• Under the “fractional rule,” benefit accrual is focused on a worker’s proportionate years of service under the plan. For example, if benefits can accrue for a maximum of 40 years up to the date of the plan’s normal retirement age (such as 65), a worker starting under the plan at age 25 and working to age 60 would get 35/40 of the maximum credit toward a pension.

These tests limit the amount of “backloading”, a practice of providing a higher benefit accrual rate for later years of service than for earlier years. “Front loading” benefits (providing a higher accrual rate for earlier years of service than for later years) is permitted, but decreases in the rate of benefit accrual cannot be based on the participant’s age.

In a DC plan, the participant’s accrued benefit is the balance in his or her account. Participants begin accruing a benefit in a DC plan once they have met the participation requirements under the terms of the plan. However, if an employer makes contributions to an employee’s account, the accrued benefit received may be treated differently for vesting purposes than the accrued benefit from employee contributions.

Anti-cutback Rule

ERISA Section 204(g) prohibits plan amendments that eliminate or reduce benefits already accrued by plan participants. This prohibition is commonly referred to as the “anti-cutback rule.” Benefits subject to the anti-cutback rule include basic accrued benefits, as well as any early retirement benefits, “retirement-type” subsidies, and other optional forms of benefits that an individual who has met certain requirements (as defined by the plan) is eligible to receive.

However, the anti-cutback rule does not prevent a plan from freezing accrued benefits, reducing the rate at which benefits will accrue in the future, or eliminating future benefit accruals altogether.

Benefit Accrual and Age Discrimination

ERISA contains provisions designed to prevent age discrimination in benefit accrual. Section 204(b)(1)(H) of ERISA prohibits a DB plan from ceasing accruals or reducing the rate of accrual on account of the employee’s age. Section 204(b)(2)(A) of ERISA provides that for defined contribution plans, allocations to an employee’s account may not cease, and the rate at which amounts are allocated to an employee’s account may not be reduced on account of age.

Over the past few years, several courts have evaluated these provisions in determining whether cash balance plans are age-discriminatory. Discrimination has been alleged, among other things, because of the structure of a cash balance plan, under which
employees receive both pay credits and interest credits. After the employee terminates employment, pay credits will generally cease, but an employee will typically continue to earn interest credits. Because a younger employee has more time before retirement age in which to earn interest than an older employee, an accrued benefit may be greater for a younger employee. This result, some have argued, violates the age discrimination provisions. While certain district court decisions have held that cash balance plans violate the age discrimination provisions, all appellate courts to evaluate this issue have found that the plans are not age discriminatory.

The PPA amended the benefit accrual requirements of ERISA, as well as other federal laws, by adding new standards under which a plan can be considered inherently non-age discriminatory.

Under the act, a plan is not considered age discriminatory if a participant’s entire accrued benefit, as determined under the plan’s formula, is at least equal to that of any similarly situated, younger individual. A “similarly situated” individual is defined as an individual who is identical to the participant in every respect, including length of service, compensation, position, and work history, except for age. The PPA provides that cash balance plans do not discriminate against older workers if, among other things, benefits are fully vested after three years of service and interest credits do not exceed a market rate of return. In general, the new provisions regarding cash balance plans are effective for periods beginning on or after June 29, 2005. Thus, cash balance plans in existence prior to this date may still be subject to legal challenge.

**Minimum Vesting Standards**

While benefit accrual refers to the amount of benefits earned under ERISA, vesting occurs when a plan participant’s accrued benefit is considered to be non-forfeitable. Once benefits have vested, the participant may be able to receive the vested portion of his or her retirement benefits even if he or she leaves the job before retirement. Vesting requirements apply only to benefits derived from employer contributions to a plan. Participant contributions to a pension plan must be automatically non-forfeitable to the participant.

ERISA imposes two general vesting requirements: one depending on age and one depending on length of service. First, under Section 203(a) of ERISA, all plans must provide that the employees’ rights to their “normal retirement benefits” are fully vested upon attainment of “normal retirement age” (NRA) [IRC § 411(a)]. While a plan may choose a “normal retirement age” for purposes of determining when a participant’s benefits vest, ERISA provides that this age must be the earlier of:

- The time a participant attains normal retirement age as specified under a plan or
- The later of the time the participant attains age 65 or the fifth anniversary of the time the participant commenced participation in the plan [IRC § 411(a)(8)].
Note: In 2007, the IRS issued final regulations defining NRA for defined benefit or money purchase pension plans, including for purposes of benefit accrual and minimum vesting rules under IRC § 411. The final regulations define NRA as an “age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.” The regulations provide more specific guidelines, namely:

- A plan’s NRA of age 62 is deemed to meet the above definition;
- If the plan’s NRA is between 55 and 62, the employer’s determination that it meets the industry standard will be given deference; and
- A plan’s NRA below age 55 is presumed not to be acceptable (except for public safety employees).

Second, ERISA’s vesting provisions also require benefits to vest based on an employee’s years of service to the employer. Under ERISA § 203(b), a qualified DB plan must meet one of two vesting schedules. The first schedule is met if a participant’s benefits are fully vested after five years of service, commonly referred to as five-year “cliff” vesting. Table 4.2 displays the alternative when a participant’s benefits may vest under the following graded vesting schedule.

<table>
<thead>
<tr>
<th>Years of Service</th>
<th>Vesting Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>20%</td>
</tr>
<tr>
<td>4</td>
<td>40%</td>
</tr>
<tr>
<td>5</td>
<td>60%</td>
</tr>
<tr>
<td>6</td>
<td>80%</td>
</tr>
<tr>
<td>7</td>
<td>100%</td>
</tr>
</tbody>
</table>

Most DC plans are subject to similar vesting requirements. Exceptions include the SIMPLE 401(k) and the Safe Harbor 401(k) plans, in which participants are immediately vested in employer contributions. For other DC plans, employers have a choice between two vesting schedules for employer contributions.

For employer contributions to DC plans for plan years after December 31, 2006, the PPA of 2006 reduced the minimum vesting schedules for employer contributions to the following:

- **Cliff vesting**, participants must be 100% vested in employer contributions after no more than three years of service [IRC § 411(a)(2)(B)(ii); ERISA Section 203(a)(2)(B)(ii)]; or
- **Graduated or graded vesting: Two-to-Six Year Graded Vesting.** The accrued benefit of a participant becomes gradually vested based on the participant’s number of years of service as follows (IRC § 411(a)(2)(B)(iii); ERISA Section 203(a)(2)(B)(iii)):
0. 20% vested after two years;
0. 40% after three years;
0. 60% after four years;
0. 80% after five years; and
0. 100% vested after six years or more.

Both employer matching contributions (i.e., employer plan contributions made on behalf of an employee and on account of an employee’s elective contributions) as well as employer non-elective contributions (such as profit-sharing contributions) must vest under these rules.

**Breaks in Service**

ERISA protects plan participants from losing credit for earlier service in cases in which workers leave their jobs and then return to work within five years. Once an employee becomes eligible to participate in a pension plan, all years of service with the employer during which the employer maintained the plan (including service before becoming a plan participant) must be taken into account for purposes of determining how much service will be counted toward meeting the plan’s vesting requirement. In the case of a non-vested participant, years of service before any break in service must be taken into account upon re-employment. In a DC plan, if a participant who is not 100% vested incurs a break in service of less than five years and subsequently returns to work, all service after returning to work must be added to the pre-break service in determining the vested portion of the pre-break benefit. A break in service occurs in any year in which the employee completes less than 500 hours of service. Generally, workers will not incur a break in service for up to one year’s absence due to pregnancy, childbirth, infant care, or adoption.

**Benefit Protections for Spouses**

The *Retirement Equity Act of 1984* (REA) amended ERISA to increase pension protections for the survivors of deceased plan participants. As amended by the REA, ERISA requires DB plans and money purchase plans to provide pre-retirement and post-retirement survivor annuities to married employees unless a written election to waive the survivor annuity is signed by both the employee and his or her spouse. In the event of divorce, ERISA requires plan administrators to honor *qualified domestic relations orders* (QDROs) issued by state courts that divide the pension or account balance between the two parties. This requirement ensures that a court order awarding a share of a vested pension benefit to the former spouse of a divorced plan participant will be honored by the plan.

- **Pre-retirement Survivor Benefits:** ERISA requires DB plans to provide a survivor annuity to the spouse of a vested active participant or vested former participant. The cost of the pre-retirement survivor annuity may be paid by the employer or passed on to covered participants through reduced benefits or increased contributions. To waive the pre-retirement survivor benefit, both participant and
spouse must sign a waiver form. The plan can defer payment of the survivor annuity until the month in which the deceased participant would have reached the plan’s earliest retirement age.

Profit sharing plans (including 401(k) plans) and stock bonus plans must provide for automatic payment of the participant’s vested account balance to his or her spouse upon the death of the participant unless both parties designate an alternate beneficiary in writing. If either a profit-sharing plan or stock bonus plan offers a life annuity option, it must provide a pre-retirement survivor annuity.

- **Post-retirement Survivor Benefits:** ERISA requires the default form of benefit paid to a married participant in a DB plan to be a joint and survivor annuity that provides a life annuity to the survivor equal to at least 50% of the joint benefit paid while the participant was living. Beginning in 2008, the PPA requires plans to offer a 75% survivor annuity option if the plan’s survivor annuity is less than 75%, and to offer a 50% survivor annuity option if the plan’s survivor annuity is greater than 75% [Section 1004 of the PPA]. Waiving the survivor benefit requires the written consent of both the participant and spouse. The participant and spouse must have at least 90 days ending on the annuity starting date to waive the survivor annuity. The decision to waive the survivor annuity also can be revoked during this period.

Because a joint and survivor annuity is based on the joint life expectancy of the participant and spouse instead of a single life, the amount of the joint annuity is lower than it would be if it were a single-life annuity. Once a joint and survivor annuity is in effect, and the retirement annuity has commenced, the spouse to whom the participant was married on the date that the annuity started is entitled to the survivor annuity, even if the couple is no longer married when the participant dies.

Before the annuity begins, the employer must provide each participant with a written notice that states:

- The terms and conditions of the qualified joint and survivor annuity;
- The right of the participant and spouse to decline the survivor annuity and the effect of the decision;
- The rights of the spouse; and
- The right to reverse the decision and the effect of reversing it.

**Qualified Domestic Relations Orders**

The REA of 1984 amended ERISA to allow plans to honor state court orders awarding a share of a worker’s pension to a former spouse. ERISA sets forth procedures the plan administrator must follow to determine if a court order is a **qualified domestic relations order** (QDRO). While ERISA generally requires pension plans to provide that “benefits under the plan may not be assigned or alienated,” an exception to this requirement is made for QDROs. Payments to the former spouse of a participant may begin when the participant becomes eligible to retire, even if the participant is still employed.
A QDRO must specify:

- The name and last known address of the participant and each person to receive money;
- The amount or percentage of the participant’s benefits to be paid to each person;
- The number of payments or the time period to which the order applies; and
- Each plan to which the order relates.

A QDRO generally will qualify only if it does not require the plan to:

- Provide a form of benefit not otherwise provided by the plan;
- Pay more benefits than it would have paid in the absence of the order; or
- Pay benefits to another beneficiary because of an earlier QDRO.

The PPA directed the Secretary of Labor to issue regulations to clarify whether a domestic relations order that supersedes or revises an earlier QDRO will be considered to be qualified, and to state the conditions under which a QDRO will not be treated as qualified because of the time at which it was issued.

**Same Sex Marriage**

On June 26 2015, the Supreme Court of the United States (SCOTUS) issued a decision in *Obergefell v. Hodges* holding that same-sex couples have a constitutional right to marry in all states. As a result more same-sex couples will be recognized as married for purposes of determining entitlement to their partners retirement and Social Security benefits.

**Note:** Obergefell does not apply to domestic partnerships or civil unions – State- or locally-recognized domestic partnerships and civil unions are not marriages – State and Federal income tax treatment remains the same as before

**Fiduciary Responsibility**

ERISA imposes certain obligations on plan fiduciaries, persons who are generally responsible for the management and operation of employee benefit plans. ERISA Section 3(21)(A) provides that a person is a “fiduciary” to the extent that the person:

- Exercises any discretionary authority or control with respect to the management of the plan or exercises any authority with respect to the management or disposition of plan assets;
- Renders investment advice for a fee or other compensation with respect to any plan asset or has any authority or responsibility to do so; or
- Has any discretionary responsibility in the administration of the plan.
Every plan governed by ERISA must have one or more named fiduciaries, and these fiduciaries must be named in the plan document. ERISA Section 404(a)(1) establishes the duties owed by a fiduciary to participants and beneficiaries of a plan. This section identifies four standards of conduct:

- A duty of loyalty;
- A duty of prudence;
- A duty to diversify investments; and
- A duty to follow plan documents to the extent that they comply with ERISA.

**Duty of Loyalty**

ERISA Section 404(a)(1)(A) requires plan fiduciaries to discharge their duties “solely in the interest of the participants and beneficiaries” and for the “exclusive purpose” of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. The duty of loyalty applies in situations where the fiduciary is confronted with a potential conflict of interest, for instance, when a pension plan trustee has responsibilities to both the plan and the entity (such as the employer or union) sponsoring the plan.

In addition to providing benefits, a plan fiduciary must “defray” reasonable expenses of administering the plan.” The Department of Labor stated that “in choosing among potential service providers, as well as in monitoring and deciding whether to retain a service provider, the trustees must objectively assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided.”

**Duty of Prudence**

ERISA Section 404(a)(1)(B) requires fiduciaries to act

> “…with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man would use in the conduct of an enterprise of a like character with like aims.”

When examining whether a fiduciary has violated the duty of prudence, courts typically examine the process that a fiduciary undertook in reaching a decision involving plan assets. If a fiduciary has taken the appropriate procedural steps, the success or failure of an investment can be irrelevant to a duty of prudence inquiry.

Regulations promulgated by the Department of Labor provide clarification as to the duty of prudence in regard to investment decisions. These regulations indicate that a fiduciary can satisfy his duty of prudence under ERISA by giving “appropriate consideration” to the facts and circumstances that the fiduciary knows or should know are relevant to an investment or investment course of action. “Appropriate consideration” includes:
• “A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment,” and
• Consideration of the portfolio’s composition with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the plans funding objectives.

Duty to Diversify Investments

ERISA Section 404(a)(1)(C) requires fiduciaries to diversify the investments of a plan “so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.” In general, it is believed that fiduciaries should not invest an unreasonably large proportion of a plan’s portfolio in a single security, in a single type of security, or in various securities dependent upon the success of a single enterprise or upon conditions in a single locality.

Courts have agreed that ERISA Section 404(a)(1)(C) does not create a diversification obligation in terms of fixed criteria, but instead requires a determination based on the specific facts of each individual case.

Duty to Act in Accordance with Plan Documents

ERISA Section 404(a)(1)(D) of ERISA requires fiduciaries to discharge their duties “in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with [ERISA].” Courts have interpreted this section to apply not only to a document or instrument that establishes a plan or maintains a plan, but also to other writings that have a substantive effect on the plan. These writings have included investment management agreements, collective bargaining agreements, and even internal memoranda regarding the sale of plan assets.

Under ERISA Section 404(a)(1)(d), if a plan provision conflicts with ERISA, a fiduciary is obligated to ignore the plan provision. Courts have evaluated this requirement in the context of when compliance with a plan provision leads to a breach of other fiduciary duties. The Department of Labor has argued that “if obeying a plan provision requires the fiduciary to act imprudently and disloyally in violation of ERISA Sections 404(a)(1)(A) and (B) ... the provision is not consistent with ERISA, and the fiduciary has a duty to disregard it.” This situation was addressed in Tittle v. Enron, in which the pension plan in question required employer contributions to be made “primarily in Enron stock.” The court in Enron held that the plan fiduciaries had a duty to ignore this provision if it would be imprudent to follow it.

In interpreting ERISA Section 404(a)(1)(D), courts have also held that fiduciaries do not breach the duty to act in accordance with plan documents if their failure to follow such documents results from erroneous interpretations made in good faith. In Morgan v.
Independent Drivers Association Pension Plan, the Tenth Circuit found that the trustees of a pension plan did not violate Section 404(a)(1)(D) because their decision to terminate the plan based on an erroneous interpretation of the effect of a new plan funding method was both considered in good faith and based on consultation with experts.

Prohibited Transactions

In addition to requiring plan fiduciaries to adhere to certain standards of conduct, ERISA prohibits fiduciaries from engaging in specified transactions deemed likely to injure a pension plan. Engaging in a prohibited transaction is a per se violation of ERISA. Thus, in evaluating a fiduciary’s role in a prohibited transaction, it may be considered irrelevant to examine whether the transaction would be considered prudent had it occurred between independent parties.

ERISA Section 406(a) bars certain transactions between a plan and a party in interest with respect to a plan. Subject to certain exemptions, a fiduciary must not cause a plan to engage in any transaction with a party in interest if the fiduciary knows or should know that the transaction is a:

- Sale or exchange, or leasing, of any property;
- Lending of money or other extension of credit;
- Furnishing of goods, services, or facilities;
- Transfer or use of any plan assets; or
- Acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA Section 407, which limits the amount of employer securities and property that may be held by a plan.

ERISA § 406(b) prohibits certain transactions between a plan and a plan fiduciary. A fiduciary may not:

- Deal with the assets of the plan in his own interest or for his own account;
- Act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries; or
- Receive any consideration for his personal account from any party dealing with such a plan in connection with a transaction involving the assets of the plan.

ERISA also places a limit on the amount of investment in the sponsoring employer’s stock and property held in a DB plan. ERISA § 407 generally provides that a plan may not invest in securities of an employer unless they are “qualifying employer securities.” Further, under this section, a plan may not acquire or hold employer real property unless it is “qualifying employer real property.” However, a plan may not acquire qualifying employer securities or qualifying employer property if immediately after the acquisition, the aggregate fair market value of employer securities and employer real property held by the plan is more than 10% of the fair market value of the assets of the plan.
The Section 407 requirements generally do not apply to DC plans, unless the plan requires a portion of an elective deferral to be invested in qualifying employer securities or qualifying employer real property. However, the PPA created new diversification requirements for qualifying employer securities held in DC plans. ERISA § 204(j) of ERISA provides that an individual must be allowed to elect to direct a plan to divest employee contributions and elective deferrals invested in employer securities, and reinvest these amounts in other investment options. A plan must offer at least three investment options (besides employer securities) to which an individual may direct the proceeds from the divestment. Individuals must be allowed to diversify their employee contributions out of employer stock as often as other investment changes are allowed, but at least quarterly. In addition, employees who have completed three years of service must also be allowed to diversify employer matching contributions and employer non-elective contributions out of employer stock. This requirement is phased in over three years for existing amounts contributed in plan years before 2007. The section also provides that, except as provided in regulations, plans cannot impose restrictions on employer stock investment or diversification that are not imposed on other plan investments.

ERISA provides for various exemptions from the prohibited transactions provisions. ERISA § 408(a) directs the Secretary of Labor to establish a procedure for granting administrative exemptions for certain individuals and classes. The section provides that the Secretary may not grant an exemption under this section unless it is:

- Administratively feasible;
- In the interests of the plan and of its participants and beneficiaries; and
- Protective of the rights of participants and beneficiaries of the plan. The Labor Department has promulgated regulations outlining the procedures for filing and processing prohibited transaction exemption applications.

ERISA § 408(b) provides a number of statutory exemptions. These exemptions include certain loans to participants and beneficiaries (so long as certain conditions are met); reasonable arrangements with parties in interest for office space or legal, accounting, or other services needed for the establishment or operation of the plan; certain plan investments (in the form of deposits) made in banks or in similar financial institutions whose employees are covered by the plans; as well as the purchase of life insurance, health insurance, or annuities from a qualifying insurer who is the employer maintaining the plan.

**Investment Advice**

Prior to the PPA, ERISA’s prohibited transaction restrictions were believed to have discouraged the provision of investment advice. Because it was perceived that “virtually any transaction could fall within one of these [prohibited transaction] categories,” individuals were reluctant to provide investment advice to plan participants. The PPA amended both ERISA and the IRC to add a statutory prohibited transaction exemption with regard to providing investment advice. This exemption allows fiduciaries to provide...
investment advice without fear of fiduciary liability under the prohibited transaction provisions.

ERISA § 408(g)(1), as added by Section 601(a)(2) of the PPA, states that the Act’s prohibited transaction restrictions shall not apply to transactions involving investment advice if such advice is provided by a fiduciary adviser pursuant to an “eligible investment advice arrangement.” An “eligible investment advice arrangement” is defined as an arrangement that either:

- Provides that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected; or
- Uses a computer model under an investment advice program meeting the requirements of ERISA § 408(g)(3) in connection with the provision of investment advice by a fiduciary adviser to a participant or beneficiary.

To be considered an “eligible investment advice arrangement,” an arrangement must meet other requirements identified in subsequent paragraphs of Section 408(g). These requirements include the following:

- The express authorization of the arrangement by a plan fiduciary other than the person offering the investment advice program, any person providing investment options under the plan, or any affiliate of either;
- The performance of an annual audit of the arrangement by an independent auditor; compliance with various disclosure requirements; and
- The writing of participant notifications in a clear and conspicuous manner; and the maintenance of any records showing compliance with the relevant provisions of Section 408(g) for not less than six years.

If investment advice is provided through the use of a computer model, such model must also meet certain specified requirements.

**Fiduciary Duty and Participant-Controlled Investment**

Under ERISA § 404(c), if a DC plan permits a participant or beneficiary “to exercise control over the assets in his account,” a fiduciary will not be liable for any loss which may result from the participant’s or beneficiary’s investment choices. However, in order for a fiduciary to be immune from liability, a plan must meet certain requirements. Labor Department regulations describe two basic requirements for a plan to be considered a “404(c) plan.”

- First, a plan must provide the participant or beneficiary the opportunity to exercise control over the assets in the individual’s account. Individuals must, among other things, have a “reasonable opportunity to give investment
instructions” as well as “the opportunity to obtain sufficient information to make informed decisions” about investment alternatives under the plan.

- Second, a plan must allow a participant or beneficiary to choose from a “broad range of investment alternatives.” A participant or beneficiary is deemed to have access to this range of alternatives, if among other things, the individual has the opportunity to “materially affect” the potential return and degree of risk, on the portion of the individual account, with respect to which he is permitted to exercise control. In addition, a participant or beneficiary must be given a choice of at least three investment alternatives, each of which is diversified, has different risk and return characteristics, and which, in the aggregate, enable the participant to achieve a portfolio with risk and return characteristics that are “normally appropriate” for the participant or beneficiary.

In addition, in order for a fiduciary to be immune from liability under Section 404(c), a participant or beneficiary must not only have the ability to exercise control of plan assets, but must also have taken the opportunity to “exercise independent control” with respect to the investment of assets in the individual’s account. The Section 404(c) regulations provide guidance as to when a participant or beneficiary will be deemed to have exercised control over plan assets, as well as certain circumstances under which a participant or beneficiary’s exercise of control will not be considered “independent.”

**Fiduciary Liability under ERISA Section 409**

Plan fiduciaries may be personally liable if the fiduciary breaches a responsibility, duty, or obligation under ERISA § 409. Section 409 of ERISA provides that a fiduciary may be liable to a plan for any losses resulting from such breach, and may be responsible for forfeiting to the plan any profits that were made through the improper use of plan assets. Besides this monetary relief available, a court may also award “equitable and remedial relief” as it deems appropriate.

In addition, ERISA § 409(b) provides that a fiduciary is not liable with respect to a breach of fiduciary duty “if such breach was committed before he became or after he ceased to be a fiduciary.” Courts have found that fiduciaries are not liable for losses caused by an imprudent investment made prior to when the individual assumed fiduciary responsibility. Still, a fiduciary may have an obligation to rectify breaches of fiduciary duty committed by a previous fiduciary and may be liable if he or she fails to take remedial action.

**The DOL Conflict of Interest Rule**

On April 10, 2017, the Department of Labor’s Conflict of Interest Rule, (also, referred to as the new Fiduciary Rule) will apply to virtually all recommendations of investments and insurance products to plan participants and IRAs. In addition, it will regulate recommendations to plan participants to rollover their benefits to IRAs and recommendations to IRA owners to transfer or withdraw their IRA assets.
The new fiduciary rule imposes ERISA fiduciary status on any adviser or broker who provides “investment advice” or “recommendations” to retirement savers or retirement plans.

The fiduciary advice must satisfy the “best interest” standard of care. Such advice reflects the care, skill, prudence and diligence under circumstances then prevailing that a prudent person acting in a like capacity familiar with such matters would use in the conduct of an enterprise of a like character with like aim.

Title II: Internal Revenue Code Provisions

In order for an employer-sponsored retirement plan to qualify for federal income tax deferrals and deductions, it must comply with the pension-related provisions of the Internal Revenue Code (IRC). The pension-related provisions of the IRC require plans to cover rank-and-file workers, and they include “nondiscrimination rules” that prohibit qualified plans from favoring highly compensated employees (HCE) with respect to eligibility or benefits.

Limits on Plan Contributions and Benefits

The IRC limits the amount of money that can be contributed on a tax-deductible basis to a DB plan or DC plan, the amount that can be paid annually from a DB plan, and the amount of income that can be taken into consideration when establishing benefits under a DB plan.

Defined Benefit Plan Provisions

Under IRC § 401(a)(17), no more than the first $270,000 of an employee’s annual compensation can be used in computing benefits or contributions under a DB plan in 2017 (was $265,000 in 2016). The maximum annual benefit payable in 2017 under a DB plan at age 62 is the lesser of $215,000 or 100% percent of the participant’s average compensation for his or her three highest years of earnings [IRC § 415(b)]. This dollar limit is adjusted annually by the increase in the consumer price index (CPI) and rounded down to the next lower multiple of $5,000. IRC § 415(b) requires the dollar limit on benefits to be actuarially reduced for retirement before age 62. For qualified police and firefighters with at least 15 years of service, no actuarial reduction is required. Consequently, the dollar limit for police and firefighters is the same as the unreduced IRC § 415(b) dollar limit, or $215,000 in 2017 (was $210,000 in 2016), regardless of age.

Limit on Tax Deductions for Employer Contributions

Under IRC § 415(c)(1)(A), in 2007, the maximum tax-deductible employer contribution to a DB plan was 150% of the plan’s current liability minus the value of the plan’s assets. After passing the PPA of 2006, effective for tax years beginning in 2008, Section 801 amended the maximum tax-deductible employer contribution as:
• The plan’s target normal cost; plus
• 150% of the funding target; plus
• An allowance for future pay or benefit increases; minus
• The value of the plan’s assets.

Excess employer contributions to DB plans are subject to a 10% excise tax.

**Defined Contribution Plan Provisions**

IRC § 415(c) limits the maximum “annual addition” to a DC plan (the sum of employer and employee contributions). In 2017, the maximum annual addition is the lesser of $54,000 or 100% of annual compensation [IRC § 402(g)]. The maximum employee contribution (called an “elective deferral”) to a 401(k), 403(b), or 457(b) plan is $18,000 in 2017 (unchanged from 2016) [IRC § 402(g)(1)]. This amount is indexed annually.

**Combined limit under IRC § 404(a)(7)**

IRC § 404(a)(7) establishes limits on employer tax deductions for contributions made in connection with one or more defined contribution plans and one or more defined benefit plans. One effect of these limits is that large contributions to a defined benefit plan could result in the employer’s contributions to the DC plan being nondeductible for that year. The PPA revised the law such that the combined contribution limit under IRC § 404(a)(7) is determined without regard to DB plans that are insured by the PBGC. In addition, only employer contributions to a DC plan that exceed 6% of participant compensation are subject to the limit. Employees’ elective deferrals are disregarded from the deduction limits.

**“Catch-up” Contributions**

The *Economic Growth and Tax Relief Reconciliation Act* (EGTRRA) of 2001 added IRC § 414(v) to the Internal Revenue Code. This amendment allows additional (“catch-up”) contributions by participants in 401(k), 403(b), 457(b), SEP IRA, and SIMPLE plans who are or will be age 50 or older by the end of the plan year. These contributions were to “sunset” in 2010, but they were made permanent by the PPA of 2006. The maximum catch-up contribution is the lesser of:

- A specific dollar limit; or
- The participant’s compensation for the year reduced by any other elective deferrals made during the year. In 2017, the catch-up dollar limit for 401(k), 403(b), SEP, and 457(b) plans is $6,000 (same as 2016).

For SIMPLE plans, the 2017 catch-up dollar limit is $3,000 (same as 2016). For IRAs, the catch-up dollar limit is $1,000.
Coverage and Nondiscrimination

Tax-qualified retirement plans (both DB and DC plans) may not discriminate in favor of highly-compensated employees (HCEs) with regard to coverage, amount of benefits, or availability of benefits. A “highly compensated employee” is defined in law as any employee who owns 5% or more of the company or whose compensation exceeds $120,000, indexed to inflation [IRC § 414(q)]. An employer can elect to count as HCEs only employees who rank in the top 20% of compensation in the firm, but must include anyone who owns 5% or more of the company.

Nondiscrimination Test

IRC § 410(b) specifies whom a qualified plan must cover. A plan must meet one of the following tests:

- The plan must benefit at least 70% of non-highly compensated employees (NHCE). This is called the “percentage test”; or
- The plan must benefit a percentage of non-highly compensated employees (NHCE) which is at least 70% of the percentage of HCE benefitting under the plan. This is called the “ratio test”; or
- The plan must benefit a classification of employees that do not discriminate in favor of HCE and the average benefit percentage of the NHCE must be at least 70% of the average benefit percentage of the HCE (average benefit percentage test). This is called the “nondiscriminatory classification test.”

In a DC plan, either the proportion of NHCEs covered by the plan must be at least 70% of the proportion of HCEs covered by the plan, or the average contribution percentage for NHCEs must be at least 70% of the average contribution percentage for HCEs. Plans that have after-tax contributions or matching contributions are subject to the “actual contribution percentage” (ACP) test, which measures the contribution rate to HCE’s accounts relative to the contribution rate to NHCEs’ accounts. Some IRC § 403(b) plans are subject to nondiscrimination rules; IRC § 457 plans generally are not. The actual contribution percentage of HCEs in an IRC § 401(k) plan generally cannot exceed the limits shown in Table 4.3.

Table 4.3
Maximum Average 401(k) Contributions for Highly Compensated Employees

<table>
<thead>
<tr>
<th>Non-Highly Compensated Employees (NHCE)</th>
<th>Highly Compensated Employees (HCEs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum average deferral and match</td>
<td>Maximum average deferral and match:</td>
</tr>
<tr>
<td>2% of pay or less</td>
<td>NHCE percentage x 2</td>
</tr>
<tr>
<td>More than 2% and less than 8% of pay</td>
<td>NHCE percentage + 2%</td>
</tr>
<tr>
<td>8% of pay or more</td>
<td>NHCE percentage x 1.25</td>
</tr>
</tbody>
</table>
Note: “Deferral and match” is the sum of employer and employee contributions.

Safe Harbor Plans

Any of three “Safe Harbor” 401(k) plan designs are deemed to satisfy the ACP test automatically for employer matching contributions (up to 6% of compensation):

- The employer matches 100% of employee elective deferrals up to 3% of compensation, and 50% of elective deferrals between 3% and 5% of compensation and all employer matching contributions vest immediately;
- Employer matching contributions can follow any other matching formula that results in total matching contributions that are no less than under the first design. All employer matching contributions must vest immediately; and
- The employer automatically contributes an amount equal to at least 3% of pay for all eligible NHCEs. Employer contributions must vest immediately.

All 401(k) plans must satisfy an “actual deferral percentage” (ADP) test, which measures employees’ elective deferrals. The same numerical limits are used as under the ACP test. Three “safe harbor” designs, similar to the safe harbor designs for the ACP test, are deemed to satisfy the ADP test automatically. In addition, “cross-testing” allows DC plans to satisfy the nondiscrimination tests based on projected account balances at retirement age, rather than current contribution rates. This permits bigger contributions for older workers. Because higher-paid employees receive proportionally smaller Social Security benefits relative to earnings than lower-paid workers, employers are permitted to make larger contributions on earnings in excess of the Social Security wage base ($127,200 in 2017). Regulations limit the size of the permitted disparity in favor of workers whose earnings are above the wage base.

Distributions from Qualified Plans

The Tax Reform Act of 1986 created uniform distribution rules for pension plans and established an excise tax to be imposed for failure to make a required minimum distribution (RMD). This law also specified that, if there were after-tax employee contributions to a plan, a portion of each payment to the participant is to be considered a return of employee contributions (and not taxed) and that a portion is to be considered a return of employer contributions (and subject to tax). DB plans and money purchase plans must offer participants a benefit in the form of a life annuity. DB and money purchase plans may also offer other payment options, such as lump-sum distributions. DC plans other than money purchase plans usually pay benefits in a single lump-sum or as payments over a set period of time, such as 5 or 10 years. Some of these plans also offer an annuity option.

A qualified plan must allow participants to begin receiving benefits by the latest of:

- Age 65 (or the plan’s normal retirement age, if earlier than 65);
After ten years of service; or
Upon terminating service with the employer.

DB plans and money purchase plans usually allow participants to receive benefits only after they have reached the plan’s normal retirement age, but some have provisions for early retirement, often at age 55. Most 401(k) plans allow participants to receive their account balances when they leave the employer. A 401(k) plan may allow for distributions while the worker is still employed if he or she has reached age 59½ or has suffered a severe financial hardship, such as facing imminent eviction or foreclosure. Profit sharing plans may permit participants to receive their vested benefits after a specific number of years or when they leave the employer.

Distributions from employer-sponsored plans must start no later than April 1st of the year after the year in which the participant attains age 70½, unless the participant is still employed by the firm that sponsors the plan [IRC § 401(a)(9)]. Failure to make a required distribution results in an excise tax equal to 50% of the excess of the minimum required distribution over the amount actually distributed. The amount of the RMD is based on the participant’s age and remaining life expectancy. If a participant in a DB plan retires after age 70½, his or her accrued pension benefit must be actuarially increased to reflect the value of benefits that would have been received had the employee retired at age 70½. The actuarial adjustment rule does not apply to DC plans.

Some employers now offer a “phased retirement” option that allows employees at or near retirement age to reduce their work hours to part-time and receive a pension distribution to supplement their reduced earnings. The PPA amended ERISA to allow DB plans to make in-service distributions to employed plan participants beginning at the earlier of age 62, or the plan’s normal retirement age, as amended by Section 905 of the PPA.

Distributions from a 401(k) plan can be made to a current employee without penalty beginning at age 59½. In-service distributions from either a DB plan or a DC plan are subject to income taxes.

**Plan Loans**

Qualified plans are permitted, but are not required, to offer loans to participants. The loan must charge a reasonable rate of interest and be adequately secured. A loan from a tax-qualified pension plan is treated for federal income tax purposes as a taxable plan distribution if it exceeds prescribed limits [IRC § 72(p)]. The maximum permissible loan amount takes into account other outstanding plan loans as well as the present value of the benefits earned by the recipient. A participant can borrow up to half of the present value of accrued benefits, but no more than $50,000. The loan must be repaid within five (5) years unless it is used to purchase a principal residence. Loans that are not repaid when due are treated as taxable distributions and may also be subject to a 10% additional tax if the recipient was under age 59½. DC plans established under § 401(k), § 403(b), or § 457 also can make distributions in case of financial hardship, such as imminent eviction.
or foreclosure. Hardship distributions are subject to income taxes, and if the recipient is under age 59½, they may be subject to an additional 10% tax.

**Additional Tax on Early Withdrawals**

With certain exceptions, a 10% additional tax is imposed on distributions from a qualified plan unless the individual is age 59½, dies, or becomes disabled [IRC § 72(t)]. This additional tax does not apply to early distributions if they are paid:

- After the plan participant has reached age 59½;
- To a beneficiary after the death of the participant;
- Because the participant has become disabled;
- As part of a series of substantially equal periodic payments (SOSEPPs) over the life of the participant or the joint lives of the participant and survivor;
- To an employee who has separated from service under an early retirement arrangement after reaching age 55;
- As dividends paid from an Employee Stock Ownership Plan (ESOP);
- Through an IRS levy to collect back taxes owed by the plan participant;
- To pay medical expenses of the plan participant, a spouse, or dependent, but only to the extent that they exceed 7.5% of adjusted gross income; or
- To an alternate payee under a qualified domestic relations order (QDRO).

**Rollovers**

Departing plan participants can rollover (transfer) distributions from a qualified plan to an Individual Retirement Account (IRA) or to another employer’s plan, if the plan accepts such transfers. If the accrued benefit is less than $5,000 when the participant leaves an employer, the plan can make an immediate distribution without the participant’s consent. Amounts of $5,000 or more may be cashed out only with the written consent of the participant. For married workers, the consent of the worker’s spouse is also required.

If the distribution is more than $1,000, the plan must automatically rollover the funds into an IRA that it selects, unless the participant elects to receive a lump sum payment or to roll it over into an IRA that he or she chooses. The plan must first send a notice allowing the participant to make other arrangements, and it must follow rules regarding what type of IRA can be used (for example, it cannot combine the distribution with savings the individual has deposited directly in an IRA). Rollovers must be made to an entity that is qualified to offer individual retirement plans. Also, the rollover IRA must have investments designed to preserve principal. The IRA provider may not charge more in fees and expenses for such plans than it would charge to its other IRA customers.

If the departing employee elects to receive a lump sum payment and does not transfer the money to another qualified employer plan or to an IRA, the participant will owe a 10% tax penalty if he or she is under age 59½ and does not meet the exceptions listed in §72(t). Distributions paid directly to the plan participant, rather than being rolled over...
into an IRA or a qualified employer plan, are subject to mandatory tax withholding equal to 20% of the total distribution. If the rollover—which must be equal to the cash received plus the 20% withheld—is completed within 60 days of the distribution, the tax that was withheld is applied to the individual’s income tax liability.

Integration with Social Security

The Social Security benefit formula is designed to replace a greater percentage of wages for lower-income workers than for higher-income workers. The Social Security Administration estimates that for benefits claimed at the full retirement age, Social Security currently replaces 55% of the average earnings of a low-wage worker and 27% of the earnings of a high-wage worker. Since the Revenue Act of 1942, it has been permissible for private pension plans to narrow the difference in total wage replacement by providing larger pension benefits as a percentage of compensation to higher-paid workers than to lower-paid workers. Plans may coordinate or “integrate” their retirement benefit formulas with Social Security under an “offset method” or an “excess method” [IRC § 401(a)(5)].

In DB plans, integration with Social Security is usually related to the benefit paid to participants, while in DC plans it most often relates to the contributions made by employers. In an “integrated DB plan”, the amount of the worker’s monthly pension is reduced or “offset” by a percentage of his or her Social Security benefit. In an integrated DC plan”, the amount contributed by the employer is higher for the portion of the employee’s salary that is in excess of a specific amount, called the integration level. The most common integration level is the maximum amount of annual income that is subject to Social Security taxes ($118,500 in 2016). The maximum offset allowed under an offset plan and the “maximum permitted disparity” allowed under an excess plan are both limited by the IRC.

Special Rules for “Top-Heavy” Plans

A DB pension plan is considered “top-heavy” if more than 60% of benefits (in a DB plan) are earned by key employees or if more than 60% of contributions (in a DC plan) are made on behalf of key employees. Most small pension plans are most likely to fall into the top-heavy category. Key employees are defined as company officers with earnings over $175,000 in 2017 (same as in 2016), owners of at least 1% of the company who receive over $150,000 in annual compensation, and owners of 5% or more of the company. For any plan year in which a plan is found to be top-heavy, special requirements must be met if the plan is to retain its tax qualified status. Top-heavy plan requirements fall into two main areas:

- Faster vesting schedules for non-key employees; and
- Minimum nonintegrated benefits and contributions for non-key employees.

Top-heavy plans must implement an accelerated vesting schedule. The benefits vested must include all benefits accrued (earned) under the plan, not just those accrued while the
plan is operating under the special top-heavy rules. Top-heavy plans may choose from one of two of the following special vesting schedules:

- Plan participants must be 100% vested in their benefits after three years of service; or.
- 100% vesting occurs after six years and is reached by stages:
  - 20% of the employee’s accrued benefits are vested after two years of service; and
  - an additional 20% become vested after each of the next four years.

For years in which a plan is deemed to be top-heavy, the plan must meet specific minimum benefit and contribution levels for every non-key employee covered by the plan. The specified minimum benefit or contribution may not be reduced or eliminated through integration with Social Security. For each year that a defined benefit plan is top-heavy, a minimum benefit is required equal to 2% of the employee’s average compensation earned for the five highest consecutive years of compensation. The highest minimum benefit does not have to exceed 20% of the non-key employee’s average compensation. For each year that a DC plan is top-heavy, the employer must make a contribution on behalf of each non-key employee equal to at least 3% of the employee’s annual compensation.

**Title IV: Pension Benefit Guaranty Corporation**

Title IV of ERISA established the Pension Benefit Guaranty Corporation (PBGC) as a government-owned corporation to protect the retirement income of participants and beneficiaries in private-sector DB pension plans. DC plans such as ESOPs, profit sharing plans, 401(k), 403(b), thrift/savings plans, and stock bonus plans are not insured by the PBGC.

PBGC (FY 2016) insures the pension benefits of 40 million American workers and retirees participating in nearly 24,000 private sector defined benefit plans through its two insurance programs:

- A single-employer program; and
- A multi-employer program.

The single-employer program covers about 28.4 million people (excluding those in plans that PBGC has trusted), slightly down from the 30.9 million people PBGC covered in 2015. The number of covered ongoing plans decreased from about 22,200 in 2015 to about 22,300 in 2016.

Multi-employer pensions are collectively bargained pension plans to which more than one employer contributes. The single-employer plan is the larger of the two insurance programs.
The PBGC maintains separate reserve funds for single employer plans and multiemployer plans. PBGC’s financial portfolio is one of the largest of any federal government corporation, with more than $80 billion in assets. Table 4.4 below shows the FY 2010 to 2016 annual financial operations.

Table 4.4
PBGC Single-Employer Insurance Program, Annual Operations ($ thousands)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and other income</td>
<td>$5.2 billion</td>
<td>$4.4 billion</td>
<td>$3.9 billion</td>
<td>$3.1 billion</td>
<td>$2.7 billion</td>
<td>$2.3 billion</td>
</tr>
<tr>
<td>Investment income (loss)</td>
<td>$8.648</td>
<td>$324</td>
<td>$6,439</td>
<td>$2,741</td>
<td>$8,792</td>
<td>$7,594</td>
</tr>
<tr>
<td>Actuarial charges and adjustments (credits)</td>
<td>$11,515</td>
<td>$9,504</td>
<td>$1,864</td>
<td>$3,054</td>
<td>$14,874</td>
<td>$9,421</td>
</tr>
<tr>
<td>Losses (credits) from completed an probable terminations</td>
<td>($417)</td>
<td>(780)</td>
<td>(115)</td>
<td>$468</td>
<td>$2,006</td>
<td>$509</td>
</tr>
<tr>
<td>Administrative, investment and other expenses</td>
<td>$465</td>
<td>$446</td>
<td>464</td>
<td>434</td>
<td>443</td>
<td>449</td>
</tr>
<tr>
<td>Net income (Loss)</td>
<td>$3,485</td>
<td>($4,727)</td>
<td>$8,043</td>
<td>$1,761</td>
<td>($5,876)</td>
<td>($517)</td>
</tr>
</tbody>
</table>


As of FY 2016 (September, 2016), the single employer and multi-employer programs reported deficits of $20,580 million and $58,833 million, respectively. The multi-employer program’s net position declined by $6,549 million, increasing its deficit to $58,833 million, an all-time record high for the multiemployer program.

Notwithstanding, these deficits the PBGC has about $97,342 million in single-employer assets and $2,204 million in multiemployer assets and will be able to meet its obligations for a number of years. However, neither program at present has the resources to fully satisfy PBGC’s obligations in future years.

Note: In this chapter we will only discuss single-employer plans.

Premiums for Single-Employer Plans

The PBGC receives no appropriations from Congress. Its revenues come from premiums paid by employers that sponsor defined benefit pension plans, the assets of the terminated plans that it has taken over, investment income on its trust funds, and amounts recovered from the general assets of firms that terminate underfunded pension plans. Although it receives no appropriations, the Multiemployer Pension Plan Amendments Act of 1980 (P.L. 96-364) requires the PBGC’s receipts and disbursements to be included in the
federal budget. The PBGC does not have the legal authority to set its own premiums, which are set in law by Congress.

The PBGC single employer insurance program receives two types of premiums from plan sponsors:

- Per-capita (flat-rate) premium that is charged to all single-employer defined benefit plans; and
- Variable-rate premium charged to underfunded plans.

When the PPA was passed in 2006, the PBGC’s single employer plan program was running a $23 billion dollar deficit. Thus under the act, fixed premiums were slated to increase from $19 to 30 per participant in 2008 (and be indexed to the Social Security Average Wage Index thereafter). The variable-rate premium remained $9 per $1,000 of underfunding, but the act repealed the full funding limit exemption, which had waived the premium if contributions for the prior year at least equaled that year’s full funding requirement. Plan sponsors with involuntary terminations had to pay a new termination charge of $1,250 per participant over three years. These changes combined with subsequent declines in plan funding nearly double premium income to the PBGC by 2010.


The Moving Ahead for Progress in the 21st Century Act (MAP-21, P.L. 112-141) increased the premiums that plan sponsors pay to PBGC. MAP-21 increased the single-employer flat-rate premium to $42 per participant in 2013 and to $49 per participant in 2014. After 2014, the flat-rate premium will be indexed for increases in the annual rate of growth in the average national wage. The per-participant flat premium for plan years beginning in 2015 is $57 for single-employer plans (up from $49 in 2014). The flat rate increase for plan years beginning in 2016, the flat rate premium is scheduled to increase to $64 (see Table 4.5).

The variable rate premium is equal to $9 per $1,000 of underfunded vested benefits. The interest rate for determining the amount of underfunding subject to the variable rate premium is based on a composite corporate bond rate for the month proceeding the month in which the premium payment year begins. Under prior law, an underfunded plan was exempted from the variable-rate premium if it was not underfunded in any two consecutive years out of the previous three years. Under the PPA, the variable premium is assessed on all underfunded plans, regardless of the plan’s funding status in earlier years. For employers with 25 or fewer employees, the variable premium is $5 per participant. The PPA made permanent a surcharge premium for certain distress terminations that was added by P.L. 109-171 and was to expire in 2010. An annual surcharge of $1,250 per participant will be assessed for three years against any firm that terminates an underfunded pension plan during bankruptcy if it later emerges from bankruptcy.
MAP-21 will increase the variable rate premium by $4 (after indexing) per $1,000 of unfunded vested benefits in 2014 ($13) and by another $5 (after indexing) per $1,000 of unfunded vested benefits in 2015 ($18). For plan years beginning in 2015, the variable rate premium (VRP) for single-employer plans is $24 per $1,000 of unfunded vested benefits (UVB), up from a 2014 rate of $14. For 2015, the VRP is capped at $418 times the number of participants (up from a 2014 cap of $412. Plan sponsored by small employers (generally fewer than 25 employees) may be subject to an even lower cap (see Table 4.5).

### Table 4.5

**PBGC Historical Premium Rates**

<table>
<thead>
<tr>
<th>Plan Years Beginning in</th>
<th>Single Employer Plans</th>
<th>Variable –Rate Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Per Participant Rate for Flat-Rate Premium</td>
<td>Rate per $1,000 UVBs</td>
</tr>
<tr>
<td>2016</td>
<td>$60</td>
<td>$30</td>
</tr>
<tr>
<td>2015</td>
<td>$57</td>
<td>$24</td>
</tr>
<tr>
<td>2014</td>
<td>$49</td>
<td>$14</td>
</tr>
<tr>
<td>2013</td>
<td>$42</td>
<td>$9</td>
</tr>
<tr>
<td>2012</td>
<td>$35</td>
<td>$9</td>
</tr>
<tr>
<td>2011</td>
<td>$35</td>
<td>$9</td>
</tr>
<tr>
<td>2010</td>
<td>$35</td>
<td>$9</td>
</tr>
<tr>
<td>2009</td>
<td>$34</td>
<td>$9</td>
</tr>
<tr>
<td>2008</td>
<td>$33</td>
<td>$9</td>
</tr>
<tr>
<td>2007</td>
<td>$31</td>
<td>$9</td>
</tr>
</tbody>
</table>


### The Bipartisan Budget Act of 2013

The *Bipartisan Budget Act of 2013* calls for the VRP rate to increase another $5 starting with 2016 (on top of indexing) increasing the flat-rate premium to $64 in 2016 and the rate per $1,000 UVBs to $29 and the per participant cap to $500.

### The Bipartisan Budget Act of 2015

On November 1, 2015, President Obama signed into law the *Bipartisan Budget Act (BBA) of 2015* which brings familiar changes for plan sponsors of DB pension plans. Similar to the MAP-21 (discussed above), the BBA provides relief from pension funding obligations while increasing PBGC premiums. The following summarizes the two major changes under the BBA that affect pension plans.

- **Extension of MAP-21 Rates** – Under the BBA, plan sponsors of single employer DB plans may continue to measure pension liability using the 25-year average of
segment rates plus or minus a 10% corridor (i.e., the MAP-21 rates) through 2020, with a 5% increase applying to each year thereafter through 2023. The corridor will remain at 30% after 2023. Prior to enactment of the BBA, the 10% corridor was scheduled to increase by 5% each year beginning after 2017 through 2020, and would have remained at 30% after 2020. With interest rates at historical lows, limiting the rates based on the 25-year average tends to increase the interest rates, and therefore lowers the minimum funding requirements. Of course, the benefit to a plan sponsor from the decreased funding obligation resulting from the BBA extension of the MAP-21 rates will be offset by the increased PBGC premiums.

- **Increased PBGC Premiums** – The BBA increases both the annual fixed premiums and variable rate premiums that sponsors of single employer DB pension plans are required to pay to the PBGC effective for plan years beginning in 2017 through 2019. The fixed premium is a per participant fee and the variable rate premium is based on the plan’s level of underfunding.

Table 4.6 illustrates the increased premiums contained in the BBA are even higher than the amounts originally proposed and reported. The increased rates are as follows:

<table>
<thead>
<tr>
<th>Plan years beginning in…</th>
<th>Increased Fixed (Flat) Premium</th>
<th>Variable Rate Premium Indexed for Inflation and Increased by</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$69</td>
<td>Additional $3</td>
</tr>
<tr>
<td>2018</td>
<td>$74</td>
<td>Additional $4</td>
</tr>
<tr>
<td>2019</td>
<td>$80</td>
<td>Additional $4</td>
</tr>
</tbody>
</table>

The BBA provides that after 2019, the fixed premium will be indexed for inflation. The BBA also accelerates the due date for PBGC premiums by one month for plan years beginning in 2025. Unlike Map-21, the BBA does not affect PBGC premiums for multiemployer plans.

**PBGC Insurance Limit**

The PBGC guarantees only “basic benefits.” Basic benefits include:

- Pension benefits beginning at normal retirement age;
- Most early retirement benefits;
- Annuity benefits for survivors of plan participants; and
- Disability benefits.

Only vested benefits are insured. ERISA sets a limit on the benefits insured by the PBGC. This limit is adjusted annually for increases in wage growth in the economy. For
single employer pension plans ending in 2017, the maximum yearly pension guarantee is $64,431.84 for a participant retiring at age 65 (see Table 4.7). The maximum insured benefit is reduced actuarially if a participant retires before age 65 or if the pension plan provides benefits in a form other than a life annuity. Benefits are insured at their nominal value: once the insured benefit amount is determined, it is not adjusted for inflation. Benefit increases that went into effect less than five years before a plan was terminated are not fully insured. Insurance on these benefits is phased in, guaranteeing 20% of the increase in benefits for each full year since the amendment that increased plan benefits was adopted.

Table 4.7
PBGC Maximum Monthly Guarantees for 2017

<table>
<thead>
<tr>
<th>Age</th>
<th>Annual Maximum</th>
<th>Monthly Maximum</th>
<th>Monthly Joint and 50% Survivor Maximum*</th>
</tr>
</thead>
<tbody>
<tr>
<td>75</td>
<td>$195,872.76</td>
<td>$16,322.73</td>
<td>$14,690.46</td>
</tr>
<tr>
<td>74</td>
<td>$178,080.96</td>
<td>$14,840.80</td>
<td>$13,356.72</td>
</tr>
<tr>
<td>73</td>
<td>$160,306.44</td>
<td>$13,358.87</td>
<td>$12,022.98</td>
</tr>
<tr>
<td>72</td>
<td>$142,523.28</td>
<td>$11,876.94</td>
<td>$10,689.25</td>
</tr>
<tr>
<td>71</td>
<td>$124,740.00</td>
<td>$10,395.00</td>
<td>$9,355.50</td>
</tr>
<tr>
<td>70</td>
<td>$106,956.84</td>
<td>$8,913.07</td>
<td>$8,021.76</td>
</tr>
<tr>
<td>69</td>
<td>$96,003.48</td>
<td>$8,000.29</td>
<td>$7,200.26</td>
</tr>
<tr>
<td>68</td>
<td>$86,338.68</td>
<td>$7,194.89</td>
<td>$6,475.40</td>
</tr>
<tr>
<td>67</td>
<td>$77,962.56</td>
<td>$6,496.88</td>
<td>$5,847.19</td>
</tr>
<tr>
<td>66</td>
<td>$70,875.00</td>
<td>$5,906.25</td>
<td>$5,315.63</td>
</tr>
<tr>
<td>65</td>
<td>$64,434.24</td>
<td>$5,369.52</td>
<td>$4,832.39</td>
</tr>
<tr>
<td>64</td>
<td>$59,921.64</td>
<td>$4,993.47</td>
<td>$4,494.12</td>
</tr>
<tr>
<td>63</td>
<td>$55,411.44</td>
<td>$4,617.62</td>
<td>$4,155.86</td>
</tr>
<tr>
<td>62</td>
<td>$53,061.12</td>
<td>$4,421.76</td>
<td>$3,817.58</td>
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<tr>
<td>61</td>
<td>$46,390.92</td>
<td>$3,865.91</td>
<td>$3,479.32</td>
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<tr>
<td>60</td>
<td>$41,880.72</td>
<td>$3,490.06</td>
<td>$3,141.05</td>
</tr>
<tr>
<td>55</td>
<td>$28,982.28</td>
<td>$2,415.19</td>
<td>$2,174.57</td>
</tr>
<tr>
<td>50</td>
<td>$22,551.12</td>
<td>$1,879.26</td>
<td>$1,691.33</td>
</tr>
<tr>
<td>45</td>
<td>$16,107.96</td>
<td>$1,342.33</td>
<td>$1,208.10</td>
</tr>
</tbody>
</table>

* Assumes participant and spouses are the same age.
Source: Pension Benefit Guarantee Corporation (PBGC);
* Assumes participant and spouses are the same age.

The applicable maximum guarantee is determined by the year the retiree’s plan terminated (or, if the plan terminated during the plan sponsor’s bankruptcy, the year the sponsor entered bankruptcy), even if the retiree does not begin collecting benefits until a future year. In some cases, retirees can receive more than the maximum guarantee.
According to PBGC, most retirees who get their pension from PBGC—almost 85 percent—receive the full amount of their promised benefit. In some cases, retirees can receive more than the PBGC maximum guarantee.

Plan Terminations

A sponsor of a single-employer plan can voluntarily end the pension plan in one of two ways:

- A “standard” termination if the plan is fully funded; or
- A “distress” termination.

The maximum PBGC guaranteed benefit is not reduced for participants who elect early retirement with a disability that meets the standards for Social Security disability benefits. The PBGC becomes responsible for paying benefits in the case of a distress or involuntary termination.

Standard Termination

An employer can end a plan through a standard termination only if the plan’s assets are sufficient to cover all of the plan’s liabilities. Participants and beneficiaries must be informed of the amounts due them, including data and underlying actuarial assumptions used to compute the benefits. An actuary must certify that the assets are sufficient to meet all plan liabilities. If the rules for a standard termination have been met, the plan sponsor purchases annuities from a commercial insurer or distributes lump-sum payments to beneficiaries. The employer then has no further liability to the PBGC or plan participants and can recapture any remaining assets after paying all applicable taxes.

Distress Termination

An employer can terminate an underfunded plan under a distress termination only if one of the following conditions applies:

- Bankruptcy proceedings seeking liquidation have been filed by or against the company under Chapter 7 of the Bankruptcy Code;
- The company is undergoing reorganization under Chapter 11 of the Code, and the bankruptcy court has approved a plan termination;
- The company is unable to pay its debts when due and will be unable to continue in business unless the plan is ended; or
- The company has experienced unreasonably burdensome pension costs solely as a result of a decline in its workforce.

One of the criteria for a distress termination must be met by each company that is a contributing sponsor of the plan or a “substantial member” of the sponsor’s controlled group. Generally, a substantial member is a company whose assets comprise 5% or more
of the total assets of the controlled group. The controlled group includes corporate parents and affiliates of the plan sponsor.

**Involuntary Termination**

The PBGC may end a pension plan even if a company has not filed to do so on its own initiative. PBGC may end the plan if:

- The plan has not met the minimum funding requirements;
- The plan cannot pay current benefits when due;
- A lump-sum payment has been made to a participant who is a substantial owner of the sponsoring company; or
- The loss to the PBGC is expected to increase unreasonably if the plan is not ended.

**Employer Liability to the PBGC**

In a distress termination, or in an involuntary termination initiated by the PBGC, a pension plan sponsor is liable to the PBGC for any unfunded benefit liabilities. The plan sponsor and members of the controlled group are jointly and severally liable for such obligation so each member can be held responsible for the entire liability. Each contributing sponsor also would be liable to the PBGC if the plan had an accumulated funding deficiency or a waived funding deficiency. The employer liability to the PBGC is due on the termination date, except that the PBGC can prescribe commercially reasonable terms for payment of employer liability that exceeds 30 percent of the net worth of the employer. If a company sells or transfers a business with an underfunded pension plan for the purpose of evading pension liabilities and the plan is ended within five years of the sale or transfer, the firm can be held liable for unfunded liabilities existing at the time of sale.

**Reportable Events**

The PBGC must be notified of certain events, including:

- If the plan is deemed not in compliance with the law;
- If an amendment has been adopted decreasing benefits;
- If there has been a substantial drop in the number of active participants;
- If the plan does not meet the minimum funding standards or is unable to pay benefits; or
- If there is a distribution of $10,000 or more to a substantial owner.

The PBGC also must be notified if a controlled group member leaves the group, liquidates, declares an extraordinary dividend, or redeems 10% or more of total voting stock.
Notice Requirements

As amended by the PPA, ERISA requires that if a DB plan terminates while it is underfunded through a distress termination under ERISA §4041(c), or is subject to an involuntary termination under ERISA §4042, the plan sponsor must provide to plan participants the same information that the plan is required to submit to the PBGC—subject to confidentiality limitations—within 15 days of the PBGC filing [Section 506 of the PPA, amending ERISA Section 4041]. This requirement applies to notices of intent to terminate and involuntary termination determinations.

The Future of PBGC: High Risk Area

The financial future of the PBGC is “uncertain” according to a recent Government Accountability Office Report biennial report on high-risk federal government programs and operations. (GAO -13-283). GAO based its opinion on “long-term challenges” related to PBGC’s governance and funding structure.

Yet because of long-term challenges related to PBGC’s governance and funding structure, PBGC’s financial future is uncertain. At the end of fiscal year (FY) 2016, PBGC’s combined net position decreased by $3,064 million, increasing the Corporation’s combined deficit to $79,413 million as of September 30, 2016, a record loss, from $76,349 million as of September 30, 2015. This is largely due to pension liability valuation interest factors decreasing for both insurance programs, the select interest rate factor decreased by 53 basis points to 2.27% at September 30, 2016, from 2.80% at September 30, 2015, and the ultimate factor for both insurance programs decreased to 2.14% at September 30, 2016 (after the first 20 years) from 2.86% at September 30, 2015 (after the first 25 years). The overall FY 2016 impact of the change in interest factors was $12,542 million and consists of $6,141 million from multiemployer probable plans, $6,301 million from terminated single-employer plans, and $100 million from insolvent multiemployer plans. Another factor driving the combined loss is the addition of over $6,300 million for the 11 plans added to PBGC’s inventory of multiemployer plans requiring financial assistance currently or in the future. Charges were partially offset by $8,791 million in investment income and $6,686 million in premium and other income. Thus, while Congress has enacted various provisions to strengthen PBGC’s governance and PBGC has implemented various measures to improve its operations, weaknesses in the structure of its board and its revenue streams continue to undermine the agency’s long-term financial stability.
Chapter 4
Review Questions

1. Which Title of ERISA created the Pension Benefit Guarantee Corporation?
   ( ) A. Title I
   ( ) B. Title II
   ( ) C. Title III
   ( ) D. Title IV

2. Which of the following IRS forms needs to be filed with the Department of Labor and shared with the IRS and must be done electronically?
   ( ) A. Form 5500
   ( ) B. Form 5305
   ( ) C. Form 5305B
   ( ) D. Form 8888

3. The term “year of service” is defined as a 12-month period during which the employee has worked at least how many hours for the employer?
   ( ) A. 500
   ( ) B. 1,000
   ( ) C. 1,500
   ( ) D. 2,500

4. Which Section of ERISA provides that a fiduciary may be personally liable if the fiduciary breaches a responsibility, duty, or obligation under ERISA?
   ( ) A. Section 406
   ( ) B. Section 409
   ( ) C. Section 206
   ( ) D. Section 203

5. Under the percentage test, the plan must benefit at least what percent of non-highly compensated employees (NHCE)?
   ( ) A. 70%
   ( ) B. 50%
   ( ) C. 25%
   ( ) D. 33%
CHAPTER 5

DEFINED BENEFIT (DB) PLANS

Overview

As was discussed in Chapter 4, Defined Benefit (DB) plans represent the more traditional pension programs offered by companies to their employees (plan participants). And even though the number of plans have decreased significantly over the past 20 years, there are still a number of employees who are lucky to have a DB plan and they will seeking advice on the options they have available to them in order to maximize their retirement income. In addition, many older small business owners will see an opportunity to maximize their retirement savings with the use of DB plans.

In this chapter, we will examine the characteristics, advantages and disadvantages of DB plans, the various types of DB plans, as well as the their rules, regulations and distribution options.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The basic characteristics of DB plans;
- The advantages and disadvantages of a DB plan to both the employee and employer;
- The eligibility requirements for an employee and employer to participate in a DB plan;
- The various types of DB plans;
- The minimum coverage and participation requirements for a DB plan;
- The contribution limits and caps as well as the deductibility limits to a DB plan;
- The various funding methods of DB plans;
- The DB plan funding requirements; and
- The distribution planning options of DB plans.

DB Plan Characteristics

A defined benefit (DB) plan is a qualified employer sponsored retirement (pension) plan that guarantees a specified benefit level at the plan participant’s normal retirement age (NRA), typically in the form of an annuity over the lifetime of the retiree and spouse. In the private sector, such plans, when offered, are almost always fully funded by the
employer, with employees automatically enrolled in the plan after completing an initial eligibility period, such as one year. Such plans are funded as a single account by the employer; to meet certain tax standards, the employer must contribute sufficient funds to pay future benefits promised by the plan, taking into account various actuarial assumptions about the work-life, salary, and life expectancy. With a DB plan it is the employer who assumes full responsibility of the plan. And, benefits are guaranteed by the PBGC, with some exceptions as was discussed in the previous chapter.

DB Advantages

For employees:

- **A specified benefit.** The employee will have an understanding of the actual retirement benefit he or she will receive which would help in their retirement planning;
- **Not Responsible For Contributing or Investing.** It is the employer who is responsible for contributing and making the individual investment decisions;
- **May benefit older employees and those who join the company in later years.** While most plans includes years of service in the benefit formula, some do not. In these cases, the person who joins the plan later than others will accrue benefits more rapidly than he or she might in other retirement plans. Of course, the accrued benefit formula used by the plan must satisfy the IRS nondiscrimination requirements (discussed below); and
- **Tax advantages.** As a qualified retirement plan, benefits are taxed only upon distribution.

For the employer:

- **A competitive edge in employee recruitment and retention.** DB plans are prized by employees; the company that sponsors such a plan may have a competitive edge in retaining and recruiting desirable employees;
- **Higher benefits may be paid for the older owner-employee.** Contributions to fund older workers’ benefits are ordinarily larger than they are for younger employees because the plan is age-based and older workers have fewer years in which to accrue their retirement benefits. In many instances, owner-employees are older than other workers; they also tend to have more years of service. Both of these factors give owner-employees an edge in receiving benefits. If they design their plan with a benefit formula that considers years of service, they will provide relatively greater benefits to their accounts;
- **Surplus assets do not have to be shared.** Ongoing (as opposed to terminated) DB plans are required to use forfeitures to reduce future employer contributions and cannot be used to increase the benefits of the remaining participants. However, terminating DB plans may use surplus assets (due to actuarial error or better than expected investment results) to increase the benefits of the remaining participants or to revert back to the employer plan sponsor; and
- **Tax advantages.** Like other qualified plans, employer contributions (within limits, discussed below) are deductible from current federal income taxation. Investment gains on plan funds are tax-deferred.

**DB Disadvantages**

DB plans are not without disadvantages. There is no upside to the level of benefits. DC plans give participants an opportunity to share in the good fortunes of the company (in the case of a stock bonus, ESOP, or profit sharing plan) or in the benefits of good investment results when individual participants direct their own investments. There is no such opportunity in the DB plan. Aside from this lack of opportunity, all other disadvantages affect the employer:

- **Costs of the plan are very expensive to maintain.** Fund costs are based on actuarially determined assumptions as to what will happen to the plan and employees in the future. These assumptions must be revisited on a regular basis to assure that employer funding is on track with expectations. Administrative requirements for these plans are both costly and time consuming, particularly for the smaller business that has fewer participants over which to spread fixed costs. These maintenance costs may be the single biggest disadvantage for an employer;
- **The plans may be difficult to terminate.** As was discussed in the previous chapter, the employer’s ability to terminate a DB plan at any time may be hampered if plan liabilities increase faster than plan assets. Sometimes plans may be overfunded, thus making a plan termination expensive due to possible employer reversions and penalties. (Reversion of plan funds to the employer are taxable);
- **Contributions do not change with business conditions.** Contributions are mandated by the Internal Revenue Code’s minimum funding standards (discussed below), not by business conditions; thus even in times of business distress the employer must make the required plan contributions. Obtaining a minimum funding waiver from the IRS can be difficult and time consuming; and
- **The plans are complicated and difficult to explain.** DB plans are more difficult to communicate to employees than DC plans. Consequently, the employer will have to spend more time and money explaining DB plans to employees.

**DB Rules and Requirements**

The DB plan must follow a number of rules and requirements to maintain its tax advantages as a qualified retirement plan under IRC § 401(a). In this section, we will examine those various rules and requirements, beginning with the rules for employer and employee eligibility and minimum participation requirements.
Employer Eligibility

Any type of organization that is eligible to establish a qualified retirement plan is eligible to establish a defined benefit plan. These organizations include:

- Sole proprietorships;
- Partnerships;
- Corporations (C Corp, and S Corp);
- LLCs;
- Government entities; and
- Tax exempt organizations.

The fact that a company already may have another qualified retirement plan, such as a profit sharing plan, does not disqualify it from also having a DB plan, as long as the statutory limits are observed when making contributions.

Employee Eligibility and Participation Requirements

DB plans are required to meet certain minimum participation requirements. Under IRC § 410(a)(1), this section of the Code sets forth the minimum age and service requirements for a qualified retirement plan. In addition, there are minimum coverage requirements under IRC § 401(b), as well as minimum participation requirements as set forth by IRC § 401(a)(26), known as the 50/40 test.

Minimum Age and Service Requirements

In general, a plan cannot require, as a condition of participation, that an employee complete a period of service with the employer extending beyond the later of:

- The date on which the employee attains age 21; or
- The date on which the employee completes one year of service.

IRC § 410(a)(4) sets for the rules for plan entry dates (the dates when an eligible employee must begin participation). Under IRC § 410(a)(4), a plan is not qualified unless it provides that an employee who is otherwise eligible to participate under the terms of the plan commences participation not later than the earlier or:

- The first day of the first plan year beginning after the date on which the employee satisfied IRC § 410(a)(1) minimum age and service requirements; or
- The date 6 months after the date on which the employee satisfied the minimum age and service requirements.

Minimum Coverage and Participation Requirements

A DB plan must satisfy discrimination tests that are similar to other qualified plans to show that the plan provides benefits for more than just employees who are officers, or
highly compensated employees (HCEs). Some plans may cover all employees who meet the age and service requirements (IRC § 401(a)(1) discussed above). Other plans, however, may stipulate that only certain groups of employees qualify. For example, a plan could specify that only salaried employees, employees within certain divisions, or even employees within a geographic location qualify for the plan. When participation is limited to certain groups, however, the plan must show that it satisfies the minimum coverage requirements under IRC § 401(b). This section of the Code sets out rules on whom the plan must cover. In order to satisfy this Code section, a plan must meet one of the following tests:

- The plan benefits at least 70 percent of the employees who are not highly compensated employees (HCEs). This is known as the percentage test; and
- The plan benefits:
  - A percentage of non-highly compensated employees (NHCE) which is at least 70 percent of the percentage of highly compensated employees (HCEs) benefiting under the plans. This is known as the ratio test.
  - The plan must benefit a classification of employees that do not discriminate in favor of highly compensate employees (nondiscriminatory classification test) and the average benefit percentage of the non-highly compensated employees must be at least 70 percent of the average benefit percentage of the highly compensated employees. This is known as the average benefit percentage test.

For purposes of IRC § 410(b), employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are nonresident aliens receiving no U.S. source earned income from the employer can be excluded from consideration.

Note that changes in employee demographics may affect the way that the plan satisfies the coverage tests. In addition, if the employer has been involved in a merger, acquisition or divestiture of a business unit, the plan should be reviewed to assure that it passes one of the IRC § 410(b) coverage tests.

**50/40 Test**

A DB plan must comply with the minimum participation requirements as set forth by IRC § 401(a)(26). This section of the Code makes sure that a DB plan benefits at least the number of employees set out below.

On each day of the plan year, a DB plan must benefit the lesser of:

- 50 employees of the employer; or
- The greater of:
  - 40% of all employees of the employer; or
  - 2 employees (or if there is only 1 employee, such employee).
**For Example:** A law office has 125 employees. All employees are covered by the firm’s DB plan except 70 associate attorneys and paralegals. The minimum participation requirement is satisfied because the plan covers at least the lesser of (1) 50 employees (125 - 70 = 55) or (2) 40 percent of all employees (125 x 40% = 50).

**Note:** The plan is also required to meet the minimum coverage requirement. Combining different plans of the same employer does not satisfy the requirement.

If a company has fewer than five employees, then at least two employees must be covered unless the employer has only one employee, then only one employee is required to be covered.

In addition, the plan must meet the minimum participation requirements under IRC § 410(a).

**Definition of “Highly Compensated Employee” and “Key Employee”**

Current law defines an HCE as any employee who:

- Was more-than 5% owner at any time during the current or preceding year, or
- Received compensation from the company during the previous year in excess of the compensation threshold for that year. (The “look-back” year for 2017 is 2016. The compensation threshold in effect for 2017 is $120,000).

Generally, a “Key Employee” is:

- A 5 percent owner of the employer;
- A 1 percent owner of the employer with over $150,000 in compensation from the employer; or
- An officer of the employer with over $175,000 in 2017 (subject to cost-of-living adjustments in later years) in compensation from the employer.

**Defined Benefit Limits**

Contributions to a DB plan are actuarially calculated to fund the retirement benefits provided under the plan. Under IRC § 415(b), the maximum annual benefit limit at normal retirement ages between 62 and 65 is the lesser of:

- 100% of a participant’s high consecutive three-year average compensation; or
- A specified dollar amount—for 2017 that amount is $215,000.

For tax years 2006 and later, for purposes of determining average compensation for a participant’s high three years, the high three years are the period of consecutive calendar years (not more than three) during which the participant had the greatest aggregate
compensation from the employer. The limit is reduced if the normal retirement age is younger than 62. It is also reduced if the participation in the plan is less than 10 years.

The dollar limit generally applies to a benefit payable in the form of a straight life annuity or a qualified joint and survivor annuity. If benefits are paid in a form other than a straight life annuity or a qualified joint and survivor annuity, such must be adjusted to the actuarial equivalent of a straight life annuity.

Effective for tax years beginning after 2005, for purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump sum benefit, the interest rate used generally must be not less than the greater of:

- 5.5 percent;
- The rate that provides a benefit of not more than 105 percent of the benefit that would be provided, if the rate (or rates) applicable in determining minimum lump sums, were used; or
- The interest rate specified in the plan.

Compensation Cap

The amount of compensation that can be considered when calculating a participant’s accrued benefit according to the plan’s formula is limited under IRC § 401(a)(17). The limit is $270,000 for 2017 (was $265,000 in 2016) and subject to cost-of-living adjustments in later years.

Generally, compensation for limitation purposes must include all forms of remuneration paid to an employee. Salary deferrals to qualified plans under any of the following IRC Sections must also be included: 401(k), 403(b), 457, 125 (cafeteria plans) and 132(f)(4) (transportation fringe benefit plans). Compensation also includes deemed payments to disabled participants.

Under the new regulations, compensation paid after an employee’s termination date (“post-severance compensation”) will not be included unless:

- It is paid within 2½ months of employment termination or by the end of the limitation year, if later; and
- It would have been paid had the employee remained employed.

For partners and self-employed owners of unincorporated businesses, compensation means net earnings with certain adjustments. Net earnings are reduced by 50% of self-employment tax as well as employer contributions to retirement plans made on behalf of the partner or self-employed individual. Salary deferrals are not deducted from net earnings for limitation purposes.
In S corporations, only income that is distributed to the owner as wages, subject to social security taxes, can be used for retirement plan purposes. Pass-through income is not included.

**Contribution Deductions**

One advantage of a DB plan is that the employer contributions to the plan are tax deductible. Contributions that are not deductible are subject to a 10% excise tax. The Pension Protection Act (PPA) of 2006 made a number of changes to the contribution deduction rules.

For DB plans, the contributions that are necessary to satisfy the plan's actuarial funding requirements can be deducted, even if they exceed 25% of eligible compensation. PPA liberalized the funding rules for DB plans which significantly increased deductible contribution opportunities in an attempt to improve the funding status of such plans (discussed below).

**Deductibility Limit**

Employers with defined benefit plans may receive tax deductions for contributions up to the prescribed limits under IRC § 404(a)(1)(A(i)-(iii). Typically, an employer will be allowed to deduct contributions needed to meet the minimum funding requirement for the plan as determined by the funding formula.

The Pension Protection Act (PPA) of 2006 increased the deduction limits for employer contributions made to:

- Single employer defined benefit plans;
- Multiemployer defined benefit plans; and
- Combined (DB and DC) plans.

The new PPA deduction limits are as follows:

- For tax years beginning in 2006 and 2007, the maximum deductible contribution for a single employer defined benefit plan is 150% of the plan’s current liability, minus the value of plan assets. The PPA also eliminated the IRC § 404(a)(1)(F) option to use any interest rate within 90 to 110 percent of the weighted average of the rates of interest on 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year (the permissible 30-year Treasury rate range) for purposes of determining current liability in determining the maximum deduction under IRC § 404(a)(1), rather than an interest rate within 90 to 100 percent of the weighted average of the rates of interest on amounts invested conservatively in long-term investment grade corporate bonds (the permissible corporate rate range).
For tax years beginning in 2006 and later, the maximum deductible contribution for a **multiemployer defined benefit plan** is 140% of the plan’s current liability, minus the value of plan assets;

When an employer sponsors both **DC plans and DB plans covering one or more of the same employees** (overlapping participation), the law provides that a “**combined plan limit**” applies in addition to the standard DC and DB plan limits. In this situation, the maximum deductible contribution is the greater of:

- 25% of compensation paid or accrued during the plan years to participants in the combined plans; or
- The contribution necessary to meet the minimum funding requirements, but not less than the amount of the DB plan’s unfunded current liability.

Effective for contributions made for tax years beginning in 2006 and 2007, this combined plan limit does not take into account:

- DC plan contributions that total 6% or less of participant compensation; and
- Contributions made to multiemployer plans.

In IRS Notice 2007-28, the IRS explains how to apply these new rules when a plan’s plan year is not the same as the employer’s tax year. Generally, in these situations, the employer has three options for determining its deductible contribution limit. The employer may use:

- The deductible limit for the plan year **beginning** in the tax year;
- The deductible limit for the plan year **ending** in the tax year; or
- A weighted average of alternatives 1 and 2, above.

Regardless of the plan year used, the deductible limit calculation must reflect the law in effect for the tax year for which the deduction is being taken.

**For Example:** If an employer has a non-calendar tax year that began in 2005 and ended in 2006, and a calendar plan year, the deductible limit calculation for the 2005 tax year cannot reflect the PPA rules, even if the calculation is based on the plan year beginning January 1, 2006.

**Design (Funding) Features of DB Plans**

DB plans provide a specified amount of benefit to the plan participant at the plan’s specified retirement age—the **“normal retirement age”** (ages 62-65). There are several types of formulas for determining this benefit. The most common formulas are:

- Flat amount formula;
- Flat percentage of earnings formula; or
- Unit Credit Formula

Let’s review each of these formulas in greater detail.
Flat Amount Formula

The flat amount formula provides simply a stated dollar amount (a flat benefit unrelated to earnings or service) to each plan participant.

*For Example:* The flat formula plan might provide a pension of $1,000 per month for life, beginning at age 65, for each plan participant. Such a plan might require some minimum service to obtain the full amount—perhaps 15 or 20 years of service with the employer—with the benefit being scaled back for fewer years of service. A flat amount formula does not differentiate among employees with different compensation levels, so it would be appropriate only when there is relatively little difference in compensation among the group of employees covered under the plan.

Flat Percentage of Earnings Formula

Flat percentage formulas are the most common; they provide a retirement benefit that is a percentage of the employee’s average earnings.

*For Example:* The flat percentage of earnings formula might provide a retirement benefit at age 65 equal to 50% of the employee’s average earnings prior to retirement. Under this formula, a participant whose average annual pay was $80,000 prior to retirement would receive an annual pension of $40,000. Typically, a plan will require certain minimum service—such as 15 or 20 years—to obtain the full percentage benefit, with the percentage scaled back for fewer years of service.

Unit Credit Formula

A unit credit formula is based on the employee’s service with the employer. It also may reflect a percentage of earnings. So the unit credit can be used as a flat amount per year of service, which reflects service but not earnings; or a percentage of earnings per year of service formula, which reflects both earnings and service.

*For Example:* The unit credit formula might provide 1.5% of earnings for each of the employee’s year of service, with the total percentage applied to the employee’s average earnings. Under this formula, a participant with average annual compensation of $80,000 who retired after 30 years of service would receive an annual pension of $36,000 (that is, 1.5 x 30, 45% of $80,000).

Computing Average Earnings

There are two methods generally used to compute average earnings for these formulas:

- *Career Average Method.* Under the career average method, the formula uses earnings averaged over the employee’s entire career with the employer. The
career-average method takes early and often low-earnings years into account, and thus the total benefit may not fully reflect the employee’s earning power at retirement.

- **Final Average Method.** Under the final average method, earnings are averaged over a number of years—usually the three to five years immediately prior to retirement. The final average method usually produces a retirement benefit that is better matched to the employee’s income just prior to retirement.

In either a career averaging or final average formula, only the first $270,000 (in 2017) of each employee’s compensation is taken into account (IRC § 401(a)(17)). In other words, an employee earning $290,000 in 2017 is treated as if compensation were $270,000.

**Integration with Social Security**

Another thing you must take into consideration is that many of these formulas are further modified by “integrating” them with Social Security benefits. Integrating the formula gives the employer some credit for paying the cost of employee Social Security benefit. It helps to provide a reasonable level of retirement income for all employees by taking Social Security benefits into account.

Employers must fund DB plans with periodic deposits determined actuarially to insure that the plan fund will be sufficient to pay the promised benefit as each participant retires. The objective is to accumulate a fund at the employee’s retirement age that is sufficient to “buy an annuity” equal to the retirement benefit. (In some plans, annuities are actually purchased at retirement, but this is not required.)

**Plan Funding Requirements**

To ensure that sufficient money is available to pay promised pension benefits to participants and beneficiaries, ERISA sets rules that require plan sponsors to fully fund the pension liabilities of DB plans (IRC § 415). These rules were substantially modified by the Pension Protection Act of 2006 (PPA). The funding requirements of ERISA recognize that pension liabilities are long-term liabilities. Consequently, plan liabilities need not be funded immediately, but instead can be amortized (paid off with interest) over a period of years. Single-employer plans generally are required to amortize initial past service liabilities and past service liabilities arising under plan amendments over no more than seven years. DC plans do not promise a specific benefit, and so these plans have no funding requirements.

ERISA requires employers that sponsor DB plans to fund the pension benefits that plan participants earn each year. This is referred to as funding the normal cost of the plan. In addition, DB plan sponsors must amortize the cost of any pension benefits granted to employees for past service, but for which no monies were set aside.
Furthermore, if a DB plan retroactively increases the level of benefits by plan amendment, these new liabilities must be amortized, as well. The assets of the pension plan must be kept in a trust that is separate from the employer’s general assets. Assets in the pension trust fund are protected from the claims of creditors in the event that the plan sponsor files for bankruptcy.

**Funding Requirements for Single-employer Plans**

ERISA requires companies that sponsor DB pension plans to fully fund the benefits that plan participants earn each year. If a plan is underfunded, the plan sponsor must amortize this unfunded liability over a period of years. The PPA established new rules for determining whether a DB plan is fully funded, the contribution needed to fund the benefits that plan participants will earn in the current year, and the contribution to the plan that is required if previously earned benefits are not fully funded. In general, the new rules are effective with plan years beginning in 2008, but many provisions of the PPA will be phased in over several years.

- **Minimum funding standards for single-employer plans.** Pension plan liabilities extend many years into the future. Determining whether a pension is adequately funded requires converting the future stream of pension payments into the amount that would be needed today to pay off those liabilities all at once. This amount—the “present value” of the plan’s liabilities—is then compared with the value of the plan’s assets. An underfunded plan is one in which the value of the plan’s assets falls short of the present value of its liabilities.

Converting a future stream of payments (or income) into a present value requires the future payments (or income) to be discounted using an appropriate interest rate. Other things being equal, the higher the interest rate, the smaller the present value of the future payments (or income), and vice versa.

When fully phased in, the new funding requirements established by the PPA will require plan assets to be equal to 100% of plan liabilities. Any unfunded liability will have to be amortized over no more than seven years. Sponsors of severely underfunded plans that are at risk of defaulting on their obligations will be required to fund their plans according to special rules that will result in higher employer contributions to the plan. Plan sponsors are allowed to use credit earned for past contributions (called “credit balances”) to offset required contributions, but only if the plan is funded at 80% or more. The value of credit balances must be adjusted to reflect changes in the market value of plan assets since the date the contributions that created the credit balances were made.

A plan sponsor’s minimum required contribution is based on the plan’s target normal cost and the difference between the plan’s funding target and the value of the plan’s assets. The target normal cost is the present value of all benefits that plan participants will accrue during the year. The funding target is the present value of all benefits—including early retirement benefits—already accrued by plan participants as of the beginning of the
plan year. If a plan’s assets are less than the funding target, the plan has an *unfunded liability*. This liability—less any permissible credit balances—must be amortized in annual installments over no more than seven years. The plan sponsor’s minimum required annual contribution is the plan’s target normal cost for the plan year, but not less than zero. The 100% funding target was phased in at 92% in 2008, 94% in 2009, 96% in 2010, and 100% in 2011 and later years. The phase-in does not apply to underfunded plans that were required to make deficit reduction contributions in 2007. Those plans had a 100% funding target beginning in 2008.

ERISA requires plans to discount future liabilities using three different interest rates, depending on the length of time until the liabilities must be paid.

- A short-term interest rate is used to calculate the present value of liabilities that will come due within five years;
- A mid-term interest rate is used for liabilities that will come due in five to 20 years; and
- A long-term interest rate is applied to liabilities that will come due in more than 20 years.

The Secretary of the Treasury determines these rates, which are derived from a “*yield curve*” of investment-grade corporate bonds averaged over the most recent 24 months. The yield curve is being phased in over three years.

The PPA, through this transition rule, gave pension plans a three-year period to ease into the new plan funding requirements, in which plans could gradually increase the value of the plan assets, thus relieving them from the burden of having to contribute a large part of the funding shortfall in one year. The PPA, however, placed a limitation on this transition rule, under which the rule will not apply with respect to any plan year after 2008 unless the shortfall amortization base was zero (e.g., the plan failed to meet the transition rule, or be 92% funded in 2008). Section 202 of the Worker, Retiree, and Employer Recovery Act (WRERA), enacted in December 2008, allowed plans to follow the years beginning in 2007. It will replace the four-year average of corporate bond rates established under the Pension Funding Equity Act of 2004, which expired on December 31, 2005.

**“At risk” Plans**

Pension plans that are determined to be “at risk” of defaulting on their liabilities must use specific actuarial assumptions to determine plan liabilities. A plan is deemed to be “at-risk” if it is unable to pass either of two tests. Under the first test, a plan is at-risk if it is less than 70% funded under the “worst-case scenario” assumptions that:

- The employer is not permitted to use credit balances to reduce its cash contribution; and
- Employees will retire at the earliest possible date and will choose to take the most expensive form of benefit.
If a plan does not pass this test, it will be deemed to be at-risk unless it is at least 80% funded under standard actuarial assumptions. This latter test will be phased in over four years, with the minimum funding requirement starting at 65% in 2008 and rising to 70% in 2009, 75% in 2010, and 80% in 2011.

If a plan passes either of these two tests, it is not deemed to be at-risk; however, it is required to make up its funding shortfall over no more than seven years. Plans that have been at-risk for at least two of the previous four years also will be subject to an additional “loading factor” equal to 4% of the plan’s liabilities plus $700 per participant, which is added to the plan sponsor’s required contribution to the plan. Plan years prior to 2008 will not count for this determination. Plans with 500 or fewer participants in the preceding year are exempt from the at-risk funding requirements.

Mortality Tables

To estimate a pension plan’s future obligations, the plan’s actuaries use mortality tables to project the number of participants who will claim a pension and the average length of time that participants and their surviving beneficiaries will receive pension payments. ERISA requires the Secretary of the Treasury to prescribe the mortality tables to be used for these estimates. Large plans can petition the IRS to use a plan-specific mortality table.

Valuation of Plan Assets

Prior to enactment of the PPA, a plan sponsor could determine the value of a plan’s assets using actuarial valuations, which can differ from the current market value of those assets.

*Example:* In an actuarial valuation, the plan’s investment returns could be “smoothed” (averaged) over a five-year period and the average asset value could range from 80% to 120% of the fair market value.

Averaging asset values reduces volatility in the measurement of plan assets that can be caused by year-to-year fluctuations in interest rates and the rate of return on investments.

Averaging, therefore, reduces the year-to-year volatility in the plan sponsor’s required minimum contributions to the pension plan. The PPA narrowed the range for actuarial valuations to no less than 90% and no more than 110% of fair market value and it reduced the maximum smoothing period to two years. Plans with more than 100 participants are required to use the first day of the plan year as the basis for calculations of plan assets and liabilities. Plans with 100 or fewer participants can choose another date.

Plan contributions and Credit Balances

Within limits, plan sponsors can offset required current contributions with previous contributions. However, these so-called “credit balances” can be used to reduce the plan
sponsor’s minimum required contribution to the plan only if the plan’s assets are at least 80% of the funding target, not counting prefunding balances that have arisen since the PPA became effective. Existing credit balances and new prefunding balances must both be subtracted from assets in determining the “adjusted funding target attainment” percentage that is used to determine whether certain benefits can be paid and whether benefit increases are allowed. Credit balances also have to be adjusted for investment gains and losses since the date of the original contribution that created the credit balance. Credit balances must be separated into balances carried over from 2007 and balances resulting from contributions in 2008 and later years.

**Benefit Limitations in Underfunded Plans**

ERISA places limits on:

- Plan amendments that would increase benefits;
- Benefit accruals; and
- Benefit distribution options (such as lump sums) in single-employer DB plans that fail to meet specific funding thresholds.

**Restrictions on Benefit Accruals**

ERISA requires benefit accruals to cease in plans funded at less than 60% of full funding. Once a plan is funded above 60%, the employer—and the union in a collectively bargained plan—must decide how to credit past service accruals. This provision does not apply if the employer makes an additional contribution prescribed by statute. However, Section 203 of WRERA provides that for the first plan year beginning during the period of October 1, 2008, through September 30, 2009, this restriction on benefit accruals is determined using the funding levels from the preceding year, instead of the current year if the funding levels for the preceding year are greater.

Thus, for plans that have lost a lot in the value of plan assets, looking to the funding levels for the previous year may allow some plans to continue providing future benefit accruals that would otherwise have to cease them.

**Restrictions on Benefit Increases**

Plan amendments that increase benefits are prohibited if the plan is funded at less than 80% of the full funding level, unless the employer makes additional contributions to fully fund the new benefits. Benefit increases include—but are not limited to—increases in the rate of benefit accrual and increasing the rate at which benefits become vested.
Vesting Requirements

Under IRC §§ 401(a)(7) and 411(a), DB plans other than cash balance plans and pension equity plans (discussed in Chapter 6) and top-heavy DB plans must provide for participants to become vested in their accrued benefits over a schedule that does not exceed one of the following two alternatives:

- **Five-year cliff vesting.** At the completion of five years of service, the participant becomes fully vested in his or her account. Should the employee terminate service with the employer prior to the completion of five years of service, the employee would not be entitled to any portion of the plan account attributable to employer contributions; or

- **Three- to seven-year graded vesting.** Vesting must occur at a rate of at least 20% per year, beginning at the completion of three years of service. The participant is fully vested at the completion of seven years of service. The following table provides an example of a vesting schedule.

For cash balance and pension equity plans. Effective for plan years beginning in 2008 and thereafter, cash balance and pension equity plans must provide that each participant who has completed at least three years of service has a non-forfeitable right to 100% of his or her accrued benefit derived from employer contributions (three-year cliff vesting).

Payment Options from Defined Benefit (DB) Plans

By law, defined benefit plans must make available an annuity option at retirement. An annuity provides monthly or yearly payments for a set number of years or for life. For married employees, the plan must offer a survivor annuity, which continues benefits to the spouse in the event of the retiree’s death. The joint and survivor annuity—an option under which the employee’s benefit is reduced—is the most prominent method of providing a survivor annuity.

**Example:** A joint and survivor annuity option of 75 percent might require a 20-percent reduction in the employee’s benefit at retirement. Thus the employee’s benefit at retirement would be 80 percent of the accrued benefit and the surviving spouse would receive 75 percent of that benefit.

Under a single life only option, the employee will be the sole beneficiary of a monthly pension for the term of his or her life. Payment will end upon the employee’s death. Under the Employee Retirement Income Security Act (ERISA), this option —along with any other option—can only be chosen if the employee and the spouse reject the joint and survivor annuity in writing.

According to the latest data on benefits from the National Compensation Survey (NCS), 2015, virtually all employees covered by a defined benefit plan (98 percent) were given the option of a joint and survivor annuity at retirement. This type of payment option is
provided to approximately three-fourths of the employees with a joint and survivor annuity.

In addition to offering different kinds of annuities at retirement, defined benefit plans may also provide the option of a lump-sum buyout of the defined pension plan benefits. A lump-sum benefit is virtually always a payment option at retirement for cash balance plans. It is less prevalent among traditional defined benefit plans. However, times are changing. Lump-sum payment options were provided to 24 percent of all defined benefit participants in the 2015 NCS private industry benefits survey (see Table 5.1).

Table 5.1
Defined Benefit Plans: Availability of Selected Benefit Features, Private Industry; NCS, 2015

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Lump Sum At Retirement</th>
<th>Joint-and Survivor Annuity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Traditional</td>
<td>Non Traditional</td>
</tr>
<tr>
<td>All workers</td>
<td>24</td>
<td>96</td>
</tr>
<tr>
<td>Full-time</td>
<td>22</td>
<td>95</td>
</tr>
<tr>
<td>Part-time</td>
<td>39</td>
<td>100</td>
</tr>
<tr>
<td>Union</td>
<td>22</td>
<td>97</td>
</tr>
<tr>
<td>Non-Union</td>
<td>25</td>
<td>96</td>
</tr>
<tr>
<td>1 – 99 workers</td>
<td>37</td>
<td>-</td>
</tr>
<tr>
<td>100 or more workers</td>
<td>20</td>
<td>96</td>
</tr>
</tbody>
</table>

The categories are based on the average wage for each occupation surveyed, which may include workers with earnings both above and below the threshold. The average wages are based on the estimates published in the "National Compensation Survey: Occupational Earnings in the United States, 2009." NOTE: Dashes indicate that no data were reported or that data do not meet publication criteria.


With a lump sum buyout plan, the retiree (participant) would receive a check (fully or partially taxable unless rolled into a 401(k) or IRA) that represents the present value of all payment due over the participant’s actuarial life valued as of the time the participant accepts the payment. This present value formula is the inverse of what the participant might know as the projection of future savings value or goal that is based upon how much one invests and what interest rate or growth rate is required to achieve a savings of “x” over a period of “y” years. The formula is: 

\[ PVOA = \frac{PMT \times [(1 – (1/(1 + i) ^ n)) / i]} \]

Example: Paul is currently age 62 and receives a pension from ABC Corporation of $24,000 per year, the following would apply: the Social Security Actuarial Life Table predicts a 62 year old male will live an additional 19 years (until age 81; a female until age 84). It would be projected that you would receive an additional amount of pension equaling $456,000 ($24,000 x 19). However, the Net Present Value (or Lump Sum) Paul would receive based on a 7% interest rate
discount would be approximately $258,000. So, in order for Paul to receive the same amount as the projected pension would have yielded, he would have to accumulate an additional $198,000 ($456,000 - $258,000). This means Paul would have to grow the $258,000 lump sum amount significantly in order to cover the shortfall between the lump sum and his projected pension. These data would be slightly different for a female living to age 84. In addition, if Paul lived longer than the actuarial table predicts, he will have probably out-lived his lump-sum funds at age 81 (or at age 84 for a female). Had Paul opted to continue his pension plan instead, he would still be receiving his $24,000 pension after reaching age 81 (or age 84 for a female). Note: This is a demonstration example only!

**Important Considerations:** For a retiree who is thinking about taking a lump sum distribution, here is a list of important considerations you (the advisor) should review with him or her.

- Taking a lump sum buyout offer would:
  - Eliminate future company pension financial obligations and issuance of pension plan statements as stipulated in ERISA;
  - Eliminate any future chance to receive a 100% voluntary termination annuity payment;
  - Eliminate eligibility for PBGC insured benefits if the plan were to be involuntarily terminated after your acceptance of a lump sum pension buy-out;
  - Transfer all risk for growing the lump sum to satisfy your financial needs from the company to you.

- It is critical to understand which discount (interest) rates and actuarial assumptions (including expected longevity) were made in calculating the retiree’s lump sum offer (the present value). Any overstatement of the discount rate or error in the actuarial assumptions could seriously understate the amount of the retiree’s lump sum offer.

- As people live longer their actuarial life lengthens and the plan sponsor must increase funding (and/or grow the invested value) in the retiree’s current plan to cover the extra months he/she may live. When a retiree takes a lump sum, he/she must find a way to pay themselves for any amount of extended life beyond the actuarial amount inherent in the lump sum calculation at the time he/she accepted it. The plan sponsor is off the hook.

- A lump sum buyout places full accountability for all future income in the retiree’s hands and those of any financial advisors or money managers he/she may contract with. In effect, a buyout acceptance shifts all risks of longevity and investment return to the retiree. Based upon the present value example above, the retiree must be confident that he/she can hold onto and grow enough income from a lump sum payout over his/her lifetime to replace the pension payments he/she would have been eligible to receive if he/she had not accepted the buyout.
• If the retiree has or would elect a survivors option, make sure to check that his/her lump sum offer includes survivor benefits—if not, the retiree may need an alternative plan.

A recent Towers Watson report titled “U.S. Pension Risk Management, What Comes Next?” looks at the future of the pension risk transfer market. Their survey found that over half of plan sponsors are looking to transfer some or all of their DB plan obligations and that 1 in 6 respondents said that their DB plan will be fully terminated by 2018. When viewed over the next decade, 68% of respondents expect to reach their ultimate objective and for those whose ultimate objective is to transfer all obligations to a third party, this number climbs to 76%. The survey also concluded that the size of the plan's obligations can affect sponsor decisions. Approximately 40% of plan sponsors who have DB plan assets over $1 billion have not closed participation to new hires. However, smaller plan sponsors (i.e., companies with assets less than $1 billion) are less likely to keep their DB plan open to new hires, with only 22% doing so.

A DB pension plan may be terminated voluntarily by the plan sponsor only if the plan has sufficient assets to purchase annuities for all plan participants that would pay 100% of their accrued pension benefit for life. The annuity would include a survivorship option if the participant had chosen to accept a discount to purchase one. If any Cost of Living Adjustments (COLA) could have been expected, the participant would not be eligible for COLA consideration as part of their annuity terms.

Group DB pension buy-out sales reached $5.9 billion in the third quarter of 2016, a LIMRA Secure Retirement Institute sales survey found (see Table 15.2). It is the sixth consecutive quarter that activity has exceeded $1 billion in group annuity purchases and is the largest amount of third-quarter activity since 1990. Pension buyout activity in the third quarter jumped 80%, compared (the) prior year. The third quarter of 2015 saw about $3.3 billion in buyout activity.

Table 15.2
Pension Buyouts

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Sales (Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q12</td>
<td>238</td>
</tr>
<tr>
<td>2Q12</td>
<td>627</td>
</tr>
<tr>
<td>3Q12</td>
<td>657</td>
</tr>
<tr>
<td>4Q12</td>
<td>273</td>
</tr>
<tr>
<td>1Q13</td>
<td>573</td>
</tr>
<tr>
<td>2Q13</td>
<td>591</td>
</tr>
<tr>
<td>3Q13</td>
<td>207</td>
</tr>
<tr>
<td>4Q13</td>
<td>437</td>
</tr>
<tr>
<td>1Q14</td>
<td>866</td>
</tr>
<tr>
<td>2Q14</td>
<td>890</td>
</tr>
<tr>
<td>3Q14</td>
<td>3.628</td>
</tr>
<tr>
<td>4Q14</td>
<td>3.285</td>
</tr>
<tr>
<td>1Q15</td>
<td>6.940</td>
</tr>
<tr>
<td>2Q15</td>
<td>6,630</td>
</tr>
<tr>
<td>3Q15</td>
<td>6,938</td>
</tr>
<tr>
<td>4Q15</td>
<td>1,034</td>
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<tr>
<td>1Q16</td>
<td>1,035</td>
</tr>
<tr>
<td>2Q16</td>
<td></td>
</tr>
<tr>
<td>3Q16</td>
<td></td>
</tr>
</tbody>
</table>

As of September 30, 2016, 17,165 buy-out contracts were reported, up 0.7 percent. According to LIMRA Retirement Institute, 255 plan sponsors have converted their defined benefit (DB) pension plans to group annuity contracts. This was an all-time high and 17 percent higher compared with the prior year. By the end of the third quarter, there were $141 billion in assets in the group annuity risk transfer market.

Transactions in the third quarter included WestRock Co’s purchase of a group annuity contract from Prudential Insurance Co. of America. The Norcross, Ga.-based company transferred about $2.5 billion of its U.S. defined benefit plan liabilities. Another large transaction was PPG Industries Inc., Pittsburgh, transferring a total of $1.6 billion in pension liabilities to Massachusetts Mutual Life Insurance Co. and MetLife.

While a DB pension plan adds equity to a company, years of low interest rates and increasing Pension Benefit Guarantee Corporation premiums have encouraged more companies to consider transferring their risk to an insurer by purchasing a group annuity. LIMRA Secure Retirement Institute administers the Group Annuity Risk Transfer Survey every quarter.

IRS Notice 2015-49

The Treasury Department and Internal Revenue Service amended Treasury regulations to stop companies from offering lump sum buyouts to retirees who already receive a monthly pension.

The regulations, as amended, will provide that qualified defined benefit plans generally are not permitted to replace any joint and survivor, single life, or other annuity currently being paid with a lump sum payment or other accelerated form of distribution. The Treasury Department and the IRS intend that these amendments to the regulations will apply as of July 9, 2015. To view the notice go to: http://www.irs.gov/pub/irs-drop/n-15-49.pdf

Factors to Consider When Choosing a DB Payout Option

Probably, the biggest question your client who participates in a defined benefit plan will have: Should I choose the annuity or the lump sum payment? To help your retiree client answer that question, here are some factors that should be taken into consideration before making that life-long irrevocable decision.

Life Expectancy

The simplest analysis compares the monthly annuity payment offered to what you could help your client generate by investing the lump sum at a similar level of risk. Key to this analysis is an assumption about your client’s life expectancy. As a general rule, if your client has good reason to believe he/she will live well beyond their average life expectancy they will likely find the annuity option more attractive, while those who don't
expect to live beyond the average may find more benefit from the lump sum option. There are many other factors to consider, of course, and we'll get to those a little later. For now, let's talk about life expectancy.

Let’s imagine that your client Bill, who is age 65 and thinking about retiring, comes to you seeking advice in deciding which payout option will be best for him and his spouse. Bill’s employer is offering him a single life annuity of $2,000 per month for life or a lump sum payment of $300,000. At first blush you might think the annuity is the clear winner, since $24,000 per year ($2,000 x 12 months) amounts to an annual rate of 8% on $300,000 ($24,000 ÷ $300,000 = 8%), and 8% is hard to get without taking on significant risk.

In order to do an apples-to-apples comparison, however, you need to keep in mind that the annuity takes a total return approach (meaning that it assumes Bill will use both principal and interest during retirement, leaving a zero balance) with built-in assumptions about how long Bill will live.

If we assume that Bill’s life expectancy will be 18 or more years at age 65, then the annuity's internal rate of return is really only 4.16%. In other words, if Bill drew down $24,000 per year in both interest and principal on his $300,000 lump sum, he’d only need to earn an annual return of 4.16% to make it last for 18 years. In fact, the $300,000 would last 12½ years even with a 0% return ($300,000 ÷ $24,000 = 12.5).

Of course, the longer Bill lives beyond his actuarial life expectancy, the better the annuity deal becomes. Bill would also have the convenience of a hassle-free monthly check. Assuming Bill received a check for $2,000 at the beginning of each month and lives 25 years to age 90, his annual compounded rate of return would be 6.61%. And if Bill lives 30 years, to age 95, the annuity's yield to maturity jumps to 7.31%—not a bad rate when compared to current high-quality bond yields of similar maturity.

Planning Tip: Be sure to use a reasonable estimate of what Bill’s lump sum investment might earn. If you develop a conservative portfolio of 20% equities, 50% bonds and 30% cash could grow 3.3% on average annually over the long term. Double that equity allocation to 40%—a riskier portfolio—and our 20-year estimate is still just 4.2% 1% per year, much less than the annuity’s total return in the 30-year example above.

**IRS Notice 2015-49**

On July 9, 2015, the IRS released IRS Notice 2015-49 informing taxpayers that the IRS and the Treasury intend to amend the RMD regulations to eliminate the recent DB plan risk management strategy of offering lump sum payments to replace annuity payments to retirees currently receiving joint and survivor, single life, or other life annuity benefit payments. The regulations will provide that DB plans generally will not be permitted to offer retirees an option to replace any annuity currently being paid with a lump sum payment or other accelerated form of distribution. According to the Notice, the
amendments to the regulations will be effective as of July 9, 2015, with limited exceptions aimed solely to protect those employers who have already taken sufficient action to announce or establish a limited lump sum payment conversion program for existing in-pay status retirees. The proposed amendments were motivated by growing concerns over the prevalence of these lump sum conversion programs (discussed above) that transfer the investment and life longevity risk from the plan to retirees and whether participants were adequately advised and understood the financial tradeoffs when electing to forego the lifetime annuity for the lump-sum payment.

Chapter 5
Review Questions

1. Which of the following is not a characteristic of a traditional DB plan?

( ) A. The participant’s benefit is determined as of his/her normal retirement age (NRA)
( ) B. The employer assumes the risk of investment gains and losses
( ) C. Benefits are guaranteed by the PBGC, with some exceptions
( ) D. The employer makes contributions to each individual participant’s account

2. Under the “percentage test” what is the percent of NHCEs who must be covered by the plan?

( ) A. 70%
( ) B. 80%
( ) C. 60%
( ) D. 35%

3. Which of the following DB formulas provides simply a stated dollar amount to each plan participant?

( ) A. Unit Credit
( ) B. Flat Percentage of Earnings
( ) C. Flat Amount formula
( ) D. Final Average

4. The maximum deductible contribution for a single employer DB plan is what percent of the plan’s current liability, minus the value of plan assets?

( ) A. 60%
( ) B. 150%
( ) C. 70%
( ) D. 100%

5. DB plans funded at less than what percent are prohibited from paying lump-sum distributions?

( ) A. 25%
( ) B. 33%
( ) C. 50%
( ) D. 60%
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CHAPTER 6

HYBRID DB PLANS

Overview

In recent years, many employers have been offering and converting their traditional DB plans to “hybrid” plans that have characteristics of both defined benefit and defined contribution plans. There are a variety of these “hybrid” plans.

In this chapter, we will examine the reasons for the development of hybrid DB plans, their primary characteristics, the various types of hybrid plans, especially the two most common: cash balance plans and equity pension plans, as well as Life Cycle and Retirement Bonus plans and Floor-Offset Pension plans.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- How to define hybrid plans;
- The reasons why hybrid plans were developed;
- Identify the primary characteristics of hybrid plans;
- The types of hybrid plans;
- The features and benefits of cash balance plans;
- The features and benefits of pension equity plans;
- The comparison between cash balance plans and pension equity plans;
- Other types of hybrid plans: Life Cycle and Retirement Bonus plans and Floor-Offset Pension plans; and
- The IRS Final regulations for hybrid plans.

Let’s begin with a definition of hybrid plans.

Definition

The Internal Revenue Code (IRC) uses the term “Applicable Defined Benefit Plan” to describe hybrid plans whereas the regulations use the term Statutory Hybrid Plans for the same purposes [IRC § 411(a)(13(C)]. Essentially, each defines a hybrid plan as:

- The balance of a hypothetical account maintained for the participant (i.e., cash balance plan); or
• As an accumulation percentage of the participant’s final average compensation (i.e., pension equity plan (PEP)).

Why Hybrid Plans?

Hybrid plans were developed to meet the needs of workers who hold a number of jobs throughout their lives. Therefore, employers continue to seek new kinds of retirement income plans that let employees know their lump-sum value of their pension while they are still working. Traditional DB plans may provide lower benefits for those employees who work in multiple jobs throughout their lifetimes.

According to the Bureau of Labor Statistics’ latest data, the average person born in the latter years of the baby boom (1957-1964) held 11.7 jobs from age 18 to age 48. Nearly half of these jobs were held from ages 18 to 24. This data suggest workers may be accumulating retirement benefits from several jobs; employers have attempted to deal with these changing needs by seeking alternative approaches to providing retirement income.

The different career plans of the younger generations have led many employers to conclude that their retirement plans were not beneficial to these younger, more mobile workers. This was not conducive to attracting valuable employees that could help increase efficiency.

Today’s employers (both large and small), when designing retirement benefits, may face different issues than were faced in the past. Consider some of the needs of today’s employers:

• The ability to recruit new employees that are well into their careers;
• The ability to provide predictable retirement benefits;
• The ability to accommodate early retirement; and
• The ability to provide benefits that keep up with inflation.

To meet these needs, new, hybrid forms of pension plans—including Cash Balance Plans and Pension Equity Plans—have been developed.

Primary Characteristics of Hybrid Plans

The primary characteristics of hybrid plans are as follows:

• Accumulated Benefit and “A plus B” Requirement. The participant receives an accumulated benefit, which is the current balance of a hypothetical “account” that grows with annual credits [Treas. Reg. 1.411(a)(13)-1(d)(2)]. Traditional DB plans can be converted into a hybrid plan. For such converted plans, the conversion must meet the “A plus B” method under the Pension Protection Act
(PPA) of 2006. This is conversion protection if the plan began life as a traditional DB plan and was converted to a hybrid plan; and

- Annual Credits-Principal and Interest. The plan will provide for a formula that is used to determine the balance of a hypothetical account, and will have credits for the hypothetical account. There are two types of credits for a hypothetical account as defined in Treas. Reg. § 1.411(b)(5)-1(d)(1)(ii):
  - Interest credits (calculated based on the amount of assets in the participant’s account); and
  - Principal credits (generally a specified dollar amount or calculated as a percentage of the participant’s pay).

Types of Hybrid DB Plans

There are a variety of hybrid pension plans which include:

- Cash Balance plans;
- Pension Equity plans;
- Life Cycle (Retirement Bonus) plan; and
- Floor-Offset pension plans.

Let’s discuss each of these in greater detail, beginning with the most popular hybrid plan, Cash Balance Plans.

Cash Balance Pension Plans

Cash Balance Plans incorporate features of both DB and DC plans but are technically a DB plan. The concept of a cash balance pension plan first became widely known when Bank of America adopted a cash balance plan in the mid-1980s as an alternative to the more traditional retirement vehicles. The bank believed that the best vehicle to satisfy its needs would be a less traditional plan that combined the best features of both a DB plan and a DC plan.

Note: Bank of America Corp, SunTrust Banks Inc. and Wells Fargo all have begun to phase-out their Cash Balance Plans.

Benefits

A cash balance plan promises an employee an employer contribution equal to a percent of each year’s earnings and a rate of return on that contribution. The benefit is always expressed as a total account balance. This is in contrast to a traditional DB plan, which typically promises an employee an amount based on the formulas described in Chapter 5. Periodically, the employer contribution (such as 1 percent of earnings) and the interest rate (a fixed percent or based on some index) are credited to each employee; employees have the ability to see the value of their account at any time. The individual plan value is essentially the present value of the future benefits; at retirement, the account value could
be paid in a lump sum or turned into a lifetime annuity. The focus on these plans is on wealth building and “portability.” On the other hand, traditional DB plans are designed to encourage career employment with one employer. Instead of focusing on wealth, they focus on providing retirement security; the design of these plans does not reward employees who choose to change jobs.

Transitional Benefits

Generally, cash balance plans that are converted from traditional final pay DB plans provide special transitional benefits for employees nearing retirement. These grandfather provisions are necessary, since the accrual pattern under a cash balance plan (a career average defined benefit plan) is such that benefits accrue at a faster rate early in the career and at a lower rate later in the career, when compared with a final average DB plan. Without the grandfather provision, older and/or longer service employees could lose benefits due to the conversion. In addition, most cash balance plans do not have subsidized early retirement benefits, whereas traditional DB plans often have this feature, so grandfathering employees who are nearing retirement may be necessary or these benefits would be lost.

Investment of Assets

In a cash balance plan, the sponsor determines how the plan assets will be invested and bears all of the risk and reward. Investment gains and losses will eventually affect the amount the sponsor contributes. If the rate of return on plan assets is higher than expected, the employer may be able credit each participant’s account with the interest rate specified in the plan and then hopes to achieve a rate of return higher than or equal to that credited to the accounts. Although the sponsor may not achieve the set interest rate in any one year, the goal over time is to get a return on investment that is greater than or equal to the set rate. As with other DB plans the sponsor seeks the highest long-term return consistent with appropriate levels of risk.

IRC § 415 Limits

Cash balance plan benefits are limited by IRC § 415 in the same manner as any other DB plan. These limits are applied to the annuity equivalent of the cash balance account, not—as in a DC plan—to the annual addition to the account.

Minimum Standards

Cash balance plans are subject to the same Employee Retirement Income Security Act of 1974 (ERISA) requirements as other DB plans, including minimum standards for eligibility, vesting, and funding. The following discussion addresses areas specific to cash balance plans:

- *Vesting:* Prior to the enactment of Section 701 of the Pension Protection Act (PPA) of 2006, a cash balance plan was required to meet ERISA’s minimum
vesting requirements of full vesting after five years (cliff) or graded vesting over years three through seven. However, effective on or after June 29, 2005 new cash balance plans must follow Section 701 of the PPA which requires that statutory hybrid plans (including cash balance plans) must provide an employee who has completed at least 3 years of service with a non-forfeitable right to 100 percent of the employee’s accrued benefit derived from employer contributions. For plans in existence on June 29, 2005, the change to the 3-year cliff vesting schedule was effective for plan years beginning on or after January 1, 2008; and

- **Funding:** Minimum funding requirements apply to cash balance plans in the same manner as for other DB plans (i.e., the normal cost plus amounts required to amortize any unfunded accrued liability over a period of years, subject to the full funding limit).

### Distributions

Cash balance plans generally provide participants the option of receiving their vested account balances in the form of a lump-sum distribution or as an annuity at the time of retirement or employment termination. If the distribution is a lump sum, it is usually equal to the participant’s vested account balance. If the distribution is in the form of an annuity, the amount of the annuity is actuarially equivalent to the account balance. The lump-sum option is another characteristic of cash balance plans that is different from traditional defined benefit plans and similar to defined contribution plans.

Lump-sum distributions are popular with participants (especially in the case of employment termination) since they can be rolled over into an individual retirement account (IRA) or into a new employer’s retirement plan, enabling the benefit to continue to grow with investment earnings. Since lump-sum distributions do not guarantee that retirees will have continuing retirement benefits, some sponsors encourage the selection of an annuity by specifying a favorable actuarial basis to convert accounts into annuities. Terminating employees may also elect to leave their balances in the plan, accruing interest credits, until retirement.

The usual joint and survivor and pre-retirement survivor requirements apply to cash balance plans. Thus, in general, benefits for a participant with an eligible spouse must be paid in the form of a qualified joint and survivor annuity unless the participant and spouse elect otherwise. The preretirement survivor annuity requirements apply to cash balance plans in the same manner as to other DB plans. However, almost all cash balance plans go beyond the minimum requirements and pay the full account balance in the event of the employee’s death.

### Loans

Loans to participants are permitted under cash balance plans, but as a practical matter may be complicated to administer—just as with other DB plans.
Under a DC, when a distribution is made, the loan can be automatically paid off, but under a DB plan, if the participant elects a monthly annuity, there is no way to assure repayment of the loan.

**Plan Termination Insurance**

Like any DB plan, a cash balance plan is subject to plan termination insurance and must pay annual premiums to the Pension Benefit Guaranty Corporation (PBGC). Also, as with other DB plans, a cash balance plan may be terminated only if plan assets are insufficient to cover all benefit liabilities (i.e., all accrued benefits), unless the employer is in distress.

On standard termination of a cash balance plan, all participant accounts vest to the extent funded, and plan assets are allocated among plan participants. If the plan has residual assets, these may be used to provide additional benefits or may revert to the employer, whichever the plan provides.

If plan assets are less than the sum of account balances (either because plan assets declined in value or because the employer contributed less than the sum of the additions to individual accounts), the plan can terminate only in a distress situation. Several areas remain unclear, including how, under a distress termination, the PBGC would determine guaranteed benefits, allocate plan assets, and value benefit liabilities (discussed in Chapter 3).

**Cash Balance Plans vs. DC Plans**

A cash balance plan is similar in many ways to a DC plan, particularly a money purchase plan or a profit sharing plan, under which the employer contributes at a fixed rate. An employer’s cost under a cash balance plan is typically lower than the cost under a DC money purchase plan with the same level of additions to participant accounts because the actuary may anticipate both forfeitures and investment earnings in excess of the rates to be credited to account balances. To the extent experience differs from the actuarial assumptions, future contributions to a cash balance plan will be adjusted, which may lead to more cost volatility. The employer’s pension expense must be determined in accordance with the Financial Accounting Standards Board’s (FASB) accounting rules for all DB plans.

If a DC plan is qualified as a profit-sharing plan, elective salary deferrals are permissible under IRC § 401(k), but this is not permitted under a cash balance plan.

A DC plan is not subject to PBGC premiums and plan termination insurance provisions. Because all benefits are always fully funded under a DC plan, plan termination insurance is not needed. Under a cash balance plan, as in a DB plan, it is possible for participants to lose part of their accrued benefits on plan termination in spite of the plan termination insurance.
A cash balance plan will generally be less difficult and expensive to administer than a DC plan. Account recordkeeping is much simpler under a cash balance plan because there is no need to reconcile account balances with trust assets, and there are typically no employee contributions, loans, withdrawals, or fund transfers. However, an actuarial valuation is required. DC plans and cash balance plans are attractive to younger, shorter service employees, who generally find the accounts concept attractive and who may have little interest in retirement or in a traditional defined benefit plan.

Annuities can be paid directly from the trust of a cash balance plan and are generally larger than the policies employees could obtain from an insurance company themselves using their account balances. Under a DC plan, an employee wishing an annuity must have his or her balance transferred to an insurance company.

**Cash Balance Plan vs. Traditional DB Plans**

Under a traditional DB plan, two employees with equal pay but differing ages will earn the same amount of retirement income for each year of service. Because the money invested for a younger employee can grow with interest for many more years than that invested for an employee close to retirement, the cost of funding the pension earned for a younger employee is less than that for an older employee. For employees who terminate employment at younger ages, both the accrued benefits and the costs are low. The lower benefits are likely one of the reasons younger employees place a low value on traditional DB plans.

Traditional pension plan benefit formulas are oriented to the total retirement benefit, taking retirement age and length of service into account. In contrast, cash balance plans emphasize annual accumulations and may, therefore, not be as flexible as traditional plans in providing specified levels of retirement income.

A cash balance plan may be more difficult and costly to administer than a traditional DB plan. Records of plan accounts must be kept. In practice, the cost may be more or less than a traditional DB plan, depending on the number of employees, plan design, and data processing facilities.

**Note:** Cash balance plans are growing in popularity in the small business marketplace especially for small business owners with fewer than 20 employees and with excess profits. One aspect that makes a cash balance plan attractive to a small business owner, especially one who is older and perhaps behind on his/her retirement savings contribution, is the high levels that increase as he/she gets older.

**Example:** For a 65 year old in 2017, his maximum contribution could be as high as $225,000. In addition, he can still contribute an additional $24,000 ($18,000 plus $6,000) to a 401(k) plan if desired. This compares to a maximum contribution of $59,000 to a 401(k) plan with a profit sharing component.
For a business owner who is behind on his savings for retirement, who wants a maximum tax deduction and who has the available cash flow, a cash balance plan can be an excellent solution.

**Pension Equity Plans**

Pension Equity Plans (PEP) first became widely known when RJR Nabisco implemented one in 1993. The primary forces driving RJR’s review of its pension plans were employee hiring and retention; RJR’s work force had become increasingly mobile, and the company wanted to be able to attract mid-career hires.

The PEP, like a cash balance plan (discussed above) was designed to meet the diverse needs of a changing work force by combining portability with the security of a traditional defined benefit pension plan. Both kinds of plans define benefits in terms of a current lump-sum value rather than a deferred-annuity, but the PEP is a final average lump-sum plan, whereas a cash balance plan is a career average lump-sum plan.

**PEP Plan Design**

The PEP is a DB plan that provides an annuity or lump-sum benefit at the termination of a participant’s employment. PEPs define benefits in terms of a current lump-sum value. Annual credits can be based on age, service, or a combination of both. The plan determines the total benefits by providing a "schedule of percent’s" that are accumulated throughout the work life of the employee. When an employee leaves the employer, either at retirement or at any time once vested, the accumulated percentage is applied to final earnings (defined by the plan) to determine a lump-sum benefit.

Table 6.1 displays an example of how the PEP might accumulate percent of earnings strictly on the basis of age.

<table>
<thead>
<tr>
<th>Age</th>
<th>Percent of Earnings Accumulated</th>
</tr>
</thead>
<tbody>
<tr>
<td>29 and younger</td>
<td>2.5</td>
</tr>
<tr>
<td>30 to 34</td>
<td>3.0</td>
</tr>
<tr>
<td>35 to 39</td>
<td>4.0</td>
</tr>
<tr>
<td>40 to 44</td>
<td>5.0</td>
</tr>
<tr>
<td>45 to 49</td>
<td>6.5</td>
</tr>
<tr>
<td>50 to 54</td>
<td>8.5</td>
</tr>
<tr>
<td>55 to 59</td>
<td>10.5</td>
</tr>
<tr>
<td>60 or Over</td>
<td>13.5</td>
</tr>
</tbody>
</table>

Employees receive a percent of earnings credits for each year of service, which are accumulated throughout the employee’s career with the employer. The total percent
Final average earnings generally are defined as an annual average of the highest earnings over a specific number of years – for example the average of the highest 3 years of earnings.

Let’s review two different workers and how they would accumulate benefits under the PEP. Each employee leaves the company with the same final average earnings (as defined by the plan), but the amount of their actual lump-sum benefit – and consequently their annuity value – differs considerably because of differences in their ages and lengths of service. Because the benefit credits accumulate more quickly for older workers, employee 1 with 20 years of service at age 40 has a smaller lump-sum benefit ($29,000) than does employee 2, who has only 19 years of service at age 62 ($65,800).

**Example:** This example assumes that an individual was hired on his/her 25th birthday. He/she terminated employment on his/her 45th birthday with a final average pay of $40,000. His/her lump-sum benefit would be calculated as follows: the accumulated percentage is 72.5% (see chart below). Multiplying this by $40,000 yields a $29,000 lump-sum.

<table>
<thead>
<tr>
<th>Age</th>
<th>Percentage Earned Each Year</th>
<th>Number of Years</th>
<th>Total %</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-29</td>
<td>2.5%</td>
<td>5</td>
<td>1.5%</td>
</tr>
<tr>
<td>30-34</td>
<td>3.0%</td>
<td>5</td>
<td>15.0%</td>
</tr>
<tr>
<td>35-39</td>
<td>4.0%</td>
<td>5</td>
<td>20.0%</td>
</tr>
<tr>
<td>40-44</td>
<td>5.0%</td>
<td>5</td>
<td>25.0%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>72.5%</td>
</tr>
</tbody>
</table>

**Example:** In our second example, we have an individual who began working at age 43 and retired on his/her 62nd birthday with a final average pay of $40,000. The calculations for this individual are as follows: the accumulated percentage is 164.5 percent (see chart below). Multiplying this by $40,000 yields a $65,800 lump-sum.

<table>
<thead>
<tr>
<th>Age</th>
<th>Percentage Earned Each Year</th>
<th>Number of Years</th>
<th>Total %</th>
</tr>
</thead>
<tbody>
<tr>
<td>43-44</td>
<td>5.0%</td>
<td>2</td>
<td>10.0%</td>
</tr>
<tr>
<td>45-49</td>
<td>6.5%</td>
<td>5</td>
<td>32.5%</td>
</tr>
<tr>
<td>50-54</td>
<td>8.5%</td>
<td>5</td>
<td>42.5%</td>
</tr>
<tr>
<td>55-59</td>
<td>10.5%</td>
<td>5</td>
<td>52.5%</td>
</tr>
<tr>
<td>60-61</td>
<td>13.5%</td>
<td>2</td>
<td>27.0%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>164.5%</td>
</tr>
</tbody>
</table>

PEPs can vary their accrual rate based on both age and service, and they can provide different accruals for those earning more than the Social Security taxable wage base. For example, an employer can provide a standard age-based accrual and add to that a smaller
accrual based on service. Employees with 10 to 20 years of service might receive an additional service accrual of 2 percent per year, while those with more than 20 years of service might receive an additional 3 percent per year.

As was discussed earlier, DB plans are also allowed to "integrate" benefits with Social Security; such a provision takes into account the employer funding of Social Security benefits up to an annual threshold (the Social Security taxable wage base). A PEP might vary its accruals for those earning less than or more than the wage base.

**Example:** A plan that accrued 3 percent of earnings per year for those aged 31 to 40 might increase that accrual to 5 percent per year for those earnings that exceed the wage base.

**PEP Advantages**

The ability of employees to know the current value of their plans at any time is one of the advantages of PEPs. Another perceived advantage is that there is no reduction in benefits due to early retirement. This means that if a worker terminates his or her employment before normal retirement age (NRA), but has fulfilled the vesting requirements, the benefit will reflect the length of time worked. In contrast, a traditional DB plan specifies periodic pension distributions as the amount available at NRA. Employees receiving benefits before that age typically receive lower benefits to account for receiving benefits over a longer expected lifetime. While this early retirement "reduction" is considered a penalty by some, it is in fact, merely an adjustment based on life expectancy. (Some employers subsidize that adjustment by making the reduction less than a true actuarial reduction.) No such adjustment occurs in the PEP. Because benefit accruals typically rise with age, however, the PEP formula already has adjustment for age built into the accrual formula.

While PEPs and cash balance plans share methods of accumulating value, a major difference is the earnings used to determine the benefit. Cash balance plans specify a credit each year, based on that year’s earnings. By contrast, in the PEP, the credits are applied to final earnings. This feature provides built-in inflation protection. Regardless of whether an employee has just a few years of service required for vesting or has worked under the plan an entire career, benefits are based on earnings at the end of the employee’s career (see Table 6.2).

Through its annual benefits survey, The Bureau of Labor Statistics (BLS) has tracked the change in retirement plans over time, from traditional defined benefit to defined contribution to hybrid plans. BLS will continue to monitor and report on the changes in PEPs.
### Table 6.2
Comparison of features of Pension Equity Plans and Cash Balance Plans

<table>
<thead>
<tr>
<th>Feature</th>
<th>Pension Equity Plan (PEP)</th>
<th>Cash Balance Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit formula</td>
<td>Percent of earnings, may vary by age, service, or earnings</td>
<td>Percent of earnings, may vary by age, service, or earnings</td>
</tr>
<tr>
<td>How benefits are accumulated</td>
<td>Percent of earnings, as determined by the benefit formula, are accumulated each year, but the final benefit is not determined until employee leaves the plan</td>
<td>Dollar amount (benefit formula times earnings) placed in hypothetical account each year; interest on account balance also credited each year</td>
</tr>
<tr>
<td>Definition of earnings</td>
<td>Total accumulated benefit applied to final earnings, as defined by the plan; final earnings typically those in last 3-5 years before retirement</td>
<td>Percent applied to each year’s earnings</td>
</tr>
<tr>
<td>How to determine value of benefits for current employees</td>
<td>Employees can multiply their accumulated percent of earnings times their final earnings as defined by the plan to determine their current benefit</td>
<td>Account balance is the current benefit</td>
</tr>
<tr>
<td>Distribution</td>
<td>Specified as a lump sum, but can be converted to an annuity</td>
<td>Specified as a lump sum, but can be converted to an annuity</td>
</tr>
</tbody>
</table>

### Life Cycle Pension Plans and Retirement Bonus Plans

The concept of a Life Cycle or Retirement Bonus plan is very similar to that of a PEP plan. A Life Cycle/Retirement Bonus plan is a final average salary pension plan in which benefits are determined according to salary near retirement and years of service. A participant earns credits for each year of service. The total of the credits is considered a percentage, which is multiplied by the participant’s final average salary to determine what lump sum will be paid at retirement or termination. These plans can be changed to meet the needs of a specific employer by reducing benefits on payment before retirement eligibility, providing higher credits for older employees, integrating with Social Security covered compensation, or coordinating with other retirement benefits. Any accrued benefit earned under a DB plan prior to the effective date of the Life Cycle/Retirement Bonus plan can be preserved as transition credits that may be added to the regular credits in calculating the lump-sum benefit. Like a PEP, the benefit under a Life Cycle/Retirement Bonus plan is based on final average pay (rather than career average pay), enabling it to provide protection against inflation and to recognize the accelerated earnings of fast-track employees. The necessity of recordkeeping to account for individual account balances is eliminated.
Floor-Offset Pension Plans

A Floor-Offset Plan (also known as a “Feeder” plan) differs from most other hybrid arrangements in that it actually consists of two separate (but associated) plans— a DB “floor” plan and a DC “base” plan— rather than a single plan design with both DB and DC plan characteristics. The DB plan uses a standard formula (which may take into account age, service, and/or compensation) to establish a minimum benefit level that is dependent on the employer’s objectives and constraints. If the DC plan provides a benefit that equals or exceeds the minimum established by the DB floor plan, the participant receives the balance in the DC account and no benefit is payable from the DB floor plan. However, if the DC plan provides less than the minimum benefit (perhaps as a result of investment performance or inflation), the DB floor plan makes up the difference between what the DC plan is able to provide and the minimum benefit. In other words, the benefit provided by the DB plan is reduced by the value of the participant’s account in the DC plan. Just about any DC plan can function as the base plan, although the DC portion of a floor-offset plan is often a standard profit-sharing plan. The DB benefit formula is unrestricted. The investment risk in a DB floor-offset plan is usually borne by the employer; i.e., the employer is typically responsible for the investment of assets in both the DB and DC plans.

Such plans typically provided a floor benefit for a career employee of between 40 percent and 60 percent of pre-retirement compensation.

IRS Final Regulations on Hybrid Plans

In October 2010, the IRS issued final regulations regarding Hybrid DB pension plans, such as Cash Balance Plans and PEPs. Generally, the final regulations address the statutory requirements of the Pension Protection Act of 2006 (“PPA 2006”) and the Worker, Retiree, and Employer Recovery Act of 2008, including special vesting rules, age discrimination safe harbor, interest rate requirements as well as requirements applicable to amendments converting a traditional DB formula to a statutory hybrid formula. The final regulations generally apply to plan years beginning on or after January 1, 2011. At the same time, the Treasury and IRS proposed additional regulations that address forms of benefit payments other than lump sums, provide an alternative method for satisfying the plan conversion rules, broaden the list of permitted interest crediting rates and provide relief under benefit accrual rules.

The final regulations generally follow regulations previously proposed and transition guidance issued in 2007. Below is a summary of some of the more important aspects of the final regulations as well as the proposed regulations.

Relief Under IRC § 411(a)(13)(A)

The distinctive feature of a Cash Balance or PEP is that the accrued benefit is expressed as the value of an account or, in the case of a PEP, the value of an accumulated percentage of the participant’s final average compensation. However, prior to PPA 2006,
it was questionable whether such a plan could pay the hypothetical account balance or accumulated percentage and continue to satisfy the vesting and cash-out rules under the IRC.

As a result of PPA 2006, such plans will not be treated as failing to satisfy certain IRC requirements generally applicable to DB plans simply because plan terms provide that the present value of the accrued benefit is equal to the then current balance of a hypothetical account or the then current value of an accumulated percentage of the participant’s final average compensation. This relief is referred to as the IRC § 411(a)(13)(A) relief.

Under the final regulations, IRC § 411(a)(13)(A) relief only applies to a benefit provided under a lump sum based formula. A “lump sum based formula” is a benefit formula expressed as the current balance of a hypothetical account or as the current value of the accumulated percentage of the participant’s final average compensation. The determination as to whether a formula is a lump sum based formula is based on how the benefit is stated under the terms of the plan, not on whether the plan provides for a lump sum payment option. A lump sum based formula also includes a DB plan formula “that has an effect similar to a lump sum based formula.”

The proposed regulations impose additional requirements for IRC § 411(a)(13)(A) relief, including a requirement that at all times on or before NRA, the hypothetical account balance or the accumulated percentage of the participant’s final average compensation must not be less than the present value of the accrued benefit (or portion thereof) determined under the lump sum based formula.

IRC § 411(a)(13)(A) relief is not available for benefits provided under a formula that is not a lump sum based formula, so benefits provided under non-lump sum based formulas must comply with the vesting, distribution and allocation rules generally applicable to defined benefit plans.

The final regulations only address lump sum based formula benefits paid in the form of a lump sum. However, the proposed regulations would extend IRC § 411(a)(13)(A) relief to other optional payment forms if those other forms are actuarially equivalent to the hypothetical account balance, or the accumulated percentage.

**Special Vesting Rules**

If any portion of a participant’s accrued benefit is determined under a lump sum based formula, the plan must provide for 100% vesting of the benefit derived from employer contributions after the participant completes at least 3 years of service. This vesting requirement applies on a participant-by-participant basis and to the participant’s entire accrued benefit (not just the portion derived from the lump sum based formula). In the case of a plan in existence on June 29, 2005, the 3-year vesting rule only applies to participants with an hour of service on or after January 1, 2008.
Safe Harbor for Age Discrimination

IRC § 411(b)(1)(H)(i) prohibits any reduction in the rate of benefit accrual under a DB plan because of the attainment of any age. The final regulations describe certain safe harbor plan designs that are deemed to satisfy these age discrimination rules. A plan that does not satisfy the safe harbor is required to satisfy the general age discrimination rule of IRC § 411(b)(1)(H)(i).

Under a safe harbor design, a participant’s benefit accrued to date cannot be less than the benefit accrued to date of any similarly situated, younger person who is or could be a participant. A person is similarly situated to another individual if the individual is identical to that other individual in every respect that is relevant in determining a participant’s benefit under the plan—including, but not limited to period of service, compensation, date of hire, work history and any other respect— but excluding age.

Conversion Protection

Amendments converting a traditional DB plan formula to a lump sum based formula also must satisfy the age discrimination rules. The final regulations provide guidance on what constitutes a conversion amendment. For conversion amendments adopted after June 29, 2005, the amendment will satisfy the age discrimination rules if the participant’s benefit after the conversion can be no less than the sum of the participant’s accrued benefit as of the conversion date (including any early retirement subsidy with future growth) and the participant’s accrued benefit earned after the conversion. In other words, “wear away” of the prior accrued benefit is not permitted. A plan is permitted to convert the prior accrued benefit into an account balance or an accumulated percentage; however, the plan must top up the opening account balance or accumulated percentage at benefit commencement if it is not at least equal to the present value of the prior accrued benefit at benefit commencement. Additional alternatives are addressed in the proposed regulations; including an alternative for Cash Balance plans (but not PEP) that do not require a subsequent comparison between the opening account balance and the present value of the prior accrued benefit.

Market Rate of Interest

Another aspect of the age discrimination requirements is that the interest credit rate under the lump sum based formula must not be greater than a “market rate of return.” The final regulations provide several indices that are deemed not to be in excess of market rate: the interest rate on long-term corporate bonds (including 1st, 2nd and 3rd segment rates under IRC § 417(e)), certain other Treasury indices (and associated margins), actual plan rates of returns and annuity contract rates. The proposed regulations also permit use of a fixed rate of return (including certain minimum rates of return) and the rate of return on certain regulated investment companies.

A plan with a lump sum based formula must specify how the plan determines interest credits and how and when (at least annually) interest is credited. The proposed
regulations provide that interest credits are not required to be allocated on amounts distributed prior to the end of the interest crediting period.

The final regulations require a plan with a lump sum based formula to include a “preservation of capital” requirement, providing that interest credits will not result in a reduction of the account balance or accumulated percentage below the aggregate amount of the hypothetical allocations. The proposed rules provide guidance on the special interest credit rules that apply upon plan termination.

Both the final and proposed rules contain special relief that would permit a plan to change the rate of crediting interest without violating the anti-cutback rules of IRC § 411(d)(6).

The effective date of the final rules on market rate of return, the time for crediting interest and the extent to which a plan may use a “greater of” two or more interest rates is delayed to plan years beginning on or after January 1, 2012. For plan years beginning prior to January 1, 2012, employers may rely on the final or proposed regulations.

**Special 133⅓ Percent Test Rule**

As was discussed in the previous chapter, a DB plan cannot “back-load” the accrual of benefits, which means the plan cannot give employees disproportionately larger benefits during their last few years of service and DB plan formulas must satisfy one of three accrual rules, including the 133⅓ percent rule. The proposed regulations provide special rules that will make it easier for plans with lump sum based formulas to satisfy the 133⅓ percent accrual rule.

**Effective Date and Plan Amendments**

As noted above, the final rules (other than certain rules regarding market interest rates) are generally effective for plan years beginning on or after January 1, 2011. In 2009 guidance, the IRS and Treasury extended the deadline for Cash Balance and PEP plans to adopt plan amendments to incorporate changes required under IRC § 411(a)(13) (other than IRC § 411(a)(13)(A)) and IRC § 411(b)(5) to the last day of the 2010 plan year.

However, the preamble to the proposed regulations suggests that amendment deadline may be extended further. Specifically, the preamble provides that it is expected that when the proposed regulations are finalized, they will contain relief from the requirements of IRC § 411(d)(6) for amendments adopted before the date the final regulations apply to the plan and the cutback is limited to the extent necessary to enable the plan to meet the requirements of IRC § 411(b)(5).
1. According to the Bureau of Labor Statistics, the average worker age 46 to 54 has had how many jobs in his or her lifetime?

( ) A. 3.5  
( ) B. 5.8  
( ) C. 11.7  
( ) D. 13.5

2. Which of the following statements about a cash balance plan is TRUE?

( ) A. The benefit is always expressed as a total account balance.  
( ) B. Loans to participants are permitted under cash balance plans  
( ) C. A cash balance plan may be more difficult and costly to administer than a traditional defined benefit plan  
( ) D. All of the above

3. Hybrid DB plans must provide a ________year 100% vesting schedule.

( ) A. Two  
( ) B. Three  
( ) C. Five  
( ) D. Six

4. True or False: A PEP is a final average lump-sum plan, whereas a cash balance plan is a career average lump-sum plan.

( ) A. True  
( ) B. False

5. Which type of hybrid plan is also known as a “feeder” plan and consists of two separate (associated) plans—a DB and a DC plan?

( ) A. Pension Equity Plan  
( ) B. Floor-Offset Pension Plan  
( ) C. Cash Balance Plan  
( ) D. Life Cycle Pension Plans
CHAPTER 7

DB/k PLANS

Overview

In the Pension Protection Act of 2006, Congress passed a law to allow a new plan called a DB/k to be established to encourage savings for retirement. The plan is to have features of the popular 401(k) along with the benefits of a DB plan.

The DB/k enables businesses with fewer than 500 employees to sponsor pension and 401(k) plans with less paperwork, more predictable costs, and lower premiums. DB/k is considered good for small businesses because it enables them to offer the guaranteed income of a pension and the opportunity for workers to save in a 401(k).

In this chapter, we will examine the tax law that enacted IRC § 414(x), its minimum benefits, vesting and eligibility requirements.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The background of IRC Section 414(x) and DB/k plans;
- How to define an eligible combined plan and eligible small employer;
- The eligibility requirements for DB/k combined plans;
- The minimum benefits and vesting for defined benefit plans;
- The minimum contributions and vesting benefits and vesting for defined contribution plans; and
- The considerations for adopting a DB/k plan.

Background

As was discussed above, one of the many potential changes brought by the Pension Protection Act (PPA) of 2006 was Section 903, which provided special rules for eligible combined plans under the new IRC § 414(x) and as amended by Section 10 (c) of the Worker, Retiree and Employer Recovery Act of 2008 (WRERA).

Beginning in 2010, plan sponsors with 500 or fewer participants were permitted to combine DB and DC plans into one plan with the assets held in a single trust.
Companies would be required to establish a pension fund sufficient to pay a worker at retirement up to 20% of that individual’s average annual salary received during the last few years of work. The company would automatically put 4% of the employee’s salary into a 401(k) plan. The business must then match at least 50% of that amount.

The plans are exempt from “top heavy” rules, which traditional retirement plans must meet and which are designed to ensure that plans don’t favor highly paid workers. Another attraction is much less paperwork than would be required by operating a pension and a 401(k) plan separately. Employers with a DB/k would file only one plan document and one Form 5500—the annual information return—for the two plans.

**Eligible Combined Plan**

Under IRC § 414(x)(2)(A) of the Code, an “eligible combined plan” is a plan:

- That is maintained by an employer that is a small employer (defined below) at the time the plan is established;
- That consists of a DB plan and an applicable DC plan;
- The assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the DB plan and the applicable DC plan to the extent necessary for the separate application of the Code; and
- That meets the benefit, contribution, vesting, and nondiscrimination requirements under IRC § 414(x).

**Eligible Small Employers**

Under IRC § 414(x)(2)(A) an eligible “small employer” is generally an employer (taking into account the rules of IRC § 414(b), (c), (m), and (o)) that employed an average of at least 2 but not more than 500 employees on each business day during the preceding calendar year and who employs at least 2 employees on the first day of the plan year.

In the case of an employer that was not in existence throughout the preceding calendar year, the determination of whether the employer is a small employer is based on the average number of employees it is reasonably expected the employer will employ on business days in the current calendar year.

IRC § 414(x) (7) defines an “applicable defined contribution plan” as a DC plan that includes a qualified cash or deferred arrangement.

**Eligibility Requirements for Combined Plans**

IRC § 414(x)(1) provides that, the requirements of the Code are applied to a DB plan or applicable DC plan that is part of an eligible combined plan in the same manner as if each such plan were not a part of the eligible combined plan. Further, in the case of the termination of both the DB plan and the applicable DC plan forming an eligible
combined plan, the DB plan and the applicable EC plan must be terminated separately by the plan administrator. Under IRC § 414(x)(6)(A), the rules of IRC § 414(k), which determine the requirements applicable to DB pension plans with separate participant accounts, do not apply to eligible combined plans.

**Minimum Benefits and Vesting under DB Plan**

Under IRC § 414(x)(2)(B), the DB plan that forms part of the eligible combined plan must provide each participant with a minimum employer-provided accrued benefit. The minimum benefit must be an annual retirement benefit that is not less than the applicable percentage of the participant’s final average pay. For this purpose, the applicable percentage is the lesser of:

- 1 percent multiplied by the participant’s years of service with the employer; or
- 20 percent.

Final average pay is determined using the period of consecutive years (not exceeding five) during which the participant had the greatest aggregate compensation from the employer.

As an alternative to the minimum benefits mentioned above, the DB component of the DB/k plan may be a cash balance plan, under which the accrued benefit is calculated as the balance of a hypothetical account or an accumulated percentage of the participant’s average compensation, and which meets the applicable interest credit requirements of IRC § 411(b)(5)(B)(i) (as added by the PPA of 2006). The plan would be treated as meeting the benefit requirements if each participant received a pay credit for the year which is not less than a specified percentage of compensation, based on the participant’s age (see Table 7.1). For participants who are age 30 or less at the beginning of the year, the percentage is 2. The applicable percentage increases to 4 for participants older than 30, but younger than 40; 6 for participants older than 40, but younger than 50; and 8 for participants who are age 50 or older.

<table>
<thead>
<tr>
<th>Participant’s Age as of Beginning of Plan Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 or less</td>
<td>2</td>
</tr>
<tr>
<td>Over 30 but less than 40</td>
<td>4</td>
</tr>
<tr>
<td>40 or over but less than 50</td>
<td>6</td>
</tr>
<tr>
<td>50 or over</td>
<td>8</td>
</tr>
</tbody>
</table>

Table 7.1
Minimum Benefit Rules

For purposes of the minimum benefit rules, years of service are determined under the rules of IRC § 411(a)(4), (5), and (6), except that the plan may not disregard any year of service merely because a participant makes, or fails to make, any elective contributions.
under the qualified cash or deferred arrangement that is included in the applicable DC plan that forms part of the eligible combined plan.

Under IRC § 414(x)(2)(D)(i), a participant must be fully vested in his or her employer-provided accrued benefit under the DB plan after completion of three (3) years of service.

**Minimum Contributions and Vesting under DC plan**

Under IRC § 414(x)(2)(C), the applicable DC plan (401(k) plan) that forms part of the eligible combined plan must meet certain contribution requirements. In particular, the qualified cash or deferred arrangement included in such plan must constitute an automatic contribution arrangement, pursuant to which each eligible employee is treated as having elected to make an elective contribution of 4 percent of compensation. However, an eligible employee may elect not to make such contributions or elect contributions at a different enrollment rate.

In addition, the employer must be required to make matching contributions on behalf of each employee eligible to participate in the qualified cash or deferred arrangement. To satisfy the basic matching contribution requirement in IRC § 414(x)(2)(C)(i)(II), matching contributions must be made in an amount equal to 50 percent of the elective contributions of the employee to the extent such elective contributions do not exceed 4 percent of compensation. Alternatively, the plan may provide for a different rate of matching contribution, provided that the rate of matching contribution does not increase as the participant’s rate of elective contribution increases, and the aggregate amount of matching contributions at each rate of elective contribution is no less than the aggregate amount of matching contributions that would be provided under the basic matching contribution requirement. In no case may the rate of matching contribution for any elective contribution of a highly compensated employee at any rate of elective contribution be higher than the rate of matching contribution for a NHCE.

The applicable DC plan can also provide for non-elective employer contributions, but non-elective contributions are not taken into account in determining whether the matching contribution requirements are met.

Under IRC § 414(x)(2)(D)(ii)(I), all participants must be fully vested in any matching contributions provided under the applicable DC plan, including any matching contributions exceeding required matching contributions. In addition, under IRC § 414(x)(2)(D)(ii)(II), a participant must be fully vested in any non-elective contributions under the applicable DC plan after completion of three (3) years of service.

Under IRC § 414(x)(2)(E), all contributions and benefits under the DB plan and applicable DC plan forming part of the eligible combined plan, and all rights and features under each such plan, must be provided uniformly to all participants.

Under IRC § 414(x)(2)(F), the minimum benefit and contribution requirements applicable to the DB plan and applicable DC plan must be met without application of the
permitted disparity rules under IRC § 401(l). In addition, the DB plan and applicable DC plan must meet the nondiscrimination requirements under IRC § 401(a)(4) and the minimum coverage requirements under IRC § 410(b) without application of the permitted disparity rules and without being combined with any other plan.

Nondiscrimination and Top-Heavy Requirements

Under IRC § 414(x)(3), a qualified cash or deferred arrangement that is included in the applicable DC plan that forms part of an eligible combined plan and that meets the minimum contribution requirements described above is treated as meeting the actual deferral percentage test under IRC § 401(k) on a safe harbor basis. In addition, in applying the safe harbor contribution percentage test for matching contributions under IRC § 401(m)(11), the minimum contribution requirements described above and the notice requirements described below are substituted for the otherwise applicable minimum contribution and notice requirements.

Under IRC § 414(x)(4), a DB plan and applicable DC plan forming part of an eligible combined plan for any plan year are treated as meeting the top-heavy requirements under IRC § 416.

Automatic Contribution and Notice Requirements

Under IRC § 414(x)(5), the qualified cash or deferred arrangement that is included in an eligible combined plan is treated as an automatic contribution arrangement if it meets certain notice and election requirements and provides that each employee eligible to participate in the arrangement is treated as having elected to make elective contributions in an amount equal to four (4) percent of the employee's compensation unless the employee specifically elects not to have such contributions made or to have such contributions made at a different rate. Each employee eligible to participate in the qualified cash or deferred arrangement must receive a notice explaining the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to have the contributions made at a different rate. Each eligible employee must also have a reasonable period of time after receipt of the notice and before the first elective contribution is made to make an election. In addition, within a reasonable period before any year, each eligible employee must be given notice of the employee's rights and obligations under the arrangement. The notice must be sufficiently accurate and comprehensive to apprise the employee of the employee’s rights and obligations and must be written in a manner calculated to be understood by the average eligible employee.

Considerations for Adopting a DB/k Plan

Under IRC § 414(x), benefits may be required to vest over a shorter period than they would otherwise be required to under the terms of the plan. Likewise, the contributions required may or may not be greater than the current contribution requirements depending on many factors, including the plan’s current top-heavy status, DB plan formulas, actual
employee turnover, etc. While there are many things to consider when adopting any type of retirement plan, the major considerations include:

- **Required Funding.** Given the volatility of the stock market and the inflexible funding requirements mandated by the PPA of 2006, by utilizing IRC § 414(x), a plan sponsor gives up the flexibility of discretionary matching contributions found in the 401(k) world and the DB plan contribution must be funded no matter what the magnitude;

- **Cash Flow.** Consistent and positive cash flow is a must for this type of plan;

- **Company Size.** Small, owner-dominated companies that have both types of retirement plans are the most likely candidates; and

- **Impact of Current Testing.** The more the plans are already affected by the top-heavy and nondiscrimination rules, the more preferable this sort of arrangement becomes.

**For Example:** DB Only vs. DB/k

**Owner-Only Business.** Looking to Maximize contribution and tax deduction. Independent consultant born in 1956, has W-2 income of $300,000 and plans to retire at age 62.

<table>
<thead>
<tr>
<th></th>
<th>DB Only</th>
<th>DB + 401(k)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017 Contribution</td>
<td>$147,100</td>
<td>$185,700</td>
</tr>
<tr>
<td>Tax Savings @ 38%</td>
<td>$55,898</td>
<td>$70,566</td>
</tr>
<tr>
<td>Projected DB Accumulation</td>
<td>$2.48 million</td>
<td></td>
</tr>
<tr>
<td>Projected Annual Benefit</td>
<td>$103,635</td>
<td></td>
</tr>
</tbody>
</table>

Case B: Married Business Partners, No Employees. Husband and wife in the medical profession. Bob age 60, and Martha age 58, W-2 income for each is $260,000, both plan to retire in 5 years.

<table>
<thead>
<tr>
<th></th>
<th>DB Only</th>
<th>DB + 401(k)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017 Contribution</td>
<td>$412,100</td>
<td>$488,700</td>
</tr>
<tr>
<td>Tax Savings @ 38%</td>
<td>$156,500</td>
<td>$185,700</td>
</tr>
<tr>
<td>Projected DB Accumulation</td>
<td>$2.36 million</td>
<td></td>
</tr>
<tr>
<td>Annual DB Benefit</td>
<td>$210,000</td>
<td></td>
</tr>
</tbody>
</table>

Table 7.2 below list some high-level considerations and comments on whether a 414(x) plan merits consideration:
### Table 7.2
**IRC § 414(x) Requirements**

<table>
<thead>
<tr>
<th>Employer Type</th>
<th>Current Defined Benefit Plan</th>
<th>Consistent and Positive Company Cash Flow</th>
<th>Refunds in 401(k) Plan</th>
<th>Already Top Heavy</th>
<th>IRC § 414(x) Worthy of Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small, 25 Employees</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes – this type of arrangement may be less expensive than a safe harbor defined contribution plan (for the defined contribution plan).</td>
</tr>
<tr>
<td>Medium, 250 Employees</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Maybe – this is an efficiency issue, providing the minimum benefits may be much more expensive than making the refunds.</td>
</tr>
<tr>
<td>Large, 500 Employees</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No – if the employee base is growing then this option may not be available for long: 500 employees is the limit.</td>
</tr>
<tr>
<td>Any (with 500 or fewer employees)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Maybe – careful consideration is necessary: adding a defined benefit plan is not a benefit that allows flexibility in funding.</td>
</tr>
<tr>
<td>Any (with 500 or fewer employees)</td>
<td>Yes/No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Maybe – again, careful consideration is necessary; adding a defined benefit plan is not a benefit that allows flexibility in funding; if the goal is to reduce the current level of benefits provided in the defined benefit plan, this kind of plan might be useful</td>
</tr>
</tbody>
</table>

### IRS Revenue Ruling 2012-4: DC to DB Rollovers

Employers who sponsor both a 401(k) or other DC plan and a DB plan (combination plans) may be able to offer participants a lifetime income benefit that is already largely in place. Such employers can permit terminating employees who are covered under both plans, to roll all or a portion of their DC benefits over to the pension plan to receive a greater life annuity benefit from the pension plan. This approach may be beneficial for
retirees and other terminating employees, while still helping to minimize the employer’s administrative burdens.

Although some employers have offered such rollovers, many others were reluctant to follow suit in the absence of formal guidance on how such rollovers actually work in practice. Now that the Treasury Department and Internal Revenue Service (IRS) have issued guidance with IRS Rev. Ruling 2012-4, clarifying how this annuity conversion can be accomplished under the rules for qualified plans (discussed below), there is a renewed interest in DC to DB rollovers.

Let’s review some of the advantages and disadvantages of these rollovers, from the employer’s and the employees’ perspective.

For the employer’s, there are several advantages of offering a DC to DB rollover:

- **Distinguishing the Employer's DC Plan from the Competition.** Until this feature becomes commonplace, this option can be communicated as a positive feature of the employer's program, setting it apart from other DC plans in the marketplace. It also is a feature that employers without a DB plan, frozen or otherwise, cannot replicate;
- **Using the DC Plan to Aid Retention.** Offering this option only for employees who retire after certain age/service criteria is achieved may encourage mid-career employees to stay until the attainment of the rollover criteria;
- **Opportunity to Generate Investment Gains.** For purposes of the conversion to lifetime income, the lifetime income stream created from the rollover will be valued using actuarial assumptions based on interest rates on corporate bonds. However, unless the plan’s assets are invested only in fixed-income investments, the DB plan’s long time horizon may allow it to invest in other investments and thus possibly earn a greater return than the fixed-income rate used in the conversion; and
- **Marginal Improvement in Funded Status.** To the extent that a plan is less than 100 percent funded, rollovers will increase its funded status. This occurs because the additional liabilities attributable to the rollover are essentially 100 percent funded at the time of rollover and, therefore, drive the total plan’s funded status a bit closer to 100 percent.

Employees may want to make a DC to DB plan rollover for the following reasons:

- **Obtain Longevity Protection at Below Insurance Market Costs.** Provides longevity protection without expense and profit loads found in commercial annuities, the conversion rates used by the plan will typically be less than prevailing rates in the individual annuity marketplace. This is the primary advantage of such rollovers for employees; and.
- **Avoid the Section 415 Maximum Benefit Limit.** That limit does not apply to the rollover provided the annuity is calculated using IRC §417 (e) assumptions.
The primary disadvantages of rolling money from a DC to a DB plan are:

- **Increased Financial Exposure to the Employer.** Employees may not want to have too much of their net worth in their employer’s DB plan, especially if there are concerns about the financial solvency of the employer and if the DB plan is underfunded;
- **Use of Unisex Annuity Rates.** The DB plan would need to use unisex rates for these conversions and, unless a 100 percent female table is used, the unisex table will provide a subsidy to the female participant and penalize the male participant. From the male participant’s point of view, this financial disadvantage may outweigh the financial advantage of not having to pay for insurance company expense and profit loads; and
- **Lack of a Cash-Value Feature.** This can pose a problem for employees who face unforeseen large expenses. Of course, this can be mitigated to some extent by rolling over only a portion of the DC account balance.

Employers who are thinking about offering a DC to DB rollover option should be aware that there are still some ambiguities about the design, as noted below:

- **Pension Benefit Guaranty Corporation (PBGC) Protection.** The PBGC has not yet provided guidance on how its benefit guarantees will apply to additional lifetime payment amounts derived from a rollover contribution. In addition, in some cases, the rollover amount could cause the total benefit payable from the DB plan to exceed the maximum PBGC guarantee. Without PBGC protection, there is a possibility that participants could lose all or a portion of the rollover benefit should the plan terminate with insufficient assets;
- **How to Handle After-Tax Contributions.** Transfers of after-tax money will likely require special tax treatment; additional IRS guidance is needed; and
- **Potential Administrative Issues.** It is unclear whether the nondiscrimination rules allow the employer to require a minimum transfer amount to avoid the administrative costs of small annuities. For example, to avoid *de minimis* payments, the usual cash-out rule should apply, allowing employers to only have to pay annuity amounts that have a present value (combined with the regular DB benefit) of $5,000 or more.
Chapter 7
Review Questions

1. Which Act enacted by Congress permits employers with 500 or fewer employees the authority to establish a combination plan under IRC Section 414(x)?

(   ) A. Employee Retirement Income Security Act of 1974
(   ) B. Deficit Reduction Act of 2005
(   ) C. Pension Protection Act of 2006
(   ) D. Economic Growth Tax Relief Reconciliation Act of 2001

2. Which of the following statements about a DB/k plan under IRC Section 414(x) is FALSE?

(   ) A. Must file two separate plan documents
(   ) B. Must file only a single Form 5500
(   ) C. Must file only one plan document
(   ) D. The plan must meet specified benefit, contribution, vesting and nondiscrimination requirements.

3. For non-elective contributions to the defined contribution plan of a DB/k plan, the employee will not be fully vested in those amounts until completion of how many years of service?

(   ) A. 3 years
(   ) B. 5 years
(   ) C. 6 years
(   ) D. 7 years

4. Under IRC § 414(x)(2)(B), the defined benefit plan that forms part of the eligible combined plan must provide each participant with a minimum benefit that is lesser of 1 percent multiplied by the participant’s years of service with the employer; or

(   ) A. 10%
(   ) B. 20%
(   ) C. 50%
(   ) D. 60%

5. True or False. Under IRC § 414(x)(4), a defined benefit plan and applicable defined Contribution plan forming part of an eligible combined plan for any plan year are treated as meeting the top-heavy requirements under IRC § 416.

(   ) A. True
(   ) B. False
CHAPTER 8

FULLY INSURED DB PLAN

Overview

A fully insured defined benefit plan is defined in the IRC § 412 (e)(3), formerly known as IRC § 412(i), is called a “fully insured” DB plan because the benefits are guaranteed by an insurance company. These plans provide a great opportunity for small business owners and professionals who have few employees and a relatively short period of time for retirement.

In this chapter, we will examine the background of IRC § 412(e)(3) plans, the funding benefits, plan requirements, the advantages and disadvantages and the potential market. In addition, we will also examine the issues with “springing cash value” life insurance policies.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The background of IRC § 412(e)(3) “fully insured” DB plans;
- The funding advantages of using guaranteed insurance products under IRC § 412(e)(3);
- IRC § 412(e)(3) plan requirements and contribution limits under IRC § 415(b);
- The advantages and disadvantages of fully insured DB plans;
- The potential market for fully insured DB plans;
- The Death Benefits and the “incidental benefit” rules;
- The abuses with IRC § 412(i) fully insured DB plan; and
- The term “springing cash value” and Pension Rescue.

Background

The IRC § 412(e)(3) plan is a tax qualified, DB pension plan for business owners and their employees that must be funded with a combination of life insurance and annuities, or annuities alone.

IRC § 412(e)(3) plans are exempt from the section’s funding rules described in Chapter 5 because the burden of providing the benefit is shifted from the employer to an insurance company. Prior to the PPA Act of 2006, these plans were known as 412(i) plans. They
are referred to as a “fully insured” plan because the benefits are guaranteed by an insurance company (subject to its claims paying capacity).

Fully insured, DB plans are unique in the retirement planning arena because they have a higher tax-deduction limit than most plans. Moreover, plan contributions may be greater than those made to traditional DB plans because they are funded using fixed-annuity products. Whole-life insurance and term insurance may also be included.

Also, the interest-rate assumptions are much more conservative in these types of contracts than in a traditional DB plan. This allows for a greater deduction. While contributions (which are based on guaranteed interest and mortality assumptions) to a fully insured plan generally remain high, they can decrease over time if the assets contributed toward the plan earn dividends or interest over and above the guaranteed levels. In this situation, these “extra” earnings must be used to offset contributions.

The accrued benefit for a participant at retirement is a stated monthly pension, or simply the guaranteed cash values of the underlying policies. Business owners and professionals might appreciate the ability to set aside large amounts of money each year, while taking large tax deductions for doing so—as well as the fully guaranteed retirement benefits the plans provide.

The retirement payout is subject to the same IRS limits as all other DB retirement plans. For 2017, the maximum annual amount that can be received by each participant is generally the lesser of $215,000 or 100 percent of the participant’s average compensation for the highest three years of work. And just like a traditional DB plan, as an alternative to taking periodic distributions from the fully insured plan, a participant may take a lump sum and roll the assets into an IRA.

**Funding Advantages With IRC § 412(e)(3) Plans**

The principal advantage of IRC § 412(e)(3) plans is centered around the funding requirements for DB plans.

**Minimum Funding Requirement**

As was discussed in Chapter 5, one of the key requirements for DB plans is that the plan be adequately funded currently so that the fixed and measurable benefits payable in future years will be adequately covered. These funding rules are set forth in IRC § 412, and involve often-complex actuarial computations to determine how much money must be contributed into the plan each year in order to meet future obligations. These computations involve assumptions and projections regarding rates of asset growth, number of years until participants’ retirement, life expectancies and other factors. Reporting requirements are also imposed concerning these determinations.
IRC § 412(e)(3) provides an exemption from these funding computation rules when the plan is funded exclusively by life insurance and/or annuity contracts meeting certain simple requirements. Thus, such insurance-funded plans can eliminate the complex and costly periodic actuarial determinations and reporting requirements otherwise mandated by IRC § 412. These procedures are simply not necessary with an insurance-funded plan: the security for the plan participant’s future retirement benefits is supplied by the liability of the insurance company that issues the contract, and not by a plan trust fund. This elimination of regular actuarial determinations and reports can be an important cost-saving factor in the case of a small business.

**Contribution Limitation**

In addition to the minimum funding requirements of IRC § 412 (which are basically for the protection of plan participants), IRC § 415 imposes maximum funding limitations for qualified plans. The funding ceilings are imposed to assure that the tax benefits accorded to qualified plans are limited to plans that are designed only for retirement savings, and not for accumulation of assets for ultimate passage to heirs or other non-retirement purposes. Absent such funding limits, a business owner with no employees, for example, could use his or her qualified plan to shelter an unlimited amount of business income in excess of current spending needs.

In the case of a DB plan the maximum annual funding limitation is determined indirectly, through a maximum retirement benefit limitation; since the contributions are determined based upon the amount necessary to fund the promised retirement benefit, a limit on the retirement benefit will also effectively limit the contribution amount. IRC § 415(b)(1)(a) imposes a ceiling on annual benefits for a participant in a defined benefit plan. This maximum yearly benefit allowed is the lesser of:

- 100 percent of the participant’s average compensation for his or her highest three years; or
- A statutory dollar amount ceiling. For 2017 the ceiling amount is $215,000 (indexed in $5,000 increments).

The foregoing dollar amount limitations assume that benefits will commence at a normal retirement age between ages 62 and 65. In cases where the plan provides a retirement age outside of this range (and for participants with less than 10 years of service), the otherwise applicable dollar limit is adjusted (reduced by 10% per year), under IRS regulations, to an amount effectively equivalent, given the fewer or greater number of years involved. Thus, the applicable limitation amount is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65 [IRC § 415(b)(2)(D)].

**Higher Deductible Contributions**

In the case of a self-employed individual or a business owner with few or no covered employees, there is often an objective to maximize the deductible qualified plan
contribution. As discussed above, the maximum annual contribution to a DB plan is effectively limited by the benefit ceiling under IRC § 415(b). However, when an insurance company takes on the risk of meeting the guaranteed future retirement obligation, it typically uses a very low guaranteed interest rate, thereby requiring higher premium input, as the employer’s deductible plan contribution, to fund the maximum allowable benefit, than would be the contribution under a non-insured actuarially-based funding arrangement. Stated another way, because an actuary’s mandated range of interest rate assumptions will typically be greater than an insurance company’s guaranteed interest rate, the deductible insurance premiums needed to fund the specified benefit levels will be greater than the required plan contributions determined by an actuary under a non-insured plan.

Of course, the obvious tradeoff for the greater deduction is the low rate of return. On the other hand, this low rate is guaranteed, and it is only a minimum rate. For IRC § 412(e)(3) plans, where the products funding the plan have guaranteed returns, the IRS allows the plans to use the guaranteed return rate as the “hurdle” rate in the formula that distinguishes between a future retirement benefit and a present value contribution. Because these guaranteed rates (1%–3%) are much lower than the typical hurdle rates (4%–6% or higher), participants aiming for a particular retirement savings amount will be allowed significantly higher contribution amounts under a IRC § 412(e)(3) plan than they would be under a typical DB plan. In some conservative IRC § 412(e)(3) plans, businesses have made annual deductible contributions in excess of $215,000 for employees over age 50. For business owners over 40 years of age with few employees (or young employees whose contributions would be much lower), the large potential tax deductions of a IRC § 412(e)(3) plan can be extremely attractive.

If the insurance company’s investment results exceed the guaranteed rate, these results are eventually passed along and applied against future premiums. Before rejecting an insured arrangement because of the low guaranteed interest rate, the business owner should consider the importance of the elimination of risk. Stock market conditions and rates of return, which have such a major effect on participant account balances in defined contribution plans, also affect DB plans, but in a very different way. In a DB plan, investment risk falls upon the employer, and not the participant. If the accumulated balance in an actuarially-based plan suffers a poor investment return, the employer will have to increase the contributions in order to meet future fixed benefit levels. Even in a one-person business, contribution requirements could increase beyond the owner’s ability to comfortably pay. This risk is eliminated with an insurance-funded plan.

The insurance company’s investment results in excess of the guaranteed rate will eventually be passed on to the employer in the form of premium offsets. While such reduction of premiums would obviously reduce the future tax deduction, the focus of business owners will tend to be on the initial excess of the insured plan deduction vs. the actuarial plan deduction. Taxpayers typically want to maximize deductions as soon as available, particularly when the amount paid is going into a tax-sheltered retirement vehicle. The larger and earlier the deductible payment is, the greater the long-term sheltered growth. It should also be noted that the deduction will be less valuable for non-
corporate businesses in future years, as income tax rates are gradually reduced under the existing phase-down schedule. Thus, the planned phase-down of tax rates favors an insurance-funded plan that will result in deductible contributions/premiums that are initially higher than they would be under an actuarially-funded plan, even if the net premiums might eventually be reduced to a more comparable or lower level.

**IRC § 412(e)(3) Plan Requirements**

In order to qualify as a IRC § 412(e)(3) insurance-funded plan (aka, 412(i), the following specific requirements must be satisfied:

- The plan must be funded exclusively by the purchase of individual annuity or individual insurance contracts;
- The individual annuity or individual insurance contracts issued under the plan must provide for level annual, or more frequent, premium payments to be paid under the plan for the period commencing with the date each individual participating in the plan become a participant and ending not later than the normal retirement age for that individual or, if earlier, the date the individual ceases his participation in the plan. Premium payments may be considered to be level even though items such as experience gains and dividends are applied against premiums. In the case of an increase in benefits, the contracts must provide for level payments with respect to such increase to be paid for the period commencing at the time the increase becomes effective. If payment commences on the first payment date under the contract occurring after the date an individual becomes a participant or after the effective date of an increase in benefits, the requirements of this subdivision will be satisfied even though payment does not commence on the date on which the individual’s participation commenced or on the effective date of the benefit increase, whichever is applicable. If an individual accrues benefits after his NRA, the requirements of this subdivision are satisfied if payment is made at the time such benefits accrue. If the provisions required by this subdivision are set forth in a separate agreement with the issuer of the individual contracts, they need not be included in the individual contracts;
- Plan benefits must be payable only under the insurance contracts, and guaranteed by an insurance carrier, which must be properly licensed to do business with the plan; and
- Participants may not take out policy loans or pledge their interest in the plan as collateral.

The foregoing rules apply to both individual and group insurance contracts. Group insurance contracts are subject to the following two additional requirements:

- The value of the benefits guaranteed by the insurer with respect to each participant must not be less than the value of the benefits which the cash surrender value would provide for that participant under an annuity satisfying the requirements for an individual contract; and
• All premiums or other consideration received by the insurance company must be allocated to the purchase of individual benefits for each plan participant. In no event can funds be maintained in a separate account maintained by the insurance company, such as a group deposit administration contract.

Many insurance companies designed specific products for IRC § 412(e)(3) plans and together with IRS-approved prototype plans for adoption by client businesses.

**Potential Market for IRC § 412(e)(3)**

By and large, IRC § 412(e)(3) plans are ideal for business owners with relatively few employees that can commit to making large, regular contributions. The concept works best for businesses that are well-established and highly profitable.

The plan is equally suited to successful, self-employed individuals, who may have been unable to set money aside for retirement in their early years, due to family or other obligations, and now need to put away large amounts of money in a short amount of time. Individuals starting a second career are also good candidates for these plans, as are those who want to provide for family members and heirs in unexpected death.

**Note:** Any life-insurance contract transferred from a plan to the individual employee must be taxed at its full fair-market value, and an employer may not buy excessive life insurance under a plan (see discussion below of 412(i) abuses). The plan sponsor and third-party administrator must also ensure that their plan meets compliance requirements (see Revenue Ruling 2004-20 discussed below).

IRC § 401(a) 4 discrimination testing could allow business owners to receive a substantial portion of the plan’s benefit for themselves. A feasibility study should be performed by a qualified pension consultant to determine the right type of plan and its cost and benefits.

Many small-business owners with successful and mature businesses have higher incomes and assets than traditional wage earners. But this doesn’t always translate into higher retirement savings. According to a 2004 study by The Public Policy Institute of the AARP, only 12 percent of self-employed individuals over age 50 have a pension or retirement plan, and their average account balance is just a little more than $70,000. Professionals such as doctors, architects, lawyers and individuals with second incomes may benefit from the flexibility of a fully insured defined-benefit plan.

With the passage of the PPA of 2006, the tax law changes create opportunities for financial advisors to help clients increase tax deductions through retirement plans, increase baby boomer retirement income and enhance the advisor’s relationship with their clients. For a calendar tax year business, a new IRC § 412(e)(3) plan, must be adopted by December 31 and funded by the tax due date (including extensions).
Planning Considerations

Only “earned income” compensation may be taken into account for purposes of qualified plan contributions and benefits. The “pass through” nature of a professional “S” Corp, partnership, or limited liability company (LLC) could provide tax deductions in a personal tax bracket as high as 43.4% (39.6 % plus 3.8%). Keep in mind that Schedule K-1 profit (“passive income”) for “S” Corporation owners may not be taken into account for purposes of qualified plan contributions or benefits. Only “earned income” (W-2 compensation) may be considered for determining qualified plan amounts for “S” Corporations (Durando v. USA, 70 F. 3d 548 (9th Cir. 1995)).

However, partners and LLC members may use all their Form 1065 Schedule K-1 partnership net profit for purposes of determining qualified plan contributions and benefits as long as the net profit is classified as “earned income” in the form of “guaranteed payments.” If these professionals already have a profit sharing or SEP plan, these plans can be frozen or terminated and rolled to an IRA before the new IRC § 412(e)(3) plan is implemented.

This very same IRA can be utilized 15 years later as a direct rollover account for the IRC § 412(e)(3) annuity values plus any surrendered cash value of life insurance owned by the IRC § 412(e)(3) plan if the participant reaches the age of retirement and decides not to take annuitized defined benefit payments. Be aware of the full funding limitation provided within the Retirement Protection Act of 1994 for lump sum distributions and rollovers. The funding limit (known as the General Agreement on Tariffs and Trades (GATT) is not based on the carrier guaranteed rates…it is based on the “weighted average interest rate” at the time of the distribution. Because of this rate differential, most fully funded IRC §412(e)(3) plans will be over-funded. The lump sum distribution and termination of an over-funded plan may create taxable income to the employer, as well as a 50% excise tax on the amount of over-funding. It is important to note that this distribution limit applies only to lump sum distributions … NOT to the annuitization of benefit payments.

Naturally, the life insurance in the IRC § 412(e)(3) plan cannot be transferred to the IRA (IRC § 408(a)(3)) if the participant decides to keep the insurance in force after termination of the plan. However, the insurance policy ownership can be distributed from the plan trustee to the participant at retirement and then gifted by the participant to an irrevocable life insurance trust (ILIT) to potentially be excluded from estate taxes at death. The policy’s fair market value minus the cumulative Table 2001 “economic benefit” cost basis would be taxable income to the participant. Then the participant would gift the policy ownership (gift of net policy value) to the irrevocable life insurance trust subject to the 3 year rule of IRC § 2035 (see discussion below).

Case Example of a One Person Business

Assume an owner of a “one person” business (incorporated or not) has $400,000 of earned income and desires a plan with guaranteed retirement income and a large current
tax deduction. Table 8.1 illustrates the maximum first year contribution to an IRC § 412(e)(3) plan from a competitive carrier which specializes in these defined benefit type of plans.

### Table 8.1
**Maximum Deductible Contributions in First Year**
**To IRC § 412(e)(3) Plan**

<table>
<thead>
<tr>
<th>Age</th>
<th>Annuity Only</th>
<th>Maximum Annuity Plus Life Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td>$100,271</td>
<td>$108,782</td>
</tr>
<tr>
<td>45</td>
<td>$133,619</td>
<td>$150,482</td>
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<tr>
<td>50</td>
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<td>$227,525</td>
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<tr>
<td>55</td>
<td>$267,517</td>
<td>$339,065</td>
</tr>
</tbody>
</table>

**Note:** The contributions shown above are based on the maximum defined benefit of $215,000 in 2017.

These contributions assume the guaranteed annuity purchase rate, the guaranteed cash value of life insurance, and the guaranteed annuity accumulation rate of the competitive carrier. The values also assume that the business owner retires at age 62. In a 48.4% combined federal and state tax bracket, the tax savings are substantial.

### Use of Paired Plans for Small Businesses

IRC § 412(e)(3) plans have been criticized by some as poor investments relative to other types of diversified plans over the long term. Modern portfolio theory, however, dictates that a mix of equities and bonds will perform better than a portfolio comprised exclusively of one or the other. Diversification can be accomplished by incorporating a profit sharing plan along with the pension plan, or adding a pension plan to a profit sharing plan.

Under such a paired plan, the 401(k) profit sharing plan has the benefits and burdens of the equities market. The IRC § 412(e)(3) has the benefit of a guaranteed retirement, with guaranteed lifetime income and lump-sum distributions depending on how the plan is structured. Under IRC § 412(e)(3) the plan cannot be in the equities market and by law must be invested in guaranteed contracts (no variable universal life insurance contracts, as well). The benefit of a dual plan design is to allow market and nonmarket exposure in a company’s retirement planning structure. Of course, similar investment strategies can be made using money market funds as the nonmarket investments.

The most important rule in investing retirement funds is not to lose money.

*For example:* If an account is worth $100,000 and has a 40% loss, it is now worth $60,000. A 40% gain in the following year would bring the account up to $84,000. A gain of 68% is needed to bring the account current in the following
year. The greater the loss, the greater the percentage gain needed to restore the account.

**Example:** an account worth $100,000 has a loss of 90% and is worth $10,000. The account now has a 90% gain and is worth $19,000. A gain of 90% each year over 3 years would not restore the account. This is known as the “mathematics of loss”.

Consider these two paired plan hypothetical examples:

**Example 1:** A small company contributes $100,000 to retirement accounts. The 412(e)(3) defined benefit plan receives $80,000, and the 401(k) profit sharing plan receives $20,000. The market declines 40%. The DB plan assets were invested in a guaranteed annuity, earned 5%, and made $4,000. The 401(k) profit sharing plan was invested in the market and lost 40% or $8,000. The overall retirement program lost 4% (4,000 - 8,000 = -4,000).

**Example 2:** A small company contributes $100,000 to retirement accounts. The DB plan receives $60,000, and the profit sharing plan receives $40,000. The DB plan earns 5% or $3,000. The 401(k) profit sharing plan lost 40% or $16,000. The overall retirement program loss is 13%.

When paired with a 412(e)(3) plan, most existing 401(k) plans will need to be modified. If the plan is a match plan or safe harbor match plan, the plan needs to be converted to a 401(k) profit sharing plan because the employer contributions for safe harbor match or non-safe harbor match cannot be used to satisfy IRC § 401(a)(4) in a cross-tested plan with a defined benefit plan.

A 401(k) with a profit sharing contribution allows the profit sharing contribution to be used for cross-testing, and the plan sponsor can make a qualified non-elective contribution (QNEC) by vesting part or all of the profit sharing contributions if the plan fails actual deferral percentage (ADP) testing. Additionally, the profit sharing contribution funds can serve double-duty in passing the gateway and rate group cross-testing (see Treas. Reg. §§ 1.401(a)(4)-8(b) and 1.401(a)(4)-9(c)).

**Advantages of IRC § 412(e)(3)**

Employers may find IRC § 412(e)(3) plans attractive because they avoid the complications commonly associated with traditional DB plans. For example, no enrolled actuary’s certification is needed; there are no required quarterly contributions; there is no full funding limitation applied that might limit contributions; and administrative costs are generally lower. Another popular feature includes protection of plan assets from lawsuits and creditors.
A third-party administrator will establish the plan, which includes providing the plan and trust documents and providing the plan trustee with all documents and administrative forms that may be needed in the future. The administrator also provides annual processing of all IRS and Department of Labor forms, plan valuation and 5500 forms.

These advantages create a plan that, compared to a traditional DB plan, will produce:

- Larger initial deductions;
- Greater stability in the contribution level;
- Simpler plan administration;
- A secure promise of future benefits;
- Does not require an enrolled actuary;
- Is not subject to the full funding limitation tests of a traditional defined benefit plan;
- Is required to use the contract guarantees as funding assumptions, thus helping shield them from IRS attack as unreasonable funding assumptions;
- Can be designed to eliminate the potential of excess plan assets that, in a traditional defined benefit plan, could be subject to taxes and penalties of 80% or more upon termination of the plan;
- Produces an understandable accrued benefit since it is simply the cash value of the contracts funding the participant’s account;
- Creates larger initial deductions than a traditional defined benefit plan since the funding assumptions are required to be much more conservative; and
- Provides retirement benefits that are guaranteed by the insurance company and not just the financial strength of the particular employer providing the plan.

Potential Disadvantages of a IRC § 412(e)(3) Plans

Because of their large required contributions, these plans work only with established, highly profitable businesses. They usually work best when the business owner is within 10 years or so of retirement and is older than most of the company’s relatively few employees. In addition, the plan cannot make policy loans. Such a loan invalidates the plan altogether. There is no flexibility in investments, because the plan is funded entirely with insurance and annuity contracts. Finally, there may be limitations to the deductions or the amount of insurance that is purchased, and there may be an income component that is recaptured by the business owner.

Death Benefits and the Incidental Benefit Rule

IRC § 412(e)(3) plans typically include death benefits at least equal to the cash value in the insurance contracts at the date of death. If the plan includes a life insurance policy with a death benefit greater than the cash value at date of death, of course, this insurance amount would be the death benefit. If the plan includes a life policy coupled with an
annuity contract, the plan’s death benefit would be the sum of the life insurance face amount and the cash value of the annuity contract.

Since qualified plans are aimed at providing funds for retirement, this would ordinarily exclude the death benefit element of a life insurance contract. However, life insurance protection is permitted in a qualified plan, provided that it is only an incidental benefit, when compared with the retirement benefits provided by the plan. This is often referred to as the “incidental benefit rule” [Reg. §1.401-1(b)(1)(ii), as applied through various revenue rulings], and it applies to IRC § 412(i) plans. A plan that includes a death benefit funded by life insurance may not allow such death benefit to exceed the greater of:

- 100 times the monthly benefit amount that is scheduled to be payable if the participant retires at normal retirement age; or
- The sum of the reserve under the life insurance policy, plus the participant’s account in the auxiliary fund.

An alternative test is provided in Rev. Rul. 74-307 [1974-2 C.B. 126]. Death benefits are considered incidental if less than 50 percent of the employer contribution credited to each participant’s account is used to purchase ordinary life insurance.

### IRC § 412(i) Abuses

Let’s take a moment to discuss some of the abuses used to market IRC § 412(i) plans. Back in the early years of 2000, the life insurance industry promoted a number of techniques to distort the conservative use of IRC § 412(i) plans. One common distortion was to encourage the qualified plan to invest heavily in a life policy rather than an annuity. In many plans, 100% of the plan is invested in the life policy, with no annuity at all. Most insurance plans were set up as five-pay so that the plan could quickly soak up the majority of the money in the plan. Although this strategy was good for the insurance agent’s commission, it does not meet the business’ goal of a retirement plan. Conservative plans have at least 50% of the plan invested in annuities.

Most notably, however, some insurance promoters used the IRC § 412(i) plan as a tool for purchasing a very large life insurance policy with tax-deductible dollars that would then be transferred out (using the technique called “Pension Rescue”), by either distribution or purchase from the plan, at a value much less than the amount paid for it. Prior to Revenue Procedure 2004-16 (issued February 13, 2004), one could make a case that the value used for the purchase or distribution of a life policy out of a plan could be the policy’s cash surrender value (CSV). Often, specially designed life insurance contracts (“springing cash value life insurance”) were used to suppress the CSV at the time of transfer from the plan. This would allow the participant to reduce the cost of purchasing the policy, or the tax liability if the plan were to distribute the policy to the participant. Then, either by the design of the product itself or by language in the contract allowing for certain changes (e.g., a right of exchange to another contract or a right to reduce the face amount), the contract would be structured so that the CSV increased.
significantly after it was transferred to the employee (see discussion of “springing cash value” below). Eventually, the IRS figured out this “pension rescue” structure, and on February 13, 2004, it released proposed regulations dealing with this valuation strategy.

But before we discuss the new regulation, let’s examine the workings of “Pension Rescue” technique.

**Pension Rescue Technique**

This concept was used to "rescue" qualified plan (typically profit-sharing plan) assets from the income and estate taxes that they would otherwise incur by distributing them out of the plan. A favored technique is the purchase by the plan trustee of a life insurance contract on the life of the account owner, leading to a classic “springing cash value” scenario:

- Assets in the profit sharing plan are utilized to purchase a life insurance policy on the life of the account owner (or, where the plan permits a second-to-die policy on the account owner and spouse). The plan trustee is both policy owner and beneficiary (the ultimate recipients of the death benefit are the designated beneficiaries under the plan);
- After the policy is acquired by the plan, it is eventually distributed by the plan trustee to the account owner. Alternatively, the policy could be purchased from the plan by the account owner or by an irrevocable life insurance trust (ILIT) established by the account owner; and
- In the case of a distribution the account owner then transfers the policy to an irrevocable life insurance trust (ILIT). The beneficiary(s) of the trust can be the same as the beneficiary(s) of the retirement account.

Clearly, in order to reap any tax advantages from the transfer of the policy out of the plan, it is essential that the distributed life insurance policy be valued at an amount less than the plan account assets used for its purchase.

Alternatively, instead of distributing the policy the plan might sell it to the insured participant. The new guidance addresses this move by revoking the position of PTE 92-6 that when a policy was sold by the plan to a participant for less than fair market value, the difference is not a distribution under the plan. Thus, there is no tax advantage to the insured. (Nor would it be possible to arrange a transfer of the policy for services rendered, since Treas. Reg. § 1.83-3(e), which had stated that "only the cash surrender value of the contract is considered to be property," is also amended by the proposed regulations.)

Many insurance companies designed specific policies to meet the objectives of the pension rescue technique. They were known as “springing cash value life insurance” policies.
Springing Cash Value Contract Design

A product known as "springing cash value life insurance" was developed at least in part to minimize the income taxes applicable with respect to distributions of life insurance policies from qualified plans. As discussed above, such a distribution will represent taxable income to the recipient measured by the cash value of the policy at the time of the distribution. A springing cash value policy is structured in such a way that the stated cash values during early policy years are kept artificially low, in relation to the premiums paid by the plan for maintenance of the policy; and at some point after the policy has been distributed to the plan participant (taxable at the low cash value), the cash value "springs" back up to a level comparable to what it would have been at that point under a normal contract.

Springing cash value contracts in qualified plans are subject to special scrutiny by the IRS, which may treat the artificially reduced cash value as not reflective of economic reality, and restate the income resulting from distribution of such a policy to the plan participant, based upon what it deems a more economically realistic cash value. Because of the inherent artificiality of such a contract design, the consequences of IRS challenge could extend to treating the purchase of such a policy by the plan as a prohibited transaction or even as a form of discrimination in favor of a HCE, which would cause loss of qualified status for the plan.

Accordingly, the purchase of such a contract by a qualified plan could represent a highly risky proposition for the plan administrator/trustee, quite possibly amounting to a breach of fiduciary duty.

But of course, the IRS did not like the structure of pension rescue or the use of specific springing cash value life insurance policies, so they set their objective to shut it down. And of course, the IRS succeeded with the Rev. Rul. 2004-16; Rev. Rul. 2004-20.

2004 Regulations on Fair Market Value


In essence, the guidance a uniform standard under which the value of any life insurance contract distributed or sold by a qualified plan is its fair market value as of the transfer out of the plan. Before the new regulations, life insurance valuation at the time of
distribution from a qualified plan was subject to a welter of definitions. In the case of sale of the contract by the plan, PTE 92-6 stated that fair market value and cash surrender value may diverge, and that when the former exceeds the latter when a contract is sold, the difference is not a distribution from the plan (and thus not includible in income). In the case of distribution of the contract, Treas. Reg. §1.402(a)-1(a)(1)(iii) provides, in general, that a distribution of property by a qualified plan shall be taken into account by the distributee at its "fair market value." However, Treas. Reg. §1.402(a)-1(a)(2) of the regulations provides, in general, that upon the distribution of an annuity or life insurance contract, the "entire cash value" of the contract must be included in the distributee’s income. Worse, in other guidance a variety of other terms had accreted, including "cash value," "cash surrender value," and even "interpolated terminal reserve." Given this array of uncoordinated terms, it would be surprising if springing cash value contracts had not been invented.

Under the mass of technical detail contained in the preamble to the new regulations, the IRS’s solution is simply that:

"the requirement that a distribution of property must be included in the distributee’s income at fair market value is controlling in those situations where the existing regulations provide for the inclusion of the entire cash value."

"Fair market value" is defined here as "the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed." To determine "the value of all rights under the contract," the Service offers a formula evidently intended to approximate to fair market value:

- The premiums, paid from the date of issue through the date of distribution; plus
- Any amounts credited (or otherwise made available) to the policyholder with respect to those premiums; (including interest, dividends, and similar income items), or, in the case of variable contracts, all adjustments made with respect to the premiums paid during that period that reflect investment return and the current market value of segregated asset accounts; minus
- Reasonable mortality charges and reasonable charges (other than mortality charges) actually charged from the date of issue to the date of distribution and expected to be paid.

Cash surrender value, reserves, or other measures of value may still be used, but only if they do not arrive at an amount "significantly less than the aggregate of" the formula components. The formula is also used in Rev. Proc. 2004-16 for interim guidance. Fair market value as explained by the IRS is the value to be applied to all transfers of life policies by qualified plans to participants. Crucially, this does not prevent such a transfer from taking place at the policy’s cash surrender value, but if this is less than fair market value under the IRS formula, the difference is regarded as a distribution from the plan, contrary to PTE 92-6.
Thus, whether a policy is distributed or sold out of the plan, its fair market value or a close approximation will be recognized as income.

Two other Code sections are associated with regulations that set forth cash value criteria for life insurance valuation. IRC § 79(a)(1) provides that the cost of group term life insurance provided by an employer on the life of an employee is included in the employee’s income to the extent the coverage exceeds $50,000 (less the cost covered by the employee, if any). When combined with "permanent benefits" (defined at Treas. Reg. §1.79-0), the amount taxable to the employee is determined by a formula set forth at Treas. Reg. §1.79-1(d)(2), which includes as a component "the net level premium reserved at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year." Section 83 provides that when any property is transferred to a person in connection with the performance of services, the service provider must include in income the excess of fair market value (with qualifications) over the amount paid for the property, but Treas. Reg. §1.83-3(e) provides that

"...in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property."

In each case, the proposed regulations provide for what are essentially conforming amendments to "clarify that fair market value is also controlling with respect to life insurance contracts under [these] sections." For IRC § 79 it is merely necessary to substitute "fair market value" for "cash value." For IRC § 83(a), "property" is redefined as "the policy cash value and all other rights under [the] contract...other than current life insurance protection," the definition adopted in the new split-dollar regulations, with a grandfather clause for split-dollar arrangements entered into before September 17, 2003 and not materially modified after that date (the effective date of the new split-dollar regulations).

The two new revenue rulings address different potential abuses of life policies in qualified plans. Rev. Rul. 2004-20 attacks what one might call benefit inflation. The policy that funds an individual’s benefits provides either a greater benefit at normal retirement age that the participant is entitled to under the terms of the plan, or a greater death benefit than provided for under the plan. The employer claims a tax deduction for that portion of the premiums that represents the difference between plan-specified benefits and policy values (and the "excess" death benefit is plowed back into paying premiums of other plan participants; it does not go to the policy beneficiary). The temptation to inflate deductions by inflating coverage is obvious.

Rev. Rul. 2004-20 discusses two situations. In the first discussion, the IRS concludes that a plan that holds life policies that provide for benefits at normal retirement age greater than the plan specifies at normal retirement age is not a IRC § 412(i) plan. This conclusion is dictated by IRC § 412(i)(3), which provides that:
"...benefits provided by the plan [must be] equal to the benefits provided under each contract at normal retirement age under the plan."

In the second discussion, the issue is whether an employer can deduct "excess" premium contributions, i.e. that portion of the premium that represents a participant’s insurance coverage, if any, in excess of the participant’s death benefit under the terms of the plan. That is, is what we called "benefit inflation" above permissible? The answer is No. The plan may provide for excess coverage without sacrificing its status as an IRC § 412(i) plan, but the excess portion of the premium may not be deducted in the year incurred. It may be carried over and deducted in future years in which the employer otherwise contributes less to the plan than the maximum deduction permitted for that year, up to the maximum.

However, under IRC § 4972(a), a 10% excise tax applies to nondeductible contributions to a qualified plan, including nondeductible contributions carried over from preceding years. Furthermore, Rev. Rul. 2004-20 provides that such transactions are listed transactions for purposes of the tax shelter rules, if the death benefit exceeds the plan benefit by $100,000 and the employer has deducted that portion of the premium allocable to the excess. As listed transactions, they must be reported to the IRS by the plan sponsor, and the promoter must maintain a list of participants. Furthermore, as with all listed transactions, these transactions may be subject to other tax shelter rules.

Finally, Rev. Rul. 2004-21 holds that any plan that offers a transfer of a life policy from the plan to the employer’s HCEs but not to its NHCE violates the nondiscrimination requirement of IRC § 401(a)(4).

The new guidance is plainly intended to extinguish valuation ploys involving life insurance in a number of contexts. It is to be hoped that the guidance will achieve its aim of curbing perceived IRS abuses while permitting legitimate IRC § 412(i) plans, which retain many advantages for employers and employees alike, to continue to be used.

**Implications of the New Guidance for Pension Rescue**

In essence, Rev Proc. 2004-16; and Rev. Ruling 2004-20 and 2004-21 killed pension rescue. Due to the fact the new value of the cash value life insurance policy for roll out or purchase by an ILIT would be nearly the same amount as the premiums paid, and therefore, there is no tax savings to the transactions. The IRS accomplished its goal of throwing cold water on that pension rescue technique, and most in the industry stopped using it back in 2004 (2004-21 put it on the listed tax transaction list, which really helped advisors stay away from it). However, all that may have changed and pension rescue may make a comeback, with new IRS guidance under Rev. Proc. 2005-25.

Rev. Proc. 2004-16 provided interim relief to taxpayers in the form of a safe harbor in which the cash surrender value of a life insurance contract could be taken to be its fair market value (FMV). Essentially, it adopted the formula provided by the regulations and quoted above. It was expressly stated to be an interim measure, and was superseded by Rev. Proc. 2005-25 (April 8, 2005).

In response to public hearings on Rev. Proc. 2004-16, the Service determined that the principal modification required would be to accommodate surrender charges. This required that it introduce a way of calculating surrender charges—and also that it add a criterion for FMV for the case in which the contract could be sold between a willing buyer and a willing seller for more than the surrender value.

Taking the second point first, the IRS reintroduced the "interpolated terminal reserve" measure of Rev. Rul. 59-195. To accommodate the first point, the IRS devised the concepts of the "Average Surrender Factor" (ASF) and the "Applicable Surrender Factor." The result is two safe harbors, one for non-variable contracts and one, with necessary modifications, for variable contracts. The formulation for non-variable contracts is as follows:

- Safe Harbor for Non-Variable Contracts. Except as provided in section 3.03 of this revenue procedure (which applies only to variable contracts), the fair market value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of:
  - The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
  - The product of the PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor. The PERC amount is the aggregate of:
    - The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus
    - Dividends applied to purchase paid-up insurance prior to the valuation date, plus
    - Any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus
    - Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges
are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date, minus

- Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

The PERC amount is a tweaked version of the formula in Rev. Proc. 2004-16, and the Average Surrender Factor is the ten years’ unweighted average, going forward, of the Applicable Surrender Factor, defined as follows:

- The applicable surrender factor for a policy year is equal to the greater of 0.70 and a fraction, the numerator of which is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year (or, in the case of the policy year of the distribution or sale, the amount of cash that was actually available on the first day of that policy year) and the denominator of which is the projected (or actual) PERC amount as of that same date.

In essence, the IRS is saying that it picks .7 as the factor by which surrender charges may permissibly reduce cash value over a ten-year average. If the cash value of the contract is .7 or greater given surrender charges over that span, it comes within the safe harbor and may be considered the fair market value; if not, it doesn’t. Springing cash value arrangements, which rely on setting a low cash surrender value at surrender and spring to a higher one after the participant purchases the contract, are unlikely to satisfy the factor—at least without negating the tax advantages (or so the IRS must have calculated by setting it at .7).

**Example:** If your client has a $1,000,000 in a qualified plan and you use pension rescue, you would pay premiums of $200,000 a year for five years to soak up the money into the policy. At the end of the fifth year, you would value the policy as it distributed to the plan participant, or if it were sold to an ILIT.

If the cash account value (CAV) is $800,000 you would multiply that by the average surrender factor (ASF), which should be approximately 70 percent in year five if you are using a properly designed policy.

$800,000 x 70% = $560,000.

And there you have it- pension rescue with decent discounting is back with a safe harbor valuation. It’s not like the old days (discussed above) with an 80 percent discount or a value of $200,000 for purchase by an ILIT, but it’s not bad.
The profit sharing plan now has $560,000 in it instead of $1,000,000. Therefore, the client avoided the 75 percent tax on $440,000 dollars, which would have been double taxed had it been left in the plan. And the client moved from the “do nothing” position most clients are stuck with and ended up being proactive to mitigate the 75 percent tax trap, while at the same time moving a life insurance policy to an ILIT, which will significantly increase the after-tax estate passed to heirs.

These Proposed Regulations were finalized effective August 29, 2005. The Final Regulations were little changed from the Proposed Regulations (including the guidance of Rev. Proc. 2005-25). The principal new point to notice is that the requirement that the "bargain element" (the difference between the consideration and the fair market value when a qualified plan distributes property to a participant or beneficiary for less than fair market value) is a distribution under the plan takes effect only as of August 29, 2005 (the effective date of the Final Regulations); the bargain element is includible in the distributee’s income but not a distribution under the plan if distributed before that date but after February 13, 2004 (the effective date of the Proposed Regulations).
Chapter 8
Review Questions

1. Which Section of the Internal Revenue Code (IRC) allows a defined benefit to be funded exclusively with insurance contracts?
   ( ) A. IRC § 401(a)
   ( ) B. IRC § 403(b)
   ( ) C. IRC § 408
   ( ) D. IRC § 412(e)(3)

2. Which of the following insurance contracts cannot be used to fund a IRC § 412(e)(3) plan?
   ( ) A. Annuity contracts
   ( ) B. Whole life contracts
   ( ) C. Term life contracts
   ( ) D. Variable Universal Life

3. What is the “hurdle” rate for IRC § 412(e)(3) plans?
   ( ) A. 1% to 3%
   ( ) B. 3% to 6%
   ( ) C. 5% to 8%
   ( ) D. 6% to 10%

4. Under Rev. Rul. 74-307, death benefits are considered incidental if less than what percent of the employer contribution credited to each participant’s account is used to purchase ordinary life insurance?
   ( ) A. 10%
   ( ) B. 25%
   ( ) C. 50%
   ( ) D. 100%

5. Under the new safe harbor provisions of Rev. Proc. 2005-25, what is the factor by which surrender charges may permissibly reduce cash value over a ten year average?
   ( ) A. 70%
   ( ) B. 50%
   ( ) C. 80%
   ( ) D. 85%
CHAPTER 9

DEFINED CONTRIBUTION PLANS

Overview

Most employers today, especially small business owners, offer their employees some type of defined contribution (DC) plan. DC plans are a mainstay of employer-sponsored retirement benefit plans. According to the Investment Company Institute (ICI), Americans held $7 trillion in all employer-sponsored DC retirement plans as of the second quarter of 2016, representing ¼ of the total retirement market and almost one-tenth of U.S. households’ aggregate financial assets. Mutual funds managed $2.9 billion, or 59 percent of assets held in DC plans at the end of June.

In this chapter, we will review the basic characteristics of defined contributions (DC) plans and their unique set of rules. We will also examine the requirements of ERISA Section 404 (c) and 408(b)(2), as well as the benefits of using life insurance inside a DC plan.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The basic characteristics of defined contribution plans;
- The employee and employer advantages and disadvantages for setting up a DC plan;
- The contribution limits to a DC plan as specified under IRC § 415;
- The vesting requirements for a DC plan;
- The top-heavy rules and definition of a key employee under IRC § 416; and
- The rules of using a life insurance contract in a DC plan.

Let’s begin with some of the basic characteristics of a DC plan.

DC Plan Characteristics

A Defined Contribution (DC) plan is a qualified retirement plan that is governed under the IRC § 401(a).
With a DC plan, the employee’s benefits during retirement depend on the contributions made to and the investment performance of the assets in his or her own individual account, rather than on the employee’s years of service or earnings history. Like a typical savings account, a DC account contains a specific balance at any given time, which is equal to the market value of the assets accumulated in the account. Unlike a DB plan, employees have substantial control over how the contributions to their plan are invested, and may generally choose from an assortment of stocks, bonds, mutual funds, and other investment vehicles.

Next, let’s review some of the advantages of DC plans to the employees and to the employers.

**DC Advantages**

**For employees:**

- **Portability.** The most obvious advantage of DC plans for employees is portability. Since the contributions are paid directly into individual accounts for each employee, it is easy simply to allow the employee to take their accumulated funds with them when they change jobs;
- **Immediate Vesting.** In a pure DC plan, the employer’s contributions to the individual account become the full property of the employee upon payment. As a result, the employee enjoys immediate vesting of employer retirement contributions;
- **Personal Control.** In a DC plan, the retirement funds for each employee are under the control of the employee in their own individual account. Employees can consequently adopt the investment strategies and benefit plans that best suit their own individual needs and preferences. As a result, they may end up with higher benefits than under a traditional DB plan;
- **Tax advantages.** As a qualified retirement plan, benefits are taxed only upon distribution; and
- **Builds Retirement Security.** DC plans help the employee build their own retirement security. By using payroll deductions, a DC plan is an easy way for employees to save for retirement, especially if the employer is matching contributions.

**For the employer:**

- **No investment risk.** The most obvious advantage for the employer who sponsors a DC plan is that it eliminates investment risk for them;
- **No unfunded liability.** The DC plan also eliminates the danger of any unfunded liability that must be covered by the employer;
- **Known Cost of the DC plan.** DC plans give employers a known cost to fund the plan;
- **Tax advantages.** Like other qualified retirement plans, employer contributions (within limits) are deductible from current federal income taxation; and
• *Improved Employee Recruitment.* Finally, because of the advantages to employees noted above, DC plans can help employees attract better employees.

**DC Disadvantages**

DC plans are not without disadvantage to the employees:

• *Employee bears investment risk.* Individuals’ lack of expertise in making investment decisions can subject individual accounts to extremely unbalanced portfolios with too little or too much invested in one particular asset, such as stocks, bonds or cash;

• *Running out of Money.* Because there is no guarantee of regular payments for life after retirement, employees who do not save enough in their DC plan or who do not invest it wisely run the risk of running out of funds; and

• *Smaller Benefit for Older Employees.* Older employees may receive less benefit than under a DB plan; Per dollar of benefits paid, a DC plan is more expensive to operate than a DB plan

Employer disadvantages of sponsoring a DC Plan:

• *Limitation on Deductions.* Employers are limited to the amount of their deductions under IRC § 415 (discussed below); and

• *Take time and resources to manage.* DC plans take time and resources which can be used in other important areas of growing the business.

**DC Contribution Limits**

Under IRC §415(c)(1)(A) it provides the maximum “annual additions” that can be allocated to an individual’s account in a DC plan (profit sharing, 401(k), etc.). Annual additions include:

• Employer contributions;

• Employee contributions (deductible or after-tax); and

• Forfeitures allocated to the participant’s account.

The annual additions limit is the lesser of:

• 100% of a participant’s compensation; or

• A specified dollar amount—for limitation years ending in 2017 ($1,000 increase from 2016), the dollar limit is $54,000.
Vesting for DC Plans

The PPA of 2006 enacted faster vesting rules for employer contributions to DC plans other than certain employee stock ownership plans (ESOPs). Effective for plan years beginning in 2007 and thereafter, a qualified DC plan must provide for a participant to become vested in employer contributions made in plan years after December 31, 2006, over a schedule that does not exceed one of the following two alternatives.

Three-Year Cliff vesting

After the completion of three years of service, the participant is fully vested in his or her account. Should the employee terminate service with the employer prior to the completion of three years of service, the employee would not be entitled to any portion of the plan account attributable to employer contributions other than IRC § 401(k) contributions that are 100% vested.

Two-to Six-Year Graded Vesting

After the completion of two years of service, the participant becomes 20% vested in his or her employer contributions. For each additional year of service after three years, an increase in vesting must occur at a rate of at least 20% per year. The participant is fully vested at the end of six years of service.

Note: Alternative vesting schedules can be used as long as those schedules are as favorable to employees as the two schedules described above.

Employer Matching Contributions.

As under prior law, if the employer matches employee (or employee elective) contributions, the vesting schedules for employer matching contributions may not exceed a two- to six-year graded vesting schedule, or three-year cliff vesting. The PPA of 2006 did not modify the vesting rules for employer matching contributions, nor did it modify the top-heavy vesting rules.

Dual Vesting Schedules

Because the faster vesting schedules enacted by PPA 2006 apply to employer contributions (other than employer matching contributions that were already subject to faster vesting requirements) made in plan years after December 31, 2006, a plan may choose to vest employer contributions made for plan years prior to 2007 (“old money”) according to the prior law slower vesting schedule used for employer contributions; e.g., five-year cliff vesting or three- to seven-year-graded vesting. The simultaneous use of a prior law vesting schedule (or old vesting schedule) for old money and a new vesting schedule for contributions made after a certain date (plan years after December 31, 2006) is known as “dual vesting.” Although dual vesting might achieve a cost savings for an
employer that maintains a large plan, the cost associated with additional recordkeeping and administration would probably make this impractical for a small plan.

The IRS refers to dual vesting as “bifurcated vesting” (see IRS Notice 2007-7). This notice provides additional guidance concerning the requirements for dual vesting. Among other things, a qualified plan must separately account for contributions made before and after December 31, 2006, and give a participant with at least three years of service the right to elect to have the pre-amendment vesting schedule apply.

Note: The top-heavy vesting rules apply to all employer contributions held in a participant’s DC plan account (or all of a DB plan participant’s accrued benefits), including those made in plan years prior to 2007. Therefore, a top-heavy DC plan (or DB plan) is not permitted to maintain dual vesting schedules.

Top-Heavy Plan Rules

The top-heavy plan rules were added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). To be qualified under IRC § 401(a), a plan must contain provisions which meet the requirements of IRC § 416 and which will become effective if the plan becomes top-heavy [IRC § 401(a)(10(B)].

General Requirements

A DC plan is top-heavy if, as of the determination date, the total of the accounts of the key employees under the plan exceeds 60% of the total of the accounts of all employees under the plan. A top-heavy DC plan must provide a minimum contribution.

A top-heavy plan must also provide a special vesting schedule:

- 3-year 100% vesting schedule; or
- 6-year graded vesting schedule [IRC § 416(b)].

Plans covering few employees are more likely to be top-heavy than plans covering a large number of employees. For example:

- If key employees make up a substantial percentage of the workforce, it is more likely the plan will become top-heavy.
- Plans of larger employers can also be top-heavy where the employer maintains separate plans for its divisions. If the smaller division employs a large number of highly-paid employees who are key employees, their plans may be top-heavy.

Even if a plan passes a nondiscrimination test of IRC § 401(a)(4), it must be examined for top-heaviness. Accrual or allocation rates under a plan can be nondiscriminatory, but the total amount of the allocations in the key employees’ accounts (or their benefit
accruals) could cause them to have too large a share of the plan assets and result in a top-heavy plan.

A top-heavy plan does not include a SIMPLE IRA under IRC § 408(p). Also, a SIMPLE IRA would not be included if it meets the plan requirements of IRC § 401(k)(11) and permits no contribution other than those required by IRC § 401(k)(11) [IRC § 401(k)(11)(D)(ii)].

And, a top-heavy plan does not include a plan for any year that it meets the “safe harbor” requirements under IRC § 401(k)(12) for minimum contributions for participants and makes matching contributions that meet IRC § 401(m)(11) [IRC § 416(g)(4)(H)].

Key Employee

The general rules which apply to a key employee are as follows:

- Any employee who at any time during the plan year containing the determination date (the determination date year) is an officer who meets a compensation threshold, a 5% owner of the employer, or a 1% owner of the employer who meets a compensation threshold [IRC 416(i)];
- Compensation includes elective deferrals under a qualified cash or deferred arrangement (CODA) and other elective deferrals under IRC 402(g)(3), as well as any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of IRC §§ 125, 132(f)(4) or IRC § 457 [IRC § 416(i)(1)(D)]; and
- The compensation received from each employer is aggregated under IRC 414(b), (c) and (m) to determine who is a key employee [Reg. 1.416–1, T–20].

Officer Defined

The general rules which apply to an officer are as follows:

- An officer of the employer having annual compensation in excess of $170,000 (adjusted under IRC § 416(i)(1)) is a key employee [IRC § 416(i)(1)(A) and Reg. 1.416–1, T–12];
- An officer is determined based on the source of the officer’s authority, the term for which elected or appointed, and the nature and extent of the duties. If an employee has the title of an officer but not the authority, that employee is not an officer for purposes of determining who is a key employee. An employee who does not have the title of an officer but who has the authority of an officer is an officer for key employee purposes [Reg. 1.416–1, T–13].
- Officers (see Reg. 1.416–1, T–15) are in:
  - Corporations;
  - Sole proprietorships;
  - Partnerships;
  - Trusts;
o Labor organizations; and
o Associations

- For purposes of determining the number of officers taken into account, employees described in IRC § 414(q)(5) are excluded [IRC § 416(i)(1)(A) and IRC § 414(q)(5)]; and
- There is no minimum number of officers that may be taken into account. The maximum number of employees who can be treated as officers for purposes of counting as key employees is 50, or, if lesser, the greater of 3, or 10% of the employees. If there are more than 50 officers who meet these requirements, select the 50 officers who had the largest annual compensation during the year of the determination date [IRC § 416(i)(1) and Reg. 1.416–1, T–14].

Five Percent Owner Defined

An employee who is a 5% owner of the employer at any time during the determination date year is a key employee (without regard to compensation). A 5% owner of a corporation is any person who owns more than 5% of the outstanding stock of a corporation or stock possessing more than 5% of the total combined voting power of all stock of the corporation. Use the constructive ownership rules of IRC § 318 to help determine the 5% owner. In determining who is a 5% owner, ownership is determined without aggregating any employers under IRC § 414(b), (c) or (m).

One Percent Owner Defined

An employee who is a 1% owner of the employer at any time during the determination year and whose compensation exceeds $150,000 for the determination date year is a key employee [IRC § 416(i)(1)(A)(iii)]. Use the constructive ownership rules of IRC § 318 to help determine the 1% owner. In determining who is a 1% owner, ownership is determined without aggregating any employers under IRC § 414(b), (c) or (m).

Top-Heavy Minimum Contributions

If a DC plan is top-heavy, the employer must make a contribution to each non-key employee’s account who is a plan participant equal to at least 3% of the participant’s compensation.

Forfeitures allocated to a participant’s account are included in determining whether a 3% minimum contribution has been made, but elective contributions are not. Matching contributions under IRC § 401(m)(4)(A) are taken into account for years after 12/31/01. The 3% minimum contribution requirement is reduced if the largest percentage contribution made on behalf of a key employee for the plan year is less than 3%.

The minimum contribution cannot be reduced due to social security contributions. If the required aggregation group includes a DC plan and a DB plan aggregated to meet the requirements of IRC § 401(a)(4) or 410, then a 3% minimum contribution is generally
required in the DC plan even if the highest contribution rate for a key employee is less than 3%. (See IRC § 416(c)(2) and Reg. 1.416–1, M–7.)

**Example:** Plan A is a top-heavy plan. The largest percentage contribution made on behalf of a key employee during the 2017 plan year is to Employee M. Employee M’s compensation is $273,000. The employer makes a contribution of $10,800 to Employee M. Because Employee M’s compensation is limited to $270,000 for contribution purposes by IRC § 401(a)(17), the percentage contribution made on behalf of Employee M is 4% (10,800 ÷ 270,000 = 4%). Each non-key employee must receive a contribution equal to 3% of compensation.

**Example:** The facts are the same as in the example above, except that the employer makes a contribution of $4,000 to Employee M in 2017. The percentage contribution made on behalf of Employee M is 2% (5,400 ÷ 270,000 = 2%). Each non-key employee must receive a contribution equal to 2% of compensation.

If the employer maintains only one DC plan, each non-key employee covered by the plan must receive the DC minimum. If the employer maintains more than one DC plan and a non-key employee participates in more than one, then only one DC plan has to provide a minimum contribution for the employee [Regs. 1.416–1, T–10, M–8 and M–12].

**Aggregation of Plans**

To determine whether a plan is top-heavy, it must be aggregated with certain other plans of the employer. This type of aggregation known as the “required aggregation group.” Under certain circumstances, an employer may use “permissive aggregation” to aggregate plans not part of a required aggregation group [IRC § 416(g)(2)].

**Required Aggregation Group**

The "required aggregation group" is defined in IRC § 416(g)(2)(A)(i). It consists of each plan of the employer in which a key employee participates during the determination date year (or participated in during any of the four preceding years), and any other plan of the employer which, during this period, is aggregated with a plan in which a key employee participates to meet the non-discrimination requirements of IRC § 401(a)(4) or IRC § 410.

If the required aggregation group is top-heavy, each plan in the required aggregation group is top-heavy, even if it would not be top-heavy if tested independently, or if it covered no key employees. Similarly, if the required aggregation group is not top-heavy, no plan in the required aggregation group is top-heavy.

All plans in a required aggregation group that are top-heavy must satisfy the vesting requirements of IRC § 416(b) and the minimum benefits requirements of IRC § 416(c). [Reg. 1.416–1, T–10].
Only one DC plan need satisfy the minimum contribution requirements for any non-key employee who participates in more than one DC plan in the required aggregation group [Reg. 1.416–1, M–8 and T–10].

**Permissive Aggregation Group**

An employer may also aggregate plans that are not part of a required aggregation group with plans in a required aggregation group, to create a permissive aggregation group, as long as the permissive aggregation group satisfies IRC § 401(a)(4) and IRC § 410 [IRC 416(g)(2)(A)(ii)].

If a permissive aggregation group is not top-heavy, none of the plans are top-heavy. If a permissive aggregation group is top-heavy, then the top-heavy requirements apply only to those plans in the required aggregation group [IRC§ 416(g)(2) and Regs. 1.416–1, T-1(b) and (c), T-6, T-7, and T-9–11].

**Example:** An employer maintains Plan A which covers key employees as well as other employees and independently satisfies the requirements of IRC § 401(a)(4) and 410. Assume that Plan A is top-heavy when tested on its own. The employer also maintains Plan B. Plan B has no key employees. Plan B is not top-heavy. The employer may permissively aggregate these plans in testing for top-heaviness provided the permissive aggregation group satisfies IRC § 401(a)(4) and IRC § 410.

**ERISA § 404(c)**

ERISA § 404(c) of the Employee Retirement Security Act of 1974 (ERISA) defines the responsibilities of plan fiduciaries. Fiduciaries that control plan investments are subject to specific statutory standards of conduct such as acting in a prudent manner and being required to diversify investments. Plan fiduciaries may be personally liable for plan losses resulting from a breach of these standards. ERISA § 404 (c) provides that where participants exercise control over assets in their own account and other requirements are met (discussed below), the participant is not considered a plan fiduciary. In addition, if the requirements of ERISA § 404 (c) are met, other Plan fiduciaries, such as plan trustee, or plan administrators, will be relieved of liability for investment decisions made by participants. Even after electing ERISA § 404 (c) coverage, the fiduciary should adopt an investment policy (discussed below).

**Types of Plans Covered Under ERISA 404(c)**

ERISA Section 404 (c) applies to any plan giving certain investment information, investment choices and the ability to direct the investment assets in the account of ERISA-governed plans include defined contribution plans, such as 401(k), profit sharing, money purchase and other plans (including 403(b)), qualified under IRC § 401(a).
Note: Choosing not to comply with ERISA Section 404 (c) does not automatically cause a plan to violate ERISA. Rather, plan fiduciaries might be responsible under ERISA for participant’s decisions regarding investment options. This means that the plan fiduciary can be held responsible for participant’s imprudent investment selection. This may be true even if the participant had requested the fiduciary to make that particular investment.

**ERISA § 404(c) Protection**

As mentioned above, ERISA Section 404 (c) protection is only available for plans that permit participants to direct the investments. If a participant actually directs the investments (and if the plan provides the participant with appropriate investment options); the plan document then will provide participants with reasonable opportunity to give investment instructions (and to obtain written confirmation of those instructions) and certain other information. The participant will be legally responsible for his or her investment decisions. However, if those requirements are not met, the fiduciaries remain responsible.

To qualify for Section 404(c) relief, there are a number of requirements that must be met including:

- **Offer a broad range of diversified investments.** A plan will meet Section 404(c) guidelines if participants can choose from at least three diversified investment alternatives, each of which offers significantly different risk and return characteristics. In the aggregate, the investments offered should enable the participant to achieve a portfolio with appropriate risk-and-return characteristics. The investment options should tend to minimize through diversification the overall risk of the participant’s portfolio. These investment options are commonly referred to as “core” investments;

- **Allow participants to transfer among investment options.** Participants must be able to transfer between investments at least quarterly, or within a timeframe deemed appropriate based on the market volatility of the investments that are offered. The more volatile the investment option, the greater the need for more frequent transfers to enable participants to maintain appropriate control over their account. With today’s investment products, like mutual funds, these requirements are usually easily satisfied, with trading permitted on any day in which the major securities markets are open.

- **Provide participants with adequate information about their investment options.** Section 404(c) requires that each participant receive the following information:
  - An explanation that the plan intends to comply with the Section 404(c) requirements and that, as a result, the plan fiduciary may be relieved of liability for losses resulting from investment directions of the participants;
  - A description of the plan’s investment options, including a general description of the investment objectives and the risk and return characteristics of each investment option;
  - Identification of any investment managers for the plan;
o An explanation of how participants can give investment instructions including an explanation of any limits or restrictions on making purchases or sales in their account;
o A description of any transactions or other expenses charged to participants’ accounts;
o A description of any transaction or other expenses charged to participants’ accounts;
o A description of additional information that must be provided to participants upon request and the contact information of the individual responsible for providing that information; and
o For registered investments (like mutual funds) a copy of the most recent prospectus provided to the plan. The prospectus must be given to a participant immediately preceding or following the participant’s initial investment in an option.

Additional information that must be provided to participants upon request (or can be provided automatically by the plan sponsor):

- A description of the annual operating expenses of each investment option;
- Copies of any prospectuses, financial statements, reports, and other information relating to an investment alternative received by the plan;
- A list of the securities and value of each asset held by each investment option that constitutes plan assets;
- Past and current investment performance of the various investment options; and
- Information about the value of shares in the investment options in the participant’s account.

Note that there are additional requirements for plans offering employer stock or fixed rate investment contracts and plans that pass through voting rights.

The benefit of compliance with ERISA Section 404(c) results in plan fiduciaries not being liable “for any loss, or by reason of any breach, which results from such participant’s exercise of control”.

**Investment Policy**

The increasing emphasis on plan investment issues by the Department of Labor (DOL) increases the need for a written investment policy. ERISA Section 402(b)(1) requires that retirement plan provide a “procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan.” A formal investment policy identifies the investment goals and objectives of the plan, sets the decision-making process for structuring the overall make-up of the portfolio and selecting investments, and specifies the measuring tools for ongoing performance assessment. The investment policy should focus on how investment decisions are made, rather than the specific investments. The combination of meeting the guidance of ERISA Section 404 (c) along
with the adoption of an investment policy provides the employer with the most protection.

**ERISA Section 408(b)(2)**

A primary responsibility of a fiduciary is to run the plan solely in the interest of its participants and their beneficiaries. A fiduciary must administer a plan for the exclusive purpose of providing benefits and paying plan expenses. This includes ensuring that the plan pays only “reasonable” expenses for administering the plan and investing its assets. In the past, there was little guidance on how fiduciaries should determine if fees were reasonable.

On July 15, 2010, the DOL issued an interim final regulation under ERISA § 408(b)(2) in an effort to assist fiduciaries of “covered plans” in determining the reasonableness of fees. The regulation was deemed an interim final regulation due to the potential for revisions. Because the regulation contained substantial changes from the proposed regulation published in 2007, the DOL requested additional comments. The DOL considered those comments in drafting the final regulation, which was released on February 1, 2012.

The regulation became effective July 1, 2012, and applies to existing service arrangements as well as service arrangements entered into on or after that date. Accordingly, for those service arrangements in place on the effective date, the required disclosures were to be made by July 1, 2012.

**Service Provider Fee Disclosure**

The final regulation provides:

“No contract or arrangement for services between a ‘covered plan’ and a ‘covered service provider,’ nor any extension or renewal, is reasonable within the meaning of section 408(b)(2) unless certain disclosures are made to the responsible plan fiduciary.”

“Covered plans” include DC and DB tax-qualified retirement plans subject to ERISA. The regulation does not include SEP IRAs, SIMPLE IRAs, IRAs or any other non-ERISA tax-qualified plan, such as an Individual (Solo) 401(k) plan.

A “covered service provider” is a person or entity that enters into a contract or arrangement with a “covered plan,” and reasonably expects to receive $1,000 or more in direct or indirect compensation during the term of the arrangement.
“Covered Service Provider” Categories

There are three categories of services that cause a service provider to be considered a “covered service provider.” They are:

- Fiduciary services, including:
  - Services provided directly to a plan as a fiduciary under ERISA § 3(21);
  - Services provided directly to a plan as an investment advisor registered under either the Investment Advisers Act of 1940 or under state law (this includes services provided by Registered Investment Advisors, who are not automatically fiduciaries under ERISA, but are fiduciaries under securities law); and
  - Services provided as provided as an ERISA fiduciary to an investment contract, product or entity that holds plan assets and in which the plan has a direct equity investment.

- Recordkeeping services or brokerage services, but only when such services are provided to a participant-directed individual account plan, and when the plan makes one or more designated investment alternatives available; and

- Third, other services for which the provider receives indirect service provider need only report changes in investment-compensation, including, but not limited to:
  - Consulting services; and
  - Third-Party Administrator (TPA) services.

Required Disclosures

Under the regulation, written disclosures must be provided to the plan for the following:

- **Services** – a description of the Covered Service Provider’s services that will be provided to the plan;
- **Status** – if applicable, a statement describing services to the plan as an ERISA fiduciary and/or services to the plan as an investment advisor;
- **Compensation** – the service provider must describe all compensation it expects to receive, including:
  - Direct compensation;
  - Indirect compensation;
  - Compensation paid among related; and
  - Compensation for termination of the arrangement.
- **Investment Disclosure** – for certain fiduciary services or recordkeeping and brokerage services:
  - Compensation that may be directly charged against assets, such as sales loads or redemption fees;
  - Annual operating expenses, if the investment returns are not fixed
  - Ongoing expenses, such as wrap, mortality or expense fees;
- **Recordkeeping Services** – compensation associated with recordkeeping services or, in certain cases, an estimate of cost for recordkeeping services. Any offsets in
compensation due to other sources of revenue, such as revenue sharing, must be included; and

- **Manner of Receipt** – a description of how compensation will be received such as billed or deducted from plan assets.

### Timing of Disclosure Requirements

- **Initial disclosure requirements.** The information listed above must be provided “reasonably in advance” of the date of the arrangement. While the timing is not clear, it would be prudent to provide notices so the responsible plan fiduciary has a realistic opportunity to review the materials in advance and seek advice, as needed;
- **Changes.** A service provider must report changes in its disclosures as soon as practical, but not later than 60 days from the date the service provider is aware of the changes. However, a service provider need only report changes in investment-related information annually;
- **Existing clients.** In addition to the initial disclosure requirements for new clients, service provider service providers also must provide existing clients with the information outlined above; and
- **Ongoing disclosure requirements.** Following the initial disclosures, service providers must provide information within 30 days following receipt of a written request.

The burden of proof for providing appropriate disclosure rests with the service provider.

### Format of Disclosures

Service providers may select the manner and format of the disclosure, as long as it meets the regulatory time frames. However, the DOL strongly suggested that service providers provide a guide. A sample guide was provided that may, but is not required to be used.

### Life Insurance in a DC Plan

As was discussed in previous chapters, the “Code” requires that the primary purpose of a QRP be to provide retirement benefits. Thus, death or disability benefits provided through insurance or otherwise must be “incidental” to the retirement benefits provided under the plan [Rev. Rul. 81-275].

### Incidental Benefit Rule

The “*incidental death benefit rule,*” has been refined over time through a number of revenue rulings to mean the following:
First, the premiums paid by the QRP must not exceed certain limitations, which differ depending on both the type of life insurance contract and the type of qualified plan (DC vs. DB); and

Second, the policy must be converted to cash or distributed to the participant at or before retirement.

For life insurance in a DC plan—the most likely scenario involves the purchase of life insurance in a self-directed account in a profit sharing or 401(k) plan. Here are the basics:

- For term and universal life insurance, the aggregate total premiums paid must be 25 percent or less of the aggregate employer contributions and forfeitures allocated to the account over time; and
- For whole life insurance, the aggregate total premiums paid must be less than 50 percent of the aggregate employer contributions and forfeitures.

Keep in mind that there is an exception for “seasoned money.” For profit-sharing plans, the incidental death benefit rule does not apply to contributions which have accumulated for at least two years in the plan or when the participant has participated in the plan for at least five years. The benefit of the exception is that a client who has been contributing to a profit sharing plan for some time can tap the seasoned money to buy life insurance without regard to the 25 percent or 50 percent limitation.

**Prior to Retirement**

Within the limits generally applicable to deductibility of contributions to QRPs, premiums for plan owned life insurance are deductible, making the purchase of life insurance much more affordable in a plan than outside of a plan.

For DC plans, employer contributions are limited to 25 percent of covered compensation of all employees eligible to participate in the plan. Employee contributions are subject to an individual limit of 100 percent of compensation, which is limited to $270,000 (2017 as indexed), and not to exceed $54,000 (2017 as indexed) in any given year.

Although the portion of the employer’s contribution attributable to life insurance is deductible to the company, the insured is required to include in income the value of the pure insurance protection received each year, measured by multiplying the death benefit under the policy by the applicable one-year term rate [IRC § 72(m)(3)(B) Reg. 1.72-16(b)]. The tax is imposed on the lesser of the so-called “PS 58 Cost” as determined by published IRS Tables [Rev Rul. 55-747, 1955-2 CB 228], or the life insurance company’s one year term rates [Rev. Rul. 66-10].

**At Retirement**

Upon retirement, the client has several options;
• **Option 1**—Direct the plan trustee to distribute the policy to him or her. The policy value (essentially its cash value) is included in income but the client can reduce the taxable amount by his or her policy basis (the aggregate amount of annual term insurance costs included in income prior to retirement). Thus, if the policy’s cash value is $100,000 and the client’s basis is $5,000, the client must include $95,000 in income in the year of retirement. Unfortunately, the tax hit cannot be avoided by rolling the policy over to an IRA, because IRAs are prohibited from owning life insurance. However, the tax on the $95,000, even in a 39.6 percent bracket can be a small amount to pay for the life insurance if the client has an ongoing need for it for any of the reasons mentioned above. Also, keep in mind that the client may be able to offset some or all of the tax hit by borrowing or withdrawing cash from the policy;

• **Option 2**—Direct the plan trustee to surrender the policy and distribute the cash value along with other funds in the account as a lump sum. Because the policy no longer exists following surrender, immediate tax on the distribution can be avoided by rolling over the distributed funds to an IRA; or

• **Option 3**—Purchase the policy from the trustee. This requires the client to come up with the value of the policy out of pocket, but again this may be a small price to pay if the client needs the insurance and/or is uninsurable due to health problems. One way to reduce the client’s outlay is to have the trustee borrow from the policy to reduce its value. One concern with purchasing the policy from the plan is that the purchase could be construed as a prohibited transaction if the client is an owner or executive of the company. Fortunately, a prohibited transaction exemption (PTE) is available so long as the client files the appropriate paperwork.

Let’s say the client acquires the policy by purchase or via distribution. To avoid inclusion of the policy death proceeds in his or her estate it will be necessary for the client to transfer ownership of the policy to a third party, for example a child or irrevocable life insurance trust, and live three years following the transfer. Also, the insured’s estate cannot be a beneficiary of the policy.

**Death of the Insured**

If the participant/insured dies prior to retirement, the death benefit of the life insurance along with the other account will be paid to the named beneficiary. This is where the greatest downside associated with life insurance in a DC plan (or DB plan for that matter) surfaces. The death benefit in excess of cash value is income tax free, but the amount attributable to the cash value less the participant/insured’s basis in the contract is taxable income to the beneficiary. Contrast this to the situation where the insured owned the life insurance personally: the death benefit would have been entirely income tax free. Again, some clients may consider this a relatively small cost to pay for life insurance purchased with tax-deductible dollars.

From an estate tax perspective, the death benefit paid under the plan including the life insurance will be included in the decedent’s estate if the decedent-insured possessed any
incidents of ownership in the policy [Rev. Rul. 82-199]. However, if the surviving spouse is the beneficiary, the amount passing to him or her should qualify for the estate tax marital deduction.

**Bottom Line**

Life insurance in a DC plan is not for everyone, but for those clients (especially small business owners) needing large amounts of life insurance the cost can be made more affordable with tax deductible dollars.
Chapter 9
Review Questions

1. A defined contribution (DC) plan is a qualified retirement plan that is governed under which Section of the Internal Revenue Code (IRC)?
   (   ) A. IRC Section 401(a)
   (   ) B. IRC § 457
   (   ) C. IRC § 408A
   (   ) D. IRC § 408

2. A DC plan is top-heavy if, the total of the accounts of the key employees under the plan exceeds what percent of the total of the accounts of all employees under the plan?
   (   ) A. 25%
   (   ) B. 50%
   (   ) C. 80%
   (   ) D. 60%

3. If a DC plan is top-heavy, the employer must make a contribution to each non-key employees’ account who is a plan participant equal to at least what percent of the participant’s compensation?
   (   ) A. 5%
   (   ) B. 3%
   (   ) C. 7%
   (   ) D. 2%

4. Which Section of ERISA defines the responsibilities of plan fiduciaries?
   (   ) A. ERISA Section 408(g)(1)
   (   ) B. ERISA Section 408(b)(2)
   (   ) C. ERISA Section 404(c)
   (   ) D. ERISA Section 601(a)(2)

5. For term and universal life insurance, the aggregate total premiums paid must be what percent (or less) of the aggregate employer contributions and forfeitures allocated to the account over time.
   (   ) A. 50%
   (   ) B. 60%
   (   ) C. 70%
   (   ) D. 25%
CHAPTER 10

DC PLANS FOR SMALL BUSINESSES

Overview

DC plans encompass a broad range of programs under IRC Section 401(a). However, in this chapter we will review only the types of DC plans that may be selected by a small business owner.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The rules and requirements for setting up a Profit Sharing plan;
- Identifying the various types of Profit sharing plans;
- The rules and requirements of a Money Purchase plan;
- The rules and requirements of a Target Benefit plan; and
- The rules and requirements of a 401(k) and/or CODA plan.

Profit Sharing (PS) Plans

A profit sharing (PS) plan is a qualified employer DC plan featuring a flexible employer contribution provision. These contributions can be discretionary and may be zero in some years. Or they can be tied to a plan formula. In most cases, this formula is tied to the employer’s annual profits. The employer will set up an individual account for each participant.

PS plans are the oldest type of DC plan, dating back to the mid-1800’s when employer’s established them not as an retirement plan, but as current PS (cash) plans that paid a portion of company profits directly to employees.

PS Plan Advantages

PS plans have distinct advantages for both the employees and employers. Here are some of those advantages to the employees:

- The PS plan is a direct reward for the employees to share in the rising fortunes of the business. These can be very significant. Additional income for the employee may to a comfortable lifestyle;
• Contributions to the plan are not taxable as current income and accumulate on a tax-deferred basis;
• Employee can identify with the company. He/she will feel part of it;
• PS plans can be designed to allow for in-service distributions as long as the funds are in the employee’s account for a minimum of two years, or the employee has five years of service; and
• A PS plan may also allow employees to take their benefits with them when they leave the company.

For employers:

• A well-designed PS plan can help attract and retain talented employees;
• Contributions to a PS plan are discretionary. The employer can choose when and how much to contribute;
• A PS plan is a type of plan that gives employers flexibility designing the key features;
• A PS plan builds loyalty to the company;
• A PS plan promotes healthy employer-employee relations.
• No investment risk to the employer;
• PS plan contributions are deductible from current taxable income; and
• A PS plan is relatively easy and inexpensive to establish and administer.

**PS Plan Disadvantages**

For employees:

• There is no predictable level of employer funding under the plan;
• Retirement benefits cannot be determined in advance. This is because:
  o the employer contribution will vary from year to year, and
  o accumulation of account assets will depend upon investment results. This lack of certainty makes retirement planning very difficult for the employee.
• The focus may be on profit rather than on quality;
• All employees move up equally; and
• No distinction between efficient and inefficient. This discourages and demoralizes the efficient worker.

For employers:

• Employer may have to share their profit with workers; and
• For certain employers, the amount of deductible employer contributions allowed is considerably less than that permitted under a DB plan.
Establishing a Profit Sharing Plan

There are four initial steps for setting up a PS plan:

- **Adopt a Written Plan Document.** Plans begin with a written document that serves as the foundation for day-to-day plan operations. A PS allows the employer to decide (within limits) from year to year whether to contribute on behalf of participants. If the employer does make contributions, they will need to have a set formula to determine how the contributions are divided. This money is accounted for separately for each employee. Employer contributions to the plan can be subject to a vesting schedule (discussed below). Annual testing ensures that benefits for rank-and-file employees are proportional to benefits for owners/managers. Once an employer decides on a PS plan for the company, the employer will have flexibility in choosing some of the plan's features – such as when and which employees can participate in the plan. Other features written into the plan are required by law. For instance, the plan document must describe how certain key functions are carried out, such as how contributions are deposited in the plan. Unless the PS plan includes a 401(k) cash or deferred feature, a PS plan does not usually allow employees to contribute. A PS plan is for employers of any size;

- **Set Up Trust Fund for Plan Assets.** A plan's assets must be held in trust to assure that assets are used solely to benefit the participants and their beneficiaries. The trust must have at least one trustee to handle contributions, plan investments, and distributions. Since the financial integrity of the plan depends on the trustee, selecting a trustee is one of the most important decisions the employer will make in establishing a PS plan. **Note:** If the employer sets up the PS plan through insurance contracts, the contracts do not need to be held in trust;

- **Develop a Recordkeeping System.** An accurate recordkeeping system will track and properly attribute contributions, earnings and losses, plan investments, expenses, and benefit distributions. If a contract administrator or financial institution assists in managing the plan, that entity typically will help keep the required records. In addition, a recordkeeping system will help the employer, the plan administrator, or financial provider prepare the plan's annual return/report that must be filed with the Federal Government; and

- **Provide Plan Information to Employees Eligible to Participate.** The employer must notify employees who are eligible to participate in the plan about certain benefits, rights, and features. In addition, a summary plan description (SPD) must be provided to all participants. The SPD is the primary vehicle to inform participants and beneficiaries about the plan and how it operates. The SPD typically is created with the plan document.

Operating a PS Plan

Once the employer has established a profit sharing plan, the employer assumes certain responsibilities in operating the plan. If the employer has hired someone to help in setting up their plan, that arrangement also may have included help in operating the plan. If not,
another important decision will be whether the employer manages the plan or to hire a professional or financial institution – such as a bank, financial services firm, mutual fund provider, or insurance company – to take care of some or most aspects of operating the plan.

Certain elements of operating PS plans include:

- Participation;
- Contributions;
- Vesting; and
- Nondiscrimination

**Participation**

Typically, a plan includes a mix of rank-and-file employees and owners/managers. However, a plan may exclude some employees from a PS plan if they:

- Have not attained age 21;
- Have not completed a year of service (2 years in certain plans); or
- Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good faith bargaining.

Employees cannot be excluded from a plan merely because they are older workers.

**Contribution Limits**

Contributions can range from nothing in some years up to 25% of eligible payroll (IRC § 404). Under IRC § 415, the maximum annual addition to a participant’s account can be 25% of pay not to exceed the lesser of:

- 100% of compensation, or
- $54,000 in 2017 (was $53,000 in 2016).

The maximum salary that can be used for these calculations, for individual participants, for 2017 is $270,000 [IRC § 401(a)(17)]. There is no minimum number of employees required to sponsor a PS plan. Plans generally cover all employees that have worked for the employer for a year. However, plans can be designed to cover certain employer groups and not others.

The employer will then make flexible contributions to those accounts. The amount of contribution can be either a purely discretionary amount (or nothing at all, if the employer wishes) or can be based on some type of formula, usually relating to the employer’s annual profits. Contributions must be made in accordance to a nondiscriminatory allocation formula (discussed below).
Contribution Formulas

There are five contribution formulas for PS plans. They are:

- **Flat Formula.** A plan sponsor who uses a flat dollar contribution formula in its PS plan must contribute the same dollar amount to each eligible employee. This is known as the “Traditional Profit Sharing Plan” and is the most common.

- **Pro Rata.** This allocation formula provides each eligible participant with a contribution based on the ratio (percentage) of each of employee’s eligible compensation to the eligible compensation of all eligible participants;

- **Integrated.** A variation of the standard PS plan, also known as “Social Security-based” or “permitted disparity” plans, is to integrate the plan’s allocation formula based upon the social security taxable wage base (TWB), currently $127,200 in 2017, or some other compensation level. All employees earning less than this integration amount receive a base pro rata allocation, while those earning more than the taxable wage base are eligible to receive an additional allocation (potentially as much as 5.7% of the excess compensation). The rationale for the permissibility of this additional contribution is that such employees do not have the benefit (if you want to call it that) of the employer’s social security contribution portion on their excess compensation, so the employer is permitted to pay that amount into the plan under the integrated PS formula. The employer, however, must meet the “permitted disparity rules” of IRC § 401(1);

- **“Age Weighted” Profit Sharing Plans.** An age-weighted contribution allocation formula in a DC PS plan generally allows higher contribution levels (as a percentage of compensation) for older plan participants. That is, the formula for annual employer contributions or allocations to participant accounts is based on the participant’s compensation but also on the participant’s age on entering the plan. The salient feature of the age-weighted PS plan is the ability to skew the contribution allocation toward the older participants while retaining all the other desirable features of PS plans. This will enable greater retirement benefits for those closest to retirement. In addition, with an age-weighted formula, the employer’s plan contributions tend to be weighted toward owners and key employees since in many small businesses these employees will be older than rank-and-file employees when the plan is adopted. In addition, an age-weighted (actuarial) formula for allocating employer contributions will automatically pass the cross-testing requirements since all participants will (by design) have the same projected benefit as a percentage of compensation. Use of a formula thus reduces the complexity of the plan and the costs of compliance, since periodic cross-testing is not required; and

- **“Cross-Tested” Plans.** The most common type of plan using the age-weighting is the "cross tested" plan, also known as a “new comparability” plan. A cross-tested plan does not use a fixed age-weighted formula as such. Instead, the plan is designed to provide maximum benefits to HCEs, and benefits for other NHCE are designed to provide whatever is required by non-discrimination regulations under IRC § 401(a)(4). In a cross-tested plan, the employer selects and contributes a percentage of each owner's pay (either the same percentage for all owners or a
different percentage for each owner) and the employer also selects and contributes a percentage of each staff employee's pay. For most small business plans, this minimum allocation would be 5% (generally, the same percentage for all NHCE, this is known as the “gateway” requirement). Then current contributions are converted to projected benefits (using an interest rate between 7 ½ percent to 8 ½ percent) at retirement age and these benefits are then tested according to IRS nondiscrimination rules for benefits.

Note: The maximum 8 ½ interest rate would provide the best result for the HCE. If the IRS rules are not satisfied when contributions are tested as benefits, then the employer would have to contribute more for staff employees and/or less for one or more owners. The respective contribution percentages are flexible and may be adjusted from one year to the next. Generally, a "cross tested" plan will work best when the average age of the owners is at least 5 years more than the average age of the staff employees. One significant disadvantage of a cross-tested plan formula, when compared with an age-weighted plan (discussed above), is that additional employer contributions are required to provide increased benefits for the favored group of key employees.

**PS Plan Vesting**

In PS plans, the employer can design the plan so that employer contributions become vested (non-forfeitable) over time, according to a vesting schedule (similar to all qualified plans). The PPA of 2006 enacted faster rules for employer contributions to DC plans other than certain Employee Stock Option Plans (ESOPs) discussed below. Effective in 2007, a qualified DC plan must provide for a participant to become vested in employer contributions made in plan years after December 31, 2006, over a schedule that does not exceed one of the following two alternatives:

- **Three-Year Cliff Vesting.** After the completion of three years of service the participant is fully vested to his or her account. Should the employee terminate service with the employer prior to the completion of three years of service, the employee would not be entitled to any portion of the plan account attributable to employer contributions (other than Section 401(k) contributions that are 100% vested).

- **Two-to Six-Year Graded Vesting.** After the completion of two years of service, the participant becomes 20% vested in his or her employer contributions. For each additional year of service after three years, an increase in vesting must occur at a rate of at least 20% per year. The participant is fully vested at the end of six years of service (see Table 10.1).
Table 10.1
Profit Sharing Plan Vesting Schedules

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<th>Cliff Vesting</th>
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If the employer requires 2 years of service to participate, all contributions are immediately vested [IRC § 410(a)(1)(B)(i) and ERISA Section 202(a)(1)(B)(i)]. All employees must be vested according to plan terms. All employees must be 100% vested by the time they attain normal retirement age under the plan or when the plan is terminated.

Non-Discrimination

To preserve the tax benefits of a Profit Sharing plan, the plan must provide substantive benefits for rank-and-file employees, not just business owners and managers. These requirements are called non-discrimination rules and compare both plan participation and contributions of rank-and-file employees to owners/managers (see discussion of top-heavy rules above).

Traditional Profit Sharing plans are subject to annual testing to assure that the amount of contributions made for rank-and-file employees is proportional to contributions made for owners and managers. If the employer allocates a uniform percentage of compensation to each participant (3%), then no testing is required because the plan automatically satisfies the non-discrimination requirements.

Loans

Generally, most Profit Sharing plans allow participants to “borrow” from their vested benefits. However, in order for the loan not to be treated as a distribution (subject to income tax and possibly the 10% penalty on premature distributions prior to age 59½) the loan provisions must comply with the following IRC requirements:

- Loans must be available to participants on a reasonable equivalent basis and cannot be made available to highly compensated participants in an amount greater than the amount made available to other employees;
- The loan must be made in accordance with the plan;
- The term of the loan must not exceed five years; if the loan is not repaid in five years, it may be treated as a distribution and taxed (and penalized) as such. Loans
used to acquire the participant’s principal residence may be for a longer (unspecified) period;

- Repayments of the loan must be at least quarterly on a substantially level amortization basis;
- The loan must be accomplished by a legally enforceable loan agreement or note specifying the amount of the loan, the term, and the repayment schedule;
- The amount of the loan may not exceed the lesser of $50,000 or one-half of the present value of the participant’s vested benefit. Loan amounts up to $10,000 may be borrowed without regard to the 50% restrictions;
  - **Example:** A participant with a vested benefit of $15,500 could borrow any amount up to $10,000, even though any amount over $7,500 would exceed 50% of his or her account value[IRC § 72(p)(3)]; and
- The loan must be adequately secured [IRC§ 4975(d)(1)].

Plan loans may be made from a Profit Sharing plan to a sole proprietor, a more than 10% partner in an unincorporated business, and an S corporate employee who is a more than 5% shareholder in the corporation [IRC § 4975(f)(6)(iii)].

### In-Service Distributions

Profit Sharing plans typically allow “in-service distributions” – that is benefits payable before termination of employment. Many plans allow such distributions only in the event of “hardship” as specified in the plan. Typical hardship situations might include medical emergencies, home repair, or educational expenses.

A distribution can be taken if the following IRS guidelines for in-service distributions are both met:

- The distribution cannot exceed the participant’s vested benefit; and
- The employee must have been a plan participant for at least two years (years of service can be substituted for years of participation) [Reg. § 1.401-1(b)(1)(ii)].

### Money Purchase Pension Plan (MPP)

A money purchase pension plan (MPP) is a type of DC plan which the employer is required to contribute a fixed percentage of a participants’ annual compensation to individual participant’s account. The MPP plan is probably the simplest qualified retirement plan.

Many pension experts consider it to be a hybrid plan because it has some features of a DB plan and a DC plan combined.

### Basic Characteristics of MPP Plans

Some of the more specific or typical characteristics of MPP plans are as follows:
In establishing the plan, the employer agrees to make a mandatory fixed contribution each year for each eligible employee. This contribution is usually expressed as a percentage of pay (known as a pro rata formula), although it may be a flat dollar amount. This constitutes a definite commitment on the part of the employer and the contribution must be made each year, regardless of profits, and cannot be varied except by plan amendment;

The employer may also set up an integrated allocation formula which provides higher contributions for eligible participants who earn amounts over a set threshold, as long as the “permitted disparity” rules of IRC § 401(1) are satisfied. Integrated plans are also known as “Social Security-based” or “permitted disparity” plans. The permitted disparity rules allow the employer to give eligible participants who earn compensation above the “integration level,” which is typically the Social Security Taxable Wage Base ($127,200 in 2017), and additional contribution. This contribution is equal to the lesser of:

- two times the base contribution percentage; or
- the base contribution percentage plus, the permitted disparity factor (using the maximum Social Security Taxable Wage Base the permitted disparity factor is 5.7%);

The plan may require employees to make contributions in order to participate. If so, these contributions can be made only from after-tax income—that is salary reductions or elective deferral contributions cannot be made under a MPP plan. When employees do contribute:

- The contribution rate is fixed (unlike a typical savings plan, where the employee can choose from among different levels of participation).
- The employer’s contribution rate is often set with reference to what employees are contributing—for example, at two times the employee contribution rate;

Both employer and employee contributions are transferred to a trustee (or an insurance company under a group annuity type of contract), where they are invested on behalf of the employees;

Individual accounts are established for participating employees. Each account is credited with employer and employee contributions, allocated forfeitures (if applicable), and its proportionate share of investment gains and losses;

An employee’s benefit, at any given time, is whatever can be provided by his or her vested account balance at that time. If the employee retires, the employee will usually have the option of receiving this account in a lump sum or in a form of monthly installments—over a period equal to the employee’s life expectancy or the joint life expectancy of the employee and his or her spouse, if married; and.

Unlike conventional PS and savings plans, a MPP plan generally cannot make distributions until the employee has severed employment. Thus, in-service withdrawals are not permitted.
Advantages of MPP Plan

For the employee:

- Tax-deferred retirement savings. As with all qualified plans, a MPP plan provides a tax-deferred retirement savings medium for employees;
- Minimum funding requirement. Having contributions of a MPP plan fall under minimum funding requirements make it advantageous to the employee. Employees have the comfort of knowing that an employer is legally obligated to contribute the amount promised by the plan document; and
- Individual plan Accounts. Allows individual participants to benefit from good investment results in the plan fund.

For employers:

- Tax-deductible contributions. Required contributions are deductible and provide an employer with the opportunity to effectively recruit and retain desirable employees;
- Simple and inexpensive to set up. MPP plans are relatively easy and inexpensive to establish, maintain, and explain to participants; and
- No investment risk. While investment risk is a potential disadvantage (discussed below) to the employee, it does tend to reduce employer costs as compared with a DB benefit plan.

Disadvantages of MPP Plan

For the employee:

- Investment risk. Employees bear investment risk under the plan. The ultimate amount that can be accumulated under a MPP plan is very sensitive to investment return;
- Lesser benefits for older employees. Retirement benefits may be less for older employees who enter the plan at older ages; and
- Limited contributions. The annual addition to each employee’s account in a MPP plan is limited to the IRC § 415 limits (discussed below).

For the employer:

- Minimum funding requirements. Employers who set up a MPP plan are obligated to make fixed contributions each year to the plan based on total compensation or be subject to minimum funding penalties.
Participant Eligibility

An employer can limit participation in a money purchase pension plan as long as the plan satisfies the minimum coverage and the participation requirements set forth in the IRC. The employer can use the following requirements:

- **Age Requirements**: The maximum age requirement that a plan sponsor may impose through the terms of the MPP plan for participant eligibility is age 21 [IRC § 410(a)(1)(A)(i)].
- **Service Requirement**: A plan sponsor may require employees to complete a specified amount of service (up to two years) before becoming eligible to participate in a MPP plan. If the plan imposes a year of service requirement, each participant’s accrued benefit may be subject to a risk of forfeiture according to the plan’s vesting schedule if one applies. However, if the plan imposes two years of service, a participant’s benefit may not be subject to a vesting schedule, which then requires each participant must have an immediate non-forfeittable right to 100 percent of his or her accrued benefit under the plan.

**Note:** Some pension experts believe the MPP plan will become obsolete because of the passage of the Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) that increased the allowable deductible contribution to a Profit Sharing plan from 15% to 25% of compensation. Prior to EGTRRA, employers (especially, self-employed individuals with Keogh or HR-10 plans) commonly paired MPP plans with a PS plan (referred to as “paired plans”) because the level of deductible contributions that could be made to a PS (15 percent of compensation) was lower than that allowed under a MPP plan (25 percent of compensation). By combining a Profit Sharing plan with a MPP plan, an employer could give itself the ability to maximize contributions by making, a non-discretionary 10 percent contribution in the MPP plan, and a discretionary contribution up to 15 percent in the PS, total 25% of compensation.

But, all that changed with pension law changes under EGTRRA that brought PS plans into parity with the MPP plan limit, making paired plans obsolete. Since most employers prefer contribution flexibility, when all other features are equal, many employers have discontinued their MPP plans in recent years.

However, there are still some applications for MPP plans. Because MPP plans are subject to minimum funding standards, they provide plan participants with added security regarding plan contributions. Also, “Target Benefit” plans that comply with safe harbor requirements must be MPP plans. Employers that sponsor MPP plans are typically well-established businesses that are able to guarantee an annual contribution to their employees.
Contribution Limits

In addition to contributions being limited by terms of the plan document, there are also statutory limits that apply to MPP plan contributions. These limits include the compensation cap under IRC § 401(a)(17), the IRC § 415 (annual contribution) limit, and the employer’s IRC § 404 limit for deductibility of plan contributions.

The maximum amount of compensation that can be considered when calculating a plan participant’s contribution is determined under IRC § 401(a)(17) and IRC § 404(l). The limit under these sections for 2017 is $270,000 (was $265,000 in 2016). This amount may be indexed periodically based on cost-of-living adjustments.

Example: Let’s assume Tom Jones, a participant in ABC Company’s Money Pension Plan, which has a pro rata contribution rate of 10%, has an annual compensation of $280,000. Even though 10% of $280,000 would be $28,000, Tom’s contribution limit will be $27,000 because the plan may only consider the maximum compensation (IRC § 401(a)(17)) of $270,000 when determining contributions for 2017.

Under the IRC § 415 limit, the maximum dollar amount that can be contributed to a MPP plan on behalf of the individual participant (employer and employee contribution plus any reallocated forfeitures) cannot exceed the lesser of:

- 100 percent of compensation; or
- The applicable dollar amount, $54,000 for 2017 ($53,000 in 2015)[IRC § 415(c)].

This limit is known as the annual additions limit. Although it is possible that the 100 percent of compensation limit will be the limiting factor for making a contribution in some cases, it is far more likely that a participant’s contribution will be limited by the annual dollar limit or the employer’s deductibility limit before the 100 percent of compensation limit is reached.

Example: Let’s assume Barbara, a participant in the Ace MPP Plan, has annual compensation of $225,000. For the 2017 tax year, Ace Company makes a 25% pro rata contribution to the money purchase pension plan. For Barbara, even though 25% of $225,000 is $62,500, she may receive a maximum contribution of only $54,000 in order to stay within the annual additions limit for 2017.

Under the IRC § 404 deductibility limit the annual additions limit specifies that the maximum contribution that may be made on behalf of any one plan participant cannot exceed 100 percent of compensation up to a set dollar limit ($54,000 in 2017), it is rare that this 100 percent of compensation limit will be applied, because a plan sponsor (employer) may only receive a tax deduction for contributions up to 25 percent of eligible payroll (i.e., the total compensation of all eligible participants in the plan). As long as a plan is using a pro rata formula, this limit is easily maintained by simply choosing an allocation percentage that does not exceed 25 percent of compensation.
Vesting

Any of the Code’s permitted vesting provisions can be used in a MPP plan. Since MPP plans tend to be oriented toward longer service employees, the 3-year “cliff vesting” provision (that is, no vesting until three years of service, then 100% vesting) is often used.

Distributions

Benefits in a MPP plan are usually payable at termination of employment or at the plan’s state normal retirement age. MPP plans traditionally provide that the participant’s account balance is converted to an equivalent annuity at retirement, based on annuity rates provided in the plan. This is the origin of the term “money purchase.” It has become more common to provide for a lump sum or installment payment from the plan as an alternative to an annuity. However, a MPP plan, as a condition of qualification, must provide a joint and survivor annuity as the automatic form of benefit. The participant, with the consent of the spouse, may elect a different option.

The IRS generally does not allow MPP plans to provide for “in-service distributions.” Distributions of employer contributions or earnings from pension plans are not permitted prior to death, retirement, disability, severance of employment or termination of the plan. However, plan loan provisions are allowable, although relatively uncommon.

Target Benefit Plans

A Target Benefit (TB) plan is a DC pension plan that establishes a fixed contribution formula based on an initial actuarial determination of the contributions required to meet a specified (“targeted”) benefit level at retirement. No subsequent adjustments are made to the annual contribution except to add new participants or reflect changes in compensation. They may also be age-weighted MPP plans, and share general characteristics of MPP plans including falling under the minimum funding standard. TB plans typically use benefit formulas that are similar to the benefit formulas used by DB plans. However, unlike a DB plan, the benefits provided to participants at retirement are based on the performance of the investments, and are, therefore, not guaranteed.

Target Benefit Plan Advantages

For employees:

- Higher contributions for older employees. Older employees who enter the plan can receive a larger share of the annual contributions;
- Certainty of Benefits. Greater certainty of final retirement benefits is provided, compared with a traditional PS plan.

For employers
• *Easy to set up and maintain.* TB plans are easier and less expensive to administer than DB plans.; and
• *Benefits owner-employees.* Owner-employees and other higher paid employees, who generally are older, get a larger share of annual employer contributions.

The TB plan is extremely beneficial to business owners who, for one reason or another, have delayed the decision to establish a company retirement plan. Since they are usually older than the other employees by the time they begin to take retirement planning seriously, this type of plan makes it possible to put a greater portion of total employer contributions into their own account without running afoul of discrimination rules.

**Target Benefit Plan Disadvantages**

For employees:

• *Issues of employee equity.* Greater allocations to more recent but older employees, who make the same income as their younger associates, can create issues of equity.

For employers:

• *Minimum funding standards.* Once it commits to the plan, the company must make annual contributions, even if it is experiencing business slowdowns. As with MPP plans, discretionary funding allowed under PS plans may mean that employers will cease using TB plans since EGTRRA of 2001 equalized the allowable employer contribution under PS plans and TB plans; and
• *Annual contribution limits.* The goal of heavy allocations to the owner-employee’s account is constrained by the 25% employer deduction limit and the $54,000 individual account limit (2017, indexed).

Under current law, the flexibility and tax advantages of using a PS plan and the additional cost of administering a TB plan favor the use of a specialized PS plans only. Because the inherent advantages of a PS plan, many employers have terminated their TB plans and maintain age-weighted or cross tested PS plans only. However, if the owner/employee (who is older) is looking for a definitive benefit, the TB plan may be in their best interest.

**Contribution Formula and Limits**

In a TB plan, allocations are generally age-weighted for age and compensation. Consequently, contributions on behalf of older, more highly-paid employees tend to be greater than those provided to younger, lower-paid employees, when expressed as a percentage of compensation.

The difference between an age-weighted PS plan and an age-weighted TB plan is that a TB plan requires annual employer contributions to meet the IRC minimum funding standards.
Similar to a MPP, and/or PS plan, contribution to a TB plan are limited by the formula specified in the plan document, the applicable compensation cap $270,000 in 2017 (IRC § 401(a)(17)), and the annual additions limit of the lesser of:

- 100% of compensation; or
- $54,000 in 2017 (IRC § 415).

The employer’s contribution is also limited to the deductibility of 25% of compensation (IRC § 404).

**Participant Eligibility**

An employer can limit participation in a TB plan as long as the plan satisfies the minimum coverage and participation requirements set forth in the IRC. Such as:

- **Age Requirement.** The maximum age that a plan sponsor may impose through the terms of the TB plan for participation eligibility is age 21 (IRC § 410(a)(1)(A)(i); and.
- **Service Requirement.** A plan sponsor may require the employee to complete a specified amount of service (up to two years) before becoming eligible to participate in a TB plan. If the plan imposes a year of service requirement, each participant’s accrued benefit may be subject to a risk of forfeiture according to the plan’s vesting schedule if one applies. However, if the plan imposes two years of service, a participant’s benefit may not be subject to a vesting schedule, meaning each participant.

**Distributions**

At retirement, each employee’s account will reflect past contributions and investment history. The plan follows the same rules as a MPP plan, and is required to provide a joint and survivor annuity as an automatic distribution method. However, lump sum, a series of installment payments, or some other annuity settlement options are also permissible. Also, as with MPP plans, TB plans must provide a qualified joint survivor annuity QJSA, QOSA, and a QPSA. Any change from the automatic distribution must have the formal consent of the participant’s spouse.

TB plans face the same restriction against providing in-service distributions as MPP plans. Unless the participant is age 62 or older, in-service distributions cannot be made. However, a TB plan, similar to a MPP plan will allow provisions in the plan for loans.
401(k) Plans

401(k) plans have become a widely accepted retirement savings vehicle for many small businesses. With a 401(k) plan, employees can choose to defer a portion of their salary. So instead of receiving that amount in their paycheck today, the employees can contribute the amount into a 401(k) plan sponsored by their employer. These deferrals are accounted separately for each employee. Deferrals are made on a pretax basis but if the plan allows, they can be made on an after-tax (Roth) basis at the employee’s choosing. Many 401(k) plans provide for employer matching or other contributions. The Federal Government and most state governments do not tax employer contributions and pre-tax deferrals (plus earnings) until distributed.

Like most PS plans, 401(k) plans can vary significantly in their complexity. However, many financial institutions and other organizations offer prototype 401(k) plans, which can lessen the administrative burden on individual employers of establishing and maintaining these plans.

401(k) Plan Advantages

For the employees, 401(k) plans have these advantages:

- **Pretax contributions.** The 401(k) plan allows participants to contribute before-tax dollars to the plan, thereby reducing their W-2 taxable incomes;
- **Investment choices.** In “participant directed” plans, employees allocate their contributions among the range of choices offered through their particular plans. This range of choices can be very broad;
- **Credit for 401(k) elective deferrals.** Low income employees may receive a tax credit. This provides a strong monetary incentive for low income employees to participate in a 401(k) plan;
- **Hardship withdrawals.** In-service withdrawals by employees for certain hardships are permitted. However, hardship withdrawals are taxable and subject to potential penalties under certain circumstances; and
- **Loans.** A plan generally may permit participants to borrow against their plan accounts. However, both the IRS and U.S. Department of Labor have rules governing the operation of the loan program (as previously discussed with PS plans above).

For employers, 401(k) plans have these advantages:

- **Lower costs.** Compared to other types of qualified retirement plans, such as defined benefits plans, the cost of contributing to a 401(k) are relatively small, especially if most of the 401(k) contributions are employee elective contributions;
- **Higher tax deductions.** Total annual employer and employee elective contributions can exceed 25% and are deductible by the employer. Employer deductions for employer and employee elective plan contributions can exceed 25% of the plans participant’s compensation;
• **Limited fiduciary responsibility and minimizes risk exposure.** Most 401(k) plans give participants the option to choose how to invest the money in their plan accounts. By offering participants the right to direct their investments and complying with the other requirements of ERISA Section 404(c), the employer helps to protect itself from fiduciary liability and minimizes its exposure to investment risk;

• **Credit for 401(k) elective deferrals.** The tax credit may increase the amount of elective deferrals made by NHCE. If this happens, it will permit larger elective deferrals by HCE and make it easier for 401(k) plans to pass the ADP test; and

• **Optional profit sharing features.** An employer can use the discretionary PS features of a 401(k) PS plan to implement an age-weighted or cross-tested allocation formula that favors shareholders or key employees.

### 401(k) Plan Disadvantages

There are several disadvantages to establishing a 401(k) plan. For the employees, these include the following:

• **Inadequate retirement balance.** Unless the employer also offers another plan such as a combination plan (discussed in Chapter 7), employees who enter the plan later in life may have account balances at retirement that will not satisfy their retirement income needs; and

• **Investment risk.** If employees direct their investment choices, they run the risk of picking poor investments.

For employers, 401(k) plans have these disadvantages:

• **Administration of the plan can be costly and complex.** Employers are required to maintain ongoing administrative costs, intensive communication throughout its lifecycle;

• **Fiduciary responsibilities.** Employers are required to maintain fiduciary responsibility of the plan and follow all ERISA requirements; and

• **Non-discrimination funding and contribution requirements.** The government imposes special non-discrimination requirements on all 401(k) plans. The purpose of these requirements is to maintain a reasonable balance between amounts deferred by HCEs and those deferred by NHCEs. These requirements can be costly and difficult to administer.

A full review of 401(k) plans will be presented in Chapter 11 and Chapter 12.

### Credit for Small Employer Startup Costs

An employer may be able to claim a tax credit for part of the ordinary and necessary costs of starting a defined contribution plan, SEP or SIMPLE IRA. The credit equals 50% of the cost to set up and administer the plan and educate employees about the plan, up to
a maximum of $500 per year for each of the first 3 years of the plan. The employer can choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective. The employer must have had 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding year. At least one participant must be a NHCE.

The employees generally cannot be substantially the same employees for whom contributions were made or benefits accrued under a plan of any of the following employers in the 3-tax-year period immediately before the first year to which the credit applies. They are:

- Employer/employee;
- A member of a controlled group that includes the employer/employee; and
- A predecessor of (1) or (2).

The credit is part of the general business credit, which can be carried back or forward to other tax years if it cannot be used in the current year. However, the part of the general business credit attributable to the small employer pension plan startup cost credit cannot be carried back to a tax year beginning before January 1, 2002. The employer cannot deduct the part of the startup costs equal to the credit claimed for a tax year, but the employer can choose not to claim the allowable credit for a tax year. To take the credit, file IRS Form 8881, Credit for Small Employer Pension Plan Startup Costs.

**Retirement Savings Contributions Credit (Savers Credit)**

Retirement plan participants (including self-employed individuals) who make contributions to their plan may qualify for the retirement savings contribution credit. An individual may be able to take a tax credit of up to $1,000 ($2,000 if filing jointly) for making eligible contributions to an employer-sponsored retirement plan (or an IRA).

**Eligibility**

The individual claiming the credit must be:

- Age 18 or older;
- Not a full-time student;
- Not claimed as a dependent on another person’s return; and
- With an adjusted gross income (AGI) in 2017 not more than:
  - $62,000 if your filing status is married filing jointly (increased by $500 from 2017); or
  - $46,500 if your filing status is head of household (increased by $375 from 2017); or
  - $31,000 if your filing status is single, married filing separately, or qualifying widow(er) (increased from $30,750 in 2016).
Eligible contributions include:

- Contributions to a traditional or Roth IRA;
- Elective deferrals (including after-tax Roth contributions, if available) to a:
  - IRC § 401(k) plan (including a SIMPLE 401(k) and the Federal Thrift Savings Plan);
  - SIMPLE IRA IRC § 408(p) plan;
  - SARSEP;
  - IRC § 403(b) annuity plan;
  - IRC § 457 (b)governmental plan;
  - Contributions to a IRC § 501(c)(18) plan, and
  - Voluntary after-tax employee contributions to a qualified retirement plan or 403(b) annuity. For purposes of the credit, employee contributions will be voluntary as long as they aren’t required as a condition of employment.

Rollover contributions are not eligible for the Saver’s Credit. Also, an eligible contribution may be reduced by any recent distributions received from a retirement plan or IRA.

**Amount of the Credit**

The amount of the credit one can receive is based on the contributions they make and their credit rate. The credit rate can be as low as 10% or as high as 50%. The credit rate depends on one’s income and filing status. To calculate the credit, you must use IRS Form 8880.
Chapter 10
Review Questions

1. Which of the following is the oldest type of DC plan?

( ) A. Money Purchase plan
( ) B. Profit sharing plan
( ) C. 401(k) plan
( ) D. Target Benefit plan

2. Under the IRC § 415 limit, the maximum dollar amount that can be contributed to a money purchase pension plan on behalf of the individual participants (employer and employee contribution plus any reallocated forfeitures) cannot exceed the lesser of:

( ) A. 100% of compensation or $54,000
( ) B. 100% of compensation or $18,000
( ) C. 25% of compensation or $54,000
( ) D. 25% of compensation or $18,000

3. Which of the following is the simplest DC qualified retirement plan?

( ) A. Target Benefit Plan
( ) B. Profit Sharing Plan
( ) C. Thrift Savings Plan
( ) D. Money Purchase Plan

4. True or False: The difference between an age-weighted profit sharing plan and an age-weighted target benefit plan, is that a target benefit plan requires annual employer contributions to meet the IRC minimum funding standards.

( ) A. True
( ) B. False

5. Which of the following is not an advantage to employees who participate in a 401(k) plan?

( ) A. Pre-tax contributions
( ) B. Investment choices
( ) C. Investment risk
( ) D. Hardship withdrawals
CHAPTER 11

401(k) PLANS

Overview

Today, 401(k) plans have evolved into one of the most popular employee benefit plans for employees. IRC § 401(k) plans were first introduced as part of the Tax Revenue Act (TRA) of 1978. A 401(k) plan may be a stand-alone plan or a feature of a profit sharing or stock bonus plan. When a 401(k) feature is incorporated into a plan, the plan is called a 401(k) plan or a cash deferred arrangement” or CODA.

In this chapter, we will examine the history of the 401(k) plan, their basic qualification requirements and the various elements of operating a 401(k) plan.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The tax advantages of a 401(k) plan;
- The basic qualification requirements in setting up a 401(k) plan;
- The various elements in operating a 401(k) plan;
- The types of contributions, their limits, vesting schedule and non-discrimination rules;
- The fiduciary responsibilities of the parties to the 401(k) plan and how to limit liability to plan sponsors;
- The requirements for disclosing plan benefits to participants;
- The distribution rules pre-and post-retirement: Loans, hardships and in-service distributions; and
- The broad range of investments required to be directed by the plan participants, as well as the qualified default investment alternatives.

History of 401(K) Plans

The history of 401(k) plans can be traced back to the mid-1950s when there was a popular feature in profit sharing plans sponsored by a number of banks called a cash or deferred arrangement (CODA). Under a CODA, an eligible employee could either elect to receive a portion of the profit sharing contribution in cash or to defer it in a PS plan. The IRS was somewhat wary of this arrangement but did issue some guidance in 1956. The IRS allowed for this arrangement if two requirements were met:
The participant made an irrevocable election to defer the PS contribution before the close of the plan year for which the PS contributions were made; and

More than half of the participants in the plan (who elected to defer) were among the lowest two third of all eligible employees.

The IRS later reaffirmed that this type of arrangement could be a qualified plan. Subsequently, the IRS ruled that if such a plan met the non-discrimination rules of Revenue Ruling 56-497, the deferred contribution would be exempt from the IRS doctrine of constructive receipt. [Rev. Rul. 63-180, 1963-2 C.B. 189] Further clarification of this position was issued in another IRS revenue ruling in 1968 [Rev. Rul. 68-89, 1968-1C.B. 402]. Despite these positive rules, CODAs never became wildly popular. By the early 1970’s, there were fewer than 1,000 plans in existence. Then in 1972, the IRS issued proposed regulations that would dramatically change its previous position. Under the proposed regulations, salary reduction contributions would have been treated, for tax purposes, as if they had been received by the employee in cash. Although the regulations did not deal directly with the profit sharing deferral arrangements, they cast doubt on these arrangements.

However, Congress was concerned about the IRS stance, and when it passed the Employee Retirement Income Security Act (ERISA) of 1974 it contained a provision that froze the existing tax status of CODAs until the end of 1976. Any such arrangements in existence on June 27, 1974, retained their tax-favored status. The moratorium was deferred twice, the last time until the end of 1979.

In 1978, Congress passed the Revenue Act of 1978, which contained a provision in the Act that added Section 401(k) to the Internal Revenue Code, effective for plan years beginning after December 31, 1979. Table 11.1 below illustrates the growth in the number of 401(k) plans, active participants and plan assets from 1995 to 2014, according to the Department of Labor (latest data available).

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Plans</th>
<th>Active Participants (thousands)</th>
<th>Total Assets (millions)</th>
<th>Total Contributions (millions)</th>
<th>Total Benefits (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>200,813</td>
<td>27,759</td>
<td>863,918</td>
<td>87,416</td>
<td>62,163</td>
</tr>
<tr>
<td>2000</td>
<td>348,053</td>
<td>39,847</td>
<td>1,724,549</td>
<td>169,238</td>
<td>172,211</td>
</tr>
<tr>
<td>2005</td>
<td>436,207</td>
<td>54,623</td>
<td>2,395,792</td>
<td>223,533</td>
<td>189,822</td>
</tr>
<tr>
<td>2010</td>
<td>518,675</td>
<td>60,510</td>
<td>3,142,141</td>
<td>267,584</td>
<td>245,474</td>
</tr>
<tr>
<td>2011</td>
<td>513,496</td>
<td>61,371</td>
<td>3,146,851</td>
<td>285,679</td>
<td>252,692</td>
</tr>
<tr>
<td>2012</td>
<td>516,346</td>
<td>63,221</td>
<td>3,533,513</td>
<td>306,440</td>
<td>285,002</td>
</tr>
<tr>
<td>2013</td>
<td>527,047</td>
<td>64,495</td>
<td>4,179,351</td>
<td>327,886</td>
<td>328,680</td>
</tr>
<tr>
<td>2014</td>
<td>533,769</td>
<td>62,651</td>
<td>4,399,891</td>
<td>349,216</td>
<td>365,657</td>
</tr>
</tbody>
</table>

Source: 5500 filings with the Department of Labor
Basic Qualification Requirements

401(k) plans, like other types of qualified plans, must meet the basic qualification requirements for retirement plans contained in IRC § 401(a). In addition, 401(k) plans must meet qualification rules that apply specifically to cash or deferred arrangements in order to maintain the plans tax advantages to both the employer and employees. What are those tax advantages? They are:

- The employer may take a tax deduction for making contributions to the plan;
- Investment earnings of the plan’s assets are exempt from current taxation;
- Plan participants avoid current taxation of amounts allocated to their accounts; and
- Participants may roll over plan benefits to other employer-sponsored plans or IRAs on a tax-free basis.

Formal Requirements

There are four basic actions necessary to have a tax-advantaged 401(k) plan. They are:

- **Adopt a written plan.** A 401(k) plan will not be considered qualified unless it is established and operated in accordance with a definite written program [Treas. Reg. § 1.401-1(a)(2)]. The written document must include all provisions essential for qualification. The plan document serves to define the rights and obligations of the plan sponsor, participants, and beneficiaries. It also forms the basis of any IRS determination that the plan is tax qualified in form;
- **Arrange a trust fund for the plan assets.** All assets of a qualified plan must be held in a trust that is created and organized in the United States and maintained as a domestic trust (IRC § 401(a); Treas. Reg. § 1.401-1(a)(3)(i)]. DOL provisions generally prohibit a trustee or other fiduciary from maintaining the indicia of ownership of any assets that are not subject to the jurisdiction of the United States district courts [ERISA § 404(b)]. An exception from the trust requirement is carved out for plans that use custodial accounts held by a bank or other person satisfactory to the IRS, or annuity contracts issued by qualified insurance companies [IRC § 401(f); ERISA § 403(a)];
- **Develop a record keeping system.** An accurate recordkeeping system helps track and properly attribute contributions, earnings and losses, plan investments, expense and benefit distributions in participants’ accounts. If the plan has a contract administrator or financial institution assist in managing the plan, that entity typically will help in keeping the required records. In addition, a recordkeeping system will help the plan, the plan administrator, or financial provider prepare the plan’s annual return/report that must be filed with the Federal government; and
- **Provide plan information to participants.** The IRC requires that a plan be communicated to employees [Treas. Reg. § 401—1(a)(2)]. Department of Labor regulations also contain this requirement and detail the content and method for this communication (see Chapter 4).
Costs of Setting up a 401(k) Plan

An employer who considers the adoption of a 401(k) plan must take its financial impact into account. The biggest portion of the cost of a 401(k) plan is employer contributions to the plan. Employer contributions can be the following:

- Matching contributions;
- Non-elective contributions;
- Qualified non-elective contributions; or
- Safe harbor contributions.

The employer needs to measure the level of its contributions on both an initial and ongoing basis. The employer will also incur other costs as a result of adopting a 401(k) plan, including installation, enrollment, administration, and compliance costs. Estimating these costs will require decisions regarding the design, funding, and reporting frequency of the plan.

Eligible Entities

Virtually all organizations, with the exception of state and local governments, can establish 401(k) plans:

- **Sole Proprietors.** The sole proprietor, or self-employed person, is treated as his or her own employee. The calculations involved are difficult, since the compensation of the self-employed individual (either a sole proprietor) is reduced by the contributions made on behalf of common-law employees. Also, the self-employed individual’s compensation must be reduced by one-half of the Social Security contribution (SECA deduction);
- **Partners.** If the self-employed individual is a partner, he or she is treated as an employee of the partnership. Special rules apply to a partnership’s profit sharing plan if it includes a CODA. A partnership may maintain a CODA, and individual partners may make cash-or-deferred elections with respect to compensation attributable to services rendered to the partnership. Generally, the same qualification rules apply to a partnership CODA as apply to other CODA. A partner’s compensation is deemed currently available on the last day of the partnership taxable year. Accordingly, an individual partner may not make a cash-or-deferred election with respect to compensation for a partnership taxable year after the last day of that year;
- **Corporations.** Regular (or C), S, and limited liability corporations (LLC) are eligible;
- **Tax-exempt organizations.** Tax-exempt organizations were prevented from adopting 401(k) plans from 1987 to 1997 until the Small Business Job Protection Act of 1996 repealed earlier legislation. (Plans that were in effect prior to 1987 with tax-exempt organizations and state and local governments were grandfathered and allowed to continue.); and
- **Indian Tribal governments.**
Operating a 401(k) Plan

Once the employer decides to establish a 401(k) plan, they will assume certain responsibilities in operating the plan. If they hire someone to help in setting up the plan, the arrangement may include help in operating the plan. If not, another important decision will be whether to manage the plan themselves or to hire a professional or financial institution — such as a bank, mutual fund provider, or insurance company — to take care of some or most aspects of operating the plan.

Elements of operating 401(k) plans include the following:

- Participation;
- Contributions;
- Vesting;
- Non-discrimination;
- Investing 401(k) plan monies;
- Fiduciary responsibilities;
- Disclosing plan information to participants and reporting to government agencies; and
- Distributing plan benefits.

Participation

Typically, a plan includes a mix of rank-and-file employees and owners/managers. However, some employees may be excluded from a 401(k) plan if they:

- Have not attained age 21;
- Have not completed a year of service; or
- Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good faith bargaining.

Employees cannot be excluded from a plan merely because they are older workers.

Contributions to 401(k) Plan

A 401(k) plan always includes elective contributions and may include bonus deferral contributions, matching contributions, or discretionary non-elective contributions. A 401(k) plan may also allow deemed IRA contributions to the plan.
Elective Contributions

An “elective contribution” is a contribution made by an employer pursuant to and after an employee’s cash or deferred election is made [Treas. Reg. §§ 1.401(k)-1(g)(3), 1.401(k)-6]. Elective contributions are treated as employer contributions not employee contributions, for all purposes under the IRC [Treas. Reg. § 1.401(k)-1(a)(4)(ii)]. Elective contributions, other than the age 50 catch-up contributions, are subject to discrimination testing under the ADP test (discussed below) unless it is a SIMPLE 401(k) plan, a safe harbor 401(k) plan, or a 401(k) plan containing a qualified automatic contribution arrangement (QACA).

Matching Contributions

A “matching contribution” is an employer contribution that is allocated on the basis of a participant’s elective contributions or, less typically, a participant’s employee after tax contributions [IRC § 401(m)(4)(A; Treas. Reg. 1.401(m)-5]. The rate of matching contributions may be specified in the plan document or may be determined at the discretion of the employer. It may be made on an ongoing basis, as elective contributions are paid into the 401(k) plan, or at or after the end of the plan year. Matching contribution, together with employer after-tax contributions, are subject to discrimination testing under the ACP test unless it is a SIMPLE 401(k) plan, a safe harbor 401(k) plan, or the plan contains a QACA (see Chapter 12).

Discretionary Non-Elective Contributions

A “discretionary non-elective contribution” in a 401(k) plan is an employer contribution that is allocated on the basis of compensation or in some manner other than on the basis of elective contributions or employee after-tax contributions. Discretionary non-elective contributions do not need to be included in any of the special non-discrimination rules under IRC § 401(a)(4). Discretionary non-elective contributions may sometimes be used to help satisfy the ADP and ACP tests. A participant’s right to receive an allocation of a discretionary non-elective contribution cannot depend on whether he or she had made elective contributions [IRC § 401(k)(4)(A); Treas. Reg. § 1.401(k)-1(6)(i)].

Deemed Side Car IRA

A “deemed IRA contribution”, which is sometimes referred to as “side-car” IRA, is a voluntary participant contribution that is made to a 401(k) plan and considered for tax purposes as if it were a contribution to an IRA [IRC § 408(q)]. The concept of an IRA-type contribution to a qualified plan is not a new one. Between 1982 and 1986, a plan participant could make deductible contributions to a qualified plan. Such contributions were known as qualified voluntary employee contributions.

Deemed contributions can be made to either a Traditional IRA or to a Roth IRA, but cannot be made to IRAs established under a SEP IRA or SIMPLE IRA [Treas. Reg. § 1.408(q)-1(b)]. In order to set up the 401(k) plan must contain provisions allowing for the
deemed IRA contributions. Even though the IRS has set up a model amendment that can be used for this purpose, many employers did not set up for fear of disqualifying their existing 401(k) plan.

**401(k) Contribution Limits**

The 401(k) contribution is limited under IRC § 402(g)(1) on the exclusion for elective deferrals described in IRC § 402(g)(3) which is $18,000 for 2017 (same as 2016). In addition, the dollar limitation under IRC § 414(v)(2)(B)(i) for catch-up contributions to a 401(k) plan is $6,000 for 2017.

**Note:** For a SIMPLE 401(k) plan, the catch-up contribution limit is $3,000 [IRC § 414(v)(2)(B)(ii)].

Under IRC § 415, the maximum employer and employee contributions and forfeitures (non-vested employer contributions of terminated participants) for 2017 are subject to a per-employee overall annual limitation of the lesser of:

- 100 percent of the employee’s compensation; or
- $54,000 [IRC 415(c)(1)(A)]; plus
- $6,000 catch-up contribution (if eligible).

**Note:** The catch-up contribution of $6,000, if age 50 or above, is not counted towards the IRC § 415 limit. So the dollar limit for a salary reduction plan is, in effect $60,000 for 2017 ($54,000 plus $6,000 catch-up amount).

The deduction limit for the business is 25% (20% if self-employed) of compensation but elective deferrals do not count towards the 25% limit. The annual compensation limit under IRC §§ 401(a)(17) and 404(I) is $270,000 for 2017.

**Roth 401(k) Plan Contributions**

Beginning in 2006, Section 617(f) in the *Economic Growth Tax Relief and Reconciliation Act of 2001* (EGTRRA) allows business owners and their employees to set up the Roth 401(k) plan. Also known as a “Designated Roth Account” (DRAC). If business owners amended their plan documents to permit Roth contributions, both the owners and employees will be able to elect to allocate part or all of their elective deferrals ($18,000 in 2017) into Roth accounts in their 401(k) plans.

**Note:** Employer matching contributions cannot be allocated to the Roth accounts in a 401(k) plan.

To meet the qualifications requirements, a 401(k) plan must do the following:
• Establish separate accounts ("designated Roth accounts–DRACs") for the designated Roth contributions of each employee and any earnings properly allocable to the contributions; and
• Maintain separate recordkeeping for each account [IRC § 402 A(b)(2)].

While EGTRRA 2001 allows the creation of Roth 401(k) accounts, it does not permit a participant to make a maximum deferral to a regular 401(k) in addition to making Roth contributions. The maximum deferral amount permitted by law may be allocated between the regular and Roth accounts inside a 401(k) [IRC § 402(a)(c)(2)]. As mentioned above, the maximum contribution limitation for 2017 is $18,000 (subject to limitations by the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests discussed below), and indexed for inflation thereafter, plus catch-up contributions of $6,000 for workers age 50 or above. Therefore, the total amount a business owner or employee over age 50 could contribute to his or her regular and Roth accounts inside of a 401(k) plan is $24,000 in 2017.

The Roth 401(k) offer several benefits to participants. Among them are:

• No income phase-outs on contributions to the plan;
• Continue ability to make Roth IRA contributions (if other conditions are met);
• Creation of a hedge against future tax increases; and
• Exemption from the required minimum distribution rules.

Roth 401(k) plans were available for tax years beginning after 2005. But like all other provisions contained in EGTRRA of 2001, the Roth 401(k) plan contributions were to sunset and not be permissible after December 31, 2010. However, with the enactment of the enactment of the PPA of 2006, the Act permanently extends the Roth 401(k) features.

On January 2, 2013, President Obama signed the American Taxpayer Relief Act (ATRA) of 2012. Section 902 of the Act expanded the availability of in-plan Roth conversions, elective conversions made after December 31, 2012. Participants will now be able to do in-plan Roth conversions from any non-Roth vested account, without requiring that the amount being converted must be eligible for distribution and rollover from the plan.

Pre-Act only amounts eligible for distribution and for rollover, such as in-service withdrawals of elective contributions after age 59½, in-service withdrawals of employer contributions (after a stated age and/or stated period of time), and distributions due to disability, severance of employment, or retirement, were eligible for conversion.

A conversion will not be treated as having violated IRC § 401(k)(2)(B)(i), 403(b)(7)(A)(ii), or 457(d)(1)(A) (pertaining to limitations on distributions). However, what remains the same (not inclusive): An in-plan Roth conversion feature is discretionary; employers are not required to amend their plans to allow for conversions.

To allow in-plan Roth conversions, a 401(k), 403(b), or governmental 457(b) plan must:
- Permit on-going Roth contributions; and
- Allow conversions.

Participants who make a conversion are subject to ordinary income tax on the amount converted, but are not subject to the 10% early distribution tax.

Conversions are not subject to mandatory or optional withholding. However, since the conversion amount is subject to ordinary income tax, the participant should consider increasing their withholding or making estimated tax payments outside the plan to avoid any underpayment penalties. If the plan is subject to spousal consent requirements, no spousal consent is required for a conversion.

**Vesting**

Vesting refers to the extent to which a participant’s interest in a 401(k) plan is non-forfeitable. Any portion of that interest that is not vested is subject to possible forfeiture.

**Contributions 100% Vested**

The following kinds of contributions must always be 100% vested:

- Elective contributions [Treas. Reg. §§ 1.401(k)-1(c), 1-401(k)-6];
- Qualified matching contributions (QMACs) [Treas. Reg. § 1.401(k)-6];
- Qualified non-elective contributions (QNECs) [Treas. Reg. § 1.411(a)-1(a)(2)];
- Deemed IRA contributions [IRC § 408(q)];
- Rollover contributions; and
- Non-elective and matching contributions in a SIMPLE 401(k) or Safe Harbor 401(k) Plan (see Chapter 12).

Also, all of a participant’s interest in a 401(k) plan must be 100 percent vested upon the participant’s attainment of normal retirement age (NRA), upon the termination or partial termination of the plan, or upon the complete discontinuance of contributions to the plan [Treas. Reg. §§ 1.411(a)-1(a)(1), 1.411(d)-2(a)(1)]. Although this is not legally required, nearly all 401(k) plans will provide for 100 percent vesting upon a participant’s death or disability.

**Contributions Not Subject to 100 Vesting**

In a 401(k) plan that does not qualify as a SIMPLE plan or a Safe Harbor 401(k) plan, non-elective contributions and matching contributions are not required to be 100 percent vested at all times.

Prior to the enactment of the PPA of 2006, which now requires faster vesting for employer non-elective contributions to DC plans, a DC plan (including a 401(k) plan), satisfied the minimum vesting requirements with regard to employer non-elective
contributions if the vesting schedule was at least as fast as a five-year “cliff” vesting schedule or a three-to-seven year “graded” vesting schedule (See Table 11.2).

### Table 11.2
Vesting Table for Non-Elective and Matching Contributions Prior to PPA of 2006

<table>
<thead>
<tr>
<th>Non-Elective Contributions</th>
<th>Matching Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Years of Service</strong></td>
<td><strong>Vested %</strong></td>
</tr>
<tr>
<td>Fewer than 3</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>20</td>
</tr>
<tr>
<td>4</td>
<td>40</td>
</tr>
<tr>
<td>5</td>
<td>60</td>
</tr>
<tr>
<td>6</td>
<td>80</td>
</tr>
<tr>
<td>7 or more</td>
<td>100</td>
</tr>
<tr>
<td>Fewer than 5</td>
<td>0</td>
</tr>
<tr>
<td>5 or more</td>
<td>100</td>
</tr>
</tbody>
</table>

As a result of the enactment of the PPA of 2006, the vesting schedules above for non-elective contributions no longer apply starting with plan years beginning after December 31, 2006. Non-elective contributions made with respect to plan years beginning after that date must become vested under either of the schedules that apply to matching contributions (see Table 11.3 and 11.4).

### Table 11.3
2/20 Graded 6 Year Vesting

<table>
<thead>
<tr>
<th>Years of Service</th>
<th>Vested %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>20%</td>
</tr>
<tr>
<td>3</td>
<td>40%</td>
</tr>
<tr>
<td>4</td>
<td>60%</td>
</tr>
<tr>
<td>5</td>
<td>80%</td>
</tr>
<tr>
<td>6</td>
<td>100%</td>
</tr>
</tbody>
</table>

### Table 11.4
Three-Year Cliff Vesting

<table>
<thead>
<tr>
<th>Years of Service</th>
<th>Vested %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 2</td>
<td>0%</td>
</tr>
<tr>
<td>3</td>
<td>100%</td>
</tr>
</tbody>
</table>

Although not required to do so, most 401(k) plans will apply the six-year graded and three-year cliff vesting schedules to non-elective contributions made for pre-2007 plan years as that will simplify the administration of a 401(k) plan [IRC § 411(a)(2)(B)].
Non-discrimination Rules

The purpose of the nondiscrimination rules is to limit the extent to which plan sponsors may maintain a 401(k) plan that exclusively or primarily benefits only highly compensated or key employees.

To meet these rules, the Internal Revenue Code (IRC) establishes the following four nondiscrimination requirements:

- The plan must meet certain minimum standards concerning coverage of employees;
- The plan must not discriminate in favor of HCEs with respect to the amount of contributions or benefits, and with respect to the availability of benefits, and features of the plan;
- Elective contributions, matching contributions, and employee after-tax contributions must meet special non-discrimination tests; and
- A plan that is top-heavy must meet additional rules concerning minimum contributions or benefits.

To qualify for tax-favored treatment, plans that allow employee salary reduction contributions (elective contributions) must ensure that the average “actual deferral percentage” (ADP) of HCEs does not exceed the ADP of NHCEs by specified amounts. A problem common to all 401(k) plans is that highly paid employees tend to defer larger portions of their income; lower-paid employees are more likely to defer a minimal portion or choose to receive cash. To encourage deferred participation among the lower-paid participants, employers may establish a matching contribution, enhancing the potential return on employees’ savings dollars.

A similar test, the “actual contribution percentage” (ACP) test, is required for plans that provide an employer match and/or permit employees to make after-tax contributions.

Let’s first begin to review the rules for the Actual Deferral Percentage (ADP) Test.

Actual Deferral Percentage (ADP) Test

Elective contributions under a 401(k) plan will satisfy the ADP test if at least one of the following tests is met:

- **1.25 requirement.** To meet this requirement, the ADP for the HCE cannot be more than 125% of the ADP for the NHCE; and
- **Two percentage/200% requirement.** To meet this requirement, the ADP for the HCEs cannot be more than two percentage points greater than the ADP for the NHCEs and the ADP for the HCEs cannot be more than two times the ADP of the NHCEs [Treas. Reg. 1.401(k)-2(a)(1)].
Table 11.5 combines these two tests to show the maximum ADP for HCEs, given an ADP for NHCEs:

<table>
<thead>
<tr>
<th>ADP for Non-highly Compensated Employees (NHCEs)</th>
<th>Maximum ADP for Highly compensated Employees (HCEs)</th>
<th>Rule Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.00%</td>
<td>2.00%</td>
<td>Times 2</td>
</tr>
<tr>
<td>2.00%</td>
<td>4.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>3.00%</td>
<td>5.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>4.00%</td>
<td>6.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>5.00%</td>
<td>7.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>6.00%</td>
<td>8.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>7.00%</td>
<td>9.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>8.0%</td>
<td>10.00%</td>
<td>Times 1.25</td>
</tr>
<tr>
<td>9.0%</td>
<td>11.25%</td>
<td>Times 1.25</td>
</tr>
<tr>
<td>10.0%</td>
<td>12.50%</td>
<td>Times 1.25</td>
</tr>
</tbody>
</table>

**Example:** If the ADP of the NHCEs is 1.23 percent, the ADP of the HCEs can be no greater than 1.23 times 2, or 2.46 percent.

**Example:** If the ADP of the NHCEs is 7.43 percent, the ADP of the HCEs can be no greater than 7.43 plus 2, or 9.43 percent.

**Example:** If the ADP of the NHCEs is 9.87 percent, the ADP of the HCEs can be no greater than 9.87 times 1.25, or 12.34 percent.

If the ADP test for a plan year is not satisfied, the portion of the 401(k) plan attributable to elective contributions—and, most likely, the plan in its entirety—will no longer be qualified. Fortunately, plan administrators have several mechanisms for making corrections and can use one or more of them to bring the plan into compliance with the test:

- The employer can make fully vested non-elective contributions or matching contributions that are treated as elective contributions for purposes of the ADP test. When combined with elective contributions, these may satisfy the ADP test;
- Excess deferrals or contributions are re-characterized;
- Excess deferrals and allocable income are distributed; and
- The portion of the 401(k) plan attributable to elective contributions is restructured.
Actual Contribution Percentage Test

The “Actual Contribution Percentage” (ACP) test is similar to the ADP test discussed above. It compares the percentage of matching contributions and non-deductible employee contributions made by or on behalf of NHCEs with the percentage of matching contributions and nondeductible employee contributions made by or on behalf of HCEs. Based upon these percentages, the ACP test limits the amount of matching contributions and non-deductible employee contributions that may be made to HCEs.

The employer matching and employee contributions to a plan must satisfy either of the following tests:

- First, the ACP of the group of eligible HCEs cannot be more than 125 percent of the ACP of the eligible NHCEs; or
- Second, the ACP of the eligible HCEs cannot be more than two percentage points greater than the ACP of the eligible NHCEs, and the ACP of the eligible HCEs cannot be more than two times the ACP of the eligible NHCEs. [Treas. Reg. § 1.401(m)-2(a)(1)]

Table 11.6 displays these two rules combined to show the maximum ACP for HCEs, given an ACP for NHCEs.

### Table 11.6
Maximum ACP for HCEs, Given an ACP for NHCEs

<table>
<thead>
<tr>
<th>ACP for Non-highly Compensated Employees (NHCEs)</th>
<th>Maximum ACPDP for Highly compensated Employees (HCEs)</th>
<th>Rule Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.00%</td>
<td>2.00%</td>
<td>Times 2</td>
</tr>
<tr>
<td>2.00%</td>
<td>4.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>3.00%</td>
<td>5.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>4.00%</td>
<td>6.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>5.00%</td>
<td>7.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>6.00%</td>
<td>8.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>7.00%</td>
<td>9.00%</td>
<td>Plus 2</td>
</tr>
<tr>
<td>8.0%</td>
<td>10.00%</td>
<td>Times 1.25</td>
</tr>
<tr>
<td>9.0%</td>
<td>11.25%</td>
<td>Times 1.25</td>
</tr>
<tr>
<td>10.0%</td>
<td>12.50%</td>
<td>Times 1.25</td>
</tr>
</tbody>
</table>

**Example:** If the ACP of the NHCEs is 1.23 percent, the ACP of the HCEs can be no greater than 1.23 times 2, or 2.46 percent.

**Example:** If the ACP of the NHCEs is 7.87 percent, the ACP of the HCEs can be no greater than 7.87 plus 2, or 9.87 percent.
Example: If the ACP of the NHCEs is 10.98 percent, the ACP of the HCEs can be no greater than 10.98 times 1.25, or 13.73 percent.

As a general rule, employer matching contributions and employee after-tax contributions are combined for ACP testing purposes. However, if qualified non-elective contributions (QNECs) are treated as elective contributions for purposes of satisfying the ADP test, these contributions do not have to satisfy the ACP test; furthermore, they cannot be used to help a 401(k) plan satisfy the ACP test.

A plan can also run into trouble with the IRS if it makes excessive aggregate contributions on behalf of HCEs as a group. An excess contribution is the excess of employee contributions (this includes mandatory employee contributions and voluntary contributions) and matching contributions made to a 401(k) plan for the benefit of HCEs during a particular plan year over the maximum amount of such contributions allowed under the ACP test for that plan year. If the ACP test for a plan year is not satisfied, the plan will no longer be qualified. However, the regulations provide the following five mechanisms for correcting an ACP test that does not meet the requirements of the law:

- The employer makes QNECs that are treated as matching contributions for purpose of the ACP test and that, when combined with employee and matching contributions, cause the ACP test to be satisfied;
- Elective contributions are treated as matching contributions for purposes of the ACP test and, when combined with employee and matching contributions, cause the ACP test to be satisfied;
- Excess aggregate contributions and allocable income are distributed;
- If the plan so provides, excess aggregate contributions, to the extent attributable to non-vested matching contributions, and allocate income are forfeited; and
- The portion of the 401(k) plan attributable to employee and matching contributions is restructured.

A plan may use one or more of these correction methods [Treas. Reg. §§ 1.401(m)-2(b)(1), 1.401(m)-2(a)(6), 1.401(m)-2(a)(1)(iii)].

Fiduciary Responsibilities

Many of the actions needed to operate a 401(k) plan involve fiduciary decisions. This is true whether or not the employer (plan sponsor) hires someone to manage the plan for them or do some or all of the plan management themselves. Controlling the assets of the plan or using discretion in administering and managing the plan makes the employer (plan sponsor) and the entity hired a plan fiduciary to the extent of that discretion or control. Hiring someone to perform fiduciary functions is itself a fiduciary act. Thus, fiduciary status is based on the functions performed for the plan, not a title.

Some decisions with respect to a plan are business decisions, rather than fiduciary decisions. For instance, the decisions to establish a plan, include certain features, amend,
and terminate a plan, are all business decisions. When making these decisions, the employer is acting on behalf of the business, not the plan, and therefore, would not be a fiduciary. However, when the employer (plan sponsor) takes steps to implement these decisions, the plan sponsor (or those the plan sponsor hired) are acting on behalf of the plan and thus, in making decisions, may be acting as fiduciaries.

**Basic Responsibilities**

Those persons or entities that are fiduciaries are in a position of trust with respect to the participants and beneficiaries in the plan. The fiduciary’s responsibilities include:

- Acting solely in the interest of the participants and their beneficiaries;
- Acting for the exclusive purpose of providing benefits to workers participating in the plan and their beneficiaries, and defraying reasonable expenses of the plan;
- Carrying out duties with the care, skill, prudence, and diligence of a prudent person familiar with such matters;
- Following the plan documents; and
- Diversifying plan investments.

These are the responsibilities that fiduciaries need to keep in mind as they carry out their duties. The responsibility to be prudent covers a wide range of functions needed to operate a plan. And, since all these functions must be carried out in the same manner as a prudent person would, it may be in the employer’s best interest to consult experts in various fields, such as investments and accounting.

**Limiting Liability**

With these responsibilities, there is also some potential liability. Sponsors who go it alone can hire a service provider (a financial institution and or an investment consultant) who accepts no fiduciary responsibility for his or her advice. This does nothing to mitigate the sponsor’s fiduciary risk. However, there are actions the plan sponsor can take to demonstrate that they carried out their responsibilities properly as well as ways to limit their liability.

One way to limit the liability of the plan sponsor is to hire outside fiduciaries (service providers/advisors). For plan sponsors who are uncomfortable with bearing the risk alone, ERISA provides three options. They are:

- Section 3(16) Fiduciary;
- Section 3(38) Fiduciary; and
- Section 3(21) Fiduciary.

**ERISA Section 3(16) Fiduciary**

The plan sponsor hires an individual who accepts total responsibility for the operation of the 401(k) plan, which includes the hiring of service providers, ensuring appropriate and
timely filings, handling disclosure notices, etc. The 3(16) Fiduciary operates the plan, rather than the plan committee, business owner or board of directors. The 3(16), appoints a 3(38) Fiduciary to be responsible for the management of the plan’s investments. The only responsibility of the business owner or board of directors is to select and monitor the 3(16) Fiduciary.

**ERISA Section 3(38) Fiduciary**

The 3(38) relationship shifts the responsibility entirely onto the service provider/advisor. This means the service provider/advisor is the one who drafts the investment policy statement, designs and builds the initial fund menu, and monitors the investments. The service provider/advisor also makes whatever changes need to be made, determines mapping strategies, and provides overall documentation. In exchange for ceding total decision-making authority over the plan to the service provider/advisor, the sponsor relieves himself/herself of all fiduciary responsibility for the plan—with one important exception. Sponsors still must exercise due diligence in selecting a plan service provider/advisor. They must check out their credentials, background and track record. If they fail to do so, the service providers/advisors 3(38) status will not protect the sponsor from liability and litigation if the investment advisor does something drastically wrong. The 3(38) arrangement can be attractive to many sponsors who do not want to be bothered with the details of managing a 401(k) plan, and are wary of the potential for litigation. In their view, passing fiduciary responsibility onto a third party enables them to disengage from the plan and get on with their real business. However, the 3(38) route can be very expensive. And the liability protection under a 3(38) relationship is not without limits. Even if they’ve taken prudent care in selecting a fiduciary, sponsors still need to continuously monitor his or her activities. Sponsors also can’t second-guess or resist the fiduciary’s decisions, or they risk losing whatever liability protection the 3(38) status affords them.

**ERISA 3(21) Fiduciary**

On the other hand, there are sponsors who are uncomfortable ceding total control of their plan to a fiduciary. In that case, they have the option of entering into a 3(21) relationship. Under a 3(21) fiduciary arrangement, the service provider/advisor and sponsor become partners — in effect, co-fiduciaries. Together, they develop and draft the investment policy statement, design the fund menu and monitor the investments. When the advisor recommends changes and mapping strategies, the decisions are made jointly with the sponsor. The plan sponsor retains the responsibility to appoint and monitor the service provider/advisor and ultimately makes the investment decisions.

**Hiring a Service Provider (Advisor)**

As was discussed above, even if the plan sponsor hires a service provider/advisor to manage the plan, they retain some fiduciary responsibility for the decision to select and keep that person or entity as the plan’s service provider. Thus, the plan sponsor should
document their selection process and monitor the services provided to determine if a change needs to be made.

Some items to consider in selecting a plan service provider:

- Information about the firm itself: affiliations, financial condition, experience with 401(k) plans, and assets under their control;
- A description of business practices: how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled, and proposed fee structure;
- Information about the quality of prospective providers: the identity, experience, and qualifications of professionals who will be handling the plan’s account; any recent litigation or enforcement action that has been taken against the firm; the firm’s experience or performance record; if the firm plans to work with any of its affiliates in handling the plan’s account; and whether the firm has fiduciary liability insurance;
- Once hired, these are additional actions to take when monitoring a service provider:
  - Review the service provider’s performance;
  - Read any reports they provide;
  - Check actual fees charged;
  - Ask about policies and practices (such as trading, investment turnover, and proxy voting); and
  - Follow up on participant complaints.

**Disclosing Plan Information to Participants**

Plan sponsors are subject to extensive reporting and disclosure requirements that can be found under Sections 101 through 111 of ERISA (see Chapter 4). These sections may require disclosure of information to plan participants and beneficiaries, as well as reporting of pension and welfare plan information to governmental agencies. Some of the reporting and disclosure requirements provide that certain materials must be disseminated or made available to participants at reasonable times and places. Other requirements arise only upon the written request of a plan participant or beneficiary or upon the occurrence of a specific event.

Below is a list of documents that are required to be made available to employees that are participating in a 401(k) plan. They are:

- Summary Plan Description (SPD);
- Summary of Material Modification;
- Summary of Annual Report;
- Notice of Preretirement Survivor Benefit;
- Notice of Joint and Survivor Benefit;
Plan disclosure documents keep participants informed about the basics of plan operation, alert them to changes in the plan's structure and operations, and provide them a chance to make decisions and take timely action about their accounts.

In addition, the PPA of 2006 made enhancements to the reporting and disclosure requirements, requiring the provision of statements of a participant’s total accrued benefits, an annual funding notice for single-employer plans, as well as a notice of eligibility to divest employer securities.

**Distributing Plan Benefits**

For the most part, distributions from 401(k) plans are subject to the qualified plan distributions rules. Most plans provide for distributions in a lump sum at termination of employment.

**Rule for Elective Contributions**

A qualified 401(k) plan must provide the amounts attributable to elective contributions (including qualified non-elective contributions (QNECs) and qualified matching contributions (QMACs) that are treated as elective contributions) may not be distributed to a participant or beneficiary before the occurrence of one of the following events:

- The participant’s severance from employment, retirement, death, or disability;
- The termination of the plan without the establishment of a successor defined contribution plan (other than an employee stock ownership plan or a SEP IRA) [IRC 401(k)(10)(A)];
- The participant’s attainment of age 59 ½ if the CODA is part of a profit sharing or stock bonus plan; or
- The participant’s hardship if the CODA is part of a profit sharing or stock bonus plan.

If the amounts attributable to elective contributions (including QNECs and QMACs that are treated as elective contributions) are required by an employer to be transferred to another qualified retirement plan of any employer, the distribution restrictions continue to apply to the transferred amounts. Thus, such other plan will not be qualified if the transferred amounts are distributed before the occurrence of one of the events specified above. However, the distribution restrictions do not apply to rollovers and elective transfers by employees.

The distribution restrictions continue to apply to the sale of a corporate subsidiary to an unrelated entity (as opposed to the sale of an entire business to a different employer) with
respect to an employee who continues employment with such subsidiary at the same
desk. This rule doesn’t apply to an employee who works at the same desk for a new
employer.

Hardship distributions are exceptions to the traditional qualified plan distribution rules
and are explained in great detail below.

**Rule for Non-Elective Contributions**

In contrast to the rule for elective contributions, employer non-elective contributions may
be distributed after a fixed number of years, the attainment of a stated age, or upon the
occurrence of an event such as a layoff or illness.

**10% Tax on Early (Pre-Mature) Distributions**

If a distribution is made to an employee under the plan before he or she reaches age 59½,
the employee may have to pay a 10% additional tax on the distribution [IRC § 72(t)(1)].
This tax applies to the amount received that the employee must include in income.

**10% Tax Exemptions on Early (Premature) Distributions**

The 10% tax will not apply if distributions before age 59½ are made in any of the
following circumstances:

- Made to a beneficiary (or to the estate of the employee) on or after the death of
  the employee [IRC § 72(t)(2)(A)(ii)];
- Made due to the employee having a qualifying disability [IRC § 72(t)(2)(A)(iii)];
- Made as part of a series of substantially equal periodic payments beginning after
  separation from service and made at least annually for the life or life expectancy
  of the employee or the joint lives or life expectancies of the employee and his or
  her designated beneficiary. (The payments under this exception, except in the case
  of death or disability, must continue for at least 5 years or until the employee
  reaches age 59½, whichever is the longer period.) [IRC § 72(t)(2)(A)(iv)];
- Made to an employee after separation from service if the separation occurred
during or after the calendar year in which the employee reached age 55 [IRC §
  72(t)(2)(A)(v) and IRC § 72(t)(10)];
- Made to an alternate payee under a QDRO [IRC § 72(t)(2)(C)];
- Made to an employee for medical care up to the amount allowable as a medical
  expense deduction (determined without regard to whether the employee itemizes
deductions) [IRC § 72(t)(2)(B)];
- Timely made to reduce excess contributions under a 401(k) plan [IRC §
  401(k)(8)(D)];
- Timely made to reduce excess employee or matching employer contributions
  (excess aggregate contributions);
- Timely made to reduce excess elective deferrals [IRC § 4072(t)(2)(A)(iii)];
- Made because of an IRS levy on the plan [IRC § 72(t)(2)(A)(vi)];
• Made as a qualified reservist distribution [IRC § 72(t)(2)(G)]; and
• Made as a permissible withdrawal from an eligible automatic contribution arrangement (EACA).

To report the tax on early distributions, file IRS Form 5329, Additional Taxes on Qualified plans (including IRAs) and Other Tax-Favored Accounts. See the form instructions for additional information about this tax.

Loans and Hardships

Many 401(k) plans allow participants to take a loan from their plan accounts. An advantage (and possibly a disadvantage) of some 401(k) plans is that the participant may be able to borrow as much as 50% of their vested account balance up to $50,000 [IRC 72(p)(2)]. In most cases, if the participant systematically pays back the loan with interest in five years, there are no penalties assessed. In addition, most plans permit participants to take hardship withdrawals to finance certain contingencies, such as medical expenses, the purchase of a principal residence, or college tuition.

Loans

To receive a plan loan, a participant must apply for the loan and the loan must meet certain requirements. When a participant requests a loan, he or she should receive information from the plan administrator describing the availability of and terms for obtaining a loan (discussed below).

The maximum amount a participant may borrow from his or her plan is 50% of his or her vested account balance or $50,000, whichever is less [IRC § 72(p)(2)(A)(i)]. An exception to this limit is if 50% of the vested account balance is less than $10,000: in such case, the participant may borrow up to $10,000 [IRC § 72(p)(2)(A)(ii)]. Plans are not required to include this exception.

Example: Bill’s vested account balance is $80,000. Bill may take a loan up to $40,000, the lesser of 50% of his vested account balance and $50,000.

Example: Sue has a vested account balance of $120,000. Sue may take a loan up to $50,000, the lesser of 50% of her vested account balance of $120,000 ($60,000) or $50,000.

Generally, the employee must repay a plan loan within five years and must make payments at least quarterly [IRC § 72(p)(2)(B)(i)]. The law provides an exception to the 5-year requirement if the employee uses the loan to purchase a primary residence [IRC § 72(p)(2)(A)(ii)].

Loans that exceed the maximum amount or do not follow the required repayment schedule are considered "deemed distributions.” If the loan repayments are not made at
least quarterly, the remaining balance is treated as a distribution that is subject to income tax. In addition, if the participant is under age 59 ½, the deemed distribution would be subject to a 10% early withdrawal penalty [IRC § 72(t)1]. If the employee continues to participate in the plan after the deemed distribution occurs, he or she is still required to make loan repayments. These amounts are treated as basis and will not be taxable when later distributed by the plan. If the employee (participant) terminates employment, the plan may require the employee to repay completely the loan prior to termination. The employee can avoid the immediate income tax consequences if he or she is able to come up with the loan’s outstanding balance, within 60 days and rolls over this amount to an IRA or eligible retirement plan.

If the employee is in the armed forces, the employer may suspend the loan repayments during the employee’s period of active duty and then extend the loan repayment period by this period. If during a leave of absence from his or her employer, an employee’s salary is reduced to the point at which the salary is insufficient to repay the loan, the employer may suspend repayment up to a year. Unlike the exception for active members of the armed forces, the loan repayment period is not extended and the employee may be required to increase the scheduled payment amounts in order to pay off the loan in the originally scheduled period.

The participant should receive information describing the availability of and terms for obtaining a loan. Some information that may be provided to a participant is as follows:

- Loans are/are not permitted;
- Minimum dollar amount required to obtain a loan;
- Maximum number of loans permitted by the plan;
- Maximum dollar amount permitted;
- Term of repayment (number of years);
- Interest rate information;
- Security for the loan;
- How repayment may be made (for instance, payroll deduction); and
- Spousal consent requirements.

**Hardship Withdrawals**

A retirement plan may, but is not required to, provide for hardship distributions. Many plans that provide for elective deferrals provide for hardship distributions. Thus, 401(k) plans may permit hardship distributions. If a 401(k) plan provides for hardship distributions, it must provide the specific criteria used to make the determination of hardship. Thus, for example, a plan may provide that a distribution can be made only for medical or funeral expenses, but not for the purchase of a principal residence or payment of tuition and education expenses. In determining the existence of a need and of the amount necessary to meet the need, the plan must specify and apply nondiscriminatory and objective standards [Treas. Reg. §1.401(k)-1(d)(3)(i)].
For a distribution from a 401(k) plan to be on account of hardship, it must be made on account of an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse or dependent [Treas. Reg. §1.401(k)-1(d)(3)(i)].

Under Section 826 of the PPA of 2006, the need of the employee also may include the need of the employee's non-spouse (including domestic partners), non-dependent beneficiary. Whether a need is immediate and heavy depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including:

- Certain medical expenses;
- Costs relating to the purchase of a principal residence;
- Tuition and related educational fees and expenses;
- Payments necessary to prevent eviction from, or foreclosure on, a principal residence;
- Burial or funeral expenses; and
- Certain expenses for the repair of damage to the employee's principal residence.

A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee [Treas. Reg. §1.401(k)-1(d)(3)(iii)]. A distribution is not considered necessary to satisfy an immediate and heavy financial need of an employee if the employee has other resources available to meet the need, including assets of the employee's spouse and minor children. Whether other resources are available is determined based on facts and circumstances. Thus, for example, a vacation home owned by the employee and the employee's spouse generally is considered a resource of the employee, while property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not considered a resource of the employee [Treas. Reg. §1.401(k)-1(d)(3)(iv)(B)].

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if:

- The employee has obtained all other currently available distributions and loans under the plan and all other plans maintained by the employer; and
  - The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution. (Treas. Reg. §1.401(k)-1(d)(3)(iv)(E))

A hardship distribution may not exceed the amount of the employee's need. However, the amount required to satisfy the financial need may include amounts necessary to pay any taxes or penalties that may result from the distribution [Treas. Reg. §1.401(k)-1(d)(3)(iv)(A)]. The amount of elective contributions available for a hardship distribution cannot be more than the amount of the employee's total elective contributions, including designated Roth contributions, as of the date of distribution reduced by the amount of
previous distributions of elective contributions. This "maximum distributable amount" generally does not include earnings, qualified non-elective contributions or qualified matching contributions, unless the plan provides that certain grandfathered amounts are included. Other amounts under the plan, if any, such as regular matching contributions and discretionary profit-sharing contributions may also be distributed on account of hardship if the plan so provides [Treas. Reg. §1.401(k)-1(d)(3)(ii)]. After an employee receives a hardship distribution of elective contributions from his or her 401(k) plan, generally the employee will be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)(2)].

Hardship distributions are includible in gross income unless they consist of designated Roth contributions. In addition, they may be subject to an additional tax on early distributions of elective contributions. Unlike loans, hardship distributions are not repaid to the plan. Thus, a hardship distribution permanently reduces the employee's account balance under the plan.

In-Service Distributions

Many 401(k) plans allow workers to take “in-service” distributions from certain contributions made to the plan before they leave employment. This early payout provision is known as an in-service distribution option. Income taxes and penalties may apply to these distributions and the individual should consult with his or her tax advisor before initiating any distribution.

The in-service distribution option allows certain plan participants to receive some or all of their retirement assets while they are still employed. Furthermore, many in-service distributions are set forth in federal pension law (ERISA and PPA of 2006). In addition, the plan documents may impose additional requirements and limitations. The plan document specifies whether an in-service distribution provision is available and the conditions under which the working participant may use the in-service distribution options.

Rules for In-Service Distributions

Different contribution types are often subject to different in-service distribution rules. The rules are driven by both legal requirements and plan document language. The availability of in-service distributions can be conditioned upon various circumstances, including the following:

- **Attainment of a Specified Age.** Under this restriction, an individual still working for his or her employer may be eligible to take a distribution of some or all contribution types once he or she reaches the designated age that is outlined in the plan document. The in-service distribution option tied to the attainment of a
specified age has gained popularity with employers. For example, generally, employee salary deferrals, qualified non-elective contributions (QNECs), and qualified matching contributions (QMACs) are not eligible for in-service distribution until the participant attains age 59 ½. The distribution recipient must be aware that if he or she is not age 59 ½ or is not rolling the distribution into an IRA or other retirement plan, the amount could be subject to a 10% early distribution penalty tax;

- **Completion of a Specified Period of Service.** Under this restriction, once a participant completes a specified number of years of service with an employer, certain contribution types may be available for an in-service distribution. The following represents a review of the types of plan contributions and their respective in-service distribution rules;

- **In-Service Distributions of Employer Contributions.** Some plans allow employed participants, who otherwise would not be eligible for distributions, to take withdrawals of their employer-provided contributions. Distributions of employee salary deferrals taken while still employed are only available under a separate set of rules for hardship:
  - If the plan permits, a 401(k) plan/PS plan participant may take an in-service withdrawal of employer contributions. The portion of the individual’s account balance attributable to employer contributions that are eligible for an in-service withdrawal depends upon the length of time the individual has participated in the plan. Participants with fewer than five years of service may only access assets that have been in the plan for at least two years. This rule is sometimes referred to as the “two-year bake” rule. Participants with five or more years of service are not restricted by the two-year bake rule. The sponsoring employer may condition the withdrawal of employer contributions to situations of hardship, attainment of a specified age, or completion of a specified period of service.

- **In-Service Distributions of Employer Contributions Restricted to Hardship.** An employer may choose to limit in-service distributions of employer contributions to situations of hardship. In-service distributions as a result of hardship are not subject to the two-year bake rule. Instead, employers will frequently limit the amount of the in-service hardship withdrawal to the lesser of:
  - The employee’s vested balance in his or her individual account; attributable to employer contributions; and
  - The amount of the employee’s immediate and heavy financial need.

It is important to refer to the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Often the plan will use the same definition of hardship that applies for distributions of employee salary deferrals. Note that hardship distributions are not eligible for rollover.

- **Hardship Distributions of Employee Salary Deferrals.** Typically, employee salary deferrals may not be distributed prior to severance from employment, death, disability, plan termination, attainment of age 59½, or hardship. Hardship distributions of employee salary deferrals are not subject to the two-year bake
rule, but the plan must limit the amount of the distribution to the lesser of the participant’s employee salary deferrals, reduced by previous hardship distributions, plus the following pre-1989 amounts: earnings on deferrals, qualified non-elective contributions (QNECs) and their earnings, and qualified matching contributions (QMACs) and their earnings. It is important to review the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Hardship distributions of employee salary deferrals are not eligible for rollover;

- **In-Service Distributions of Rollover Contributions.** Another important source of in-service distribution dollars is rollover contributions. Rollover contributions are amounts a plan participant has moved into his or her current employer’s plan from a prior plan or IRA. Many plans permit in-service distributions of rollover contribution amounts at any time; and

- **In-Service Distribution of After-Tax Account.** If the plan document permits, it may be possible for a participant to request a distribution of 401(k) plan after-tax contributions while still working; the tax consequences typically depend on whether the individual rolls over the amount or whether the distribution comes from pre-1987 or post-1986 after-tax amounts. Pre-1987 after-tax contributions can potentially be recovered without associated earnings if the record keeper has tracked these dollars. Post-1986 after-tax contributions and earnings in the account are subject to special “basis recovery rules” that require the participant to treat recovered amounts as consisting of a pro rata share of after-tax contributions and earnings.

**Note:** Based on the distribution treatment of pre-1987 after-tax contributions and/or the overall ratio of after-tax contributions to earnings, plan participants should consider whether to rollover an after-tax distribution to a Traditional IRA or whether to make a rollover conversion to a Roth IRA or a mixture of both options.

### 401(k) Plan Investing

Generally, 401(k) plans allow their participants some degree of investment control over their accounts (participant-directed). The most common method is for the employer to designate a limited number of investment alternatives among which participants can elect to invest some or all of their accounts. An alternative is the fully directed plan in which participants can elect from a virtually unlimited universe of investments within the three primary asset classes: stocks, bonds and cash investments. As in any long-term investment portfolio, which asset classes are included and how much is allocated to each asset class will generally dominate the return, with such factors as investment selection and market timing being less significant.

The typical investment vehicles in 401(k) plans include mutual funds, variable annuity contracts; guaranteed investment contracts (GICs), stable value funds, life insurance contracts, and employer stock. Recently, we have seen a number of 401(k) plans expand
their investment options to various asset allocation funds, target-date funds, guaranteed income annuity contracts, REITs, alternative investment vehicles such as separately managed accounts and commingled trust funds, emerging markets, and the conversation has begun to offer ETFs.

**Participant Directed Plans**

It is important to remember that these types of participant-directed plans that offer participants a choice among a limited group of funds designated by the employer is the type of plan design that ERISA Section 404(c) regulation focuses on (see Chapter 9).

ERISA 404(c) states that if a participant in a defined contribution plan exercises control over the assets in his or her account, the participant will not be considered a fiduciary by reason of that control, and no other fiduciary shall be held responsible for losses resulting from that control.

Under DOL regulation [§ 2550.404c-1(b)], fiduciary protection is available to participant-directed plan only if it meets the following requirements:

- It permits participants to choose from a broad range of investment alternatives that meet certain criteria (discussed below); and if designated funds are used to satisfy the broad-range requirements, a minimum of three pooled or core funds must be selected;
- It provides an opportunity for participants to exercise control over the assets in their accounts. For this opportunity to exist, the following conditions must be present:
  - Participants are permitted to make transfers among investment alternatives with a frequency commensurate with the volatility of the investments. For example, if three core funds are offered to satisfy the broad-range requirement, a transfer option must be offered at least quarterly for all three core funds;
  - Participants are provided with sufficient information to permit informed investment decision making; and
  - Participants can give investment instructions to an identified plan fiduciary who is obligated to comply with those instructions.

**Broad Range of Investment Alternatives**

To satisfy the broad-range investment alternative the following conditions must be met. They are:

- Participants are given a reasonable opportunity to materially affect the level of return and degree of risk to which their accounts are subject;
- Participants are given the opportunity to choose from at least three investment alternatives that satisfy the following:
Each alternative is diversified. (A fund that invests only in assets within the same industry may not be considered adequately diversified.);

- Each alternative is materially different in terms of risk and return characteristics;
- In the aggregate, the alternatives enable participants to achieve a portfolio with aggregated risk and return a characteristic at any point within a range normally appropriate for the participants;
- Each of the three funds, when combined with other alternatives, tends to minimize through diversification the overall risks of loss; and

- Participants must have the opportunity to diversify so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participant accounts.

A plan that is self-directed—that is, one that permits participants to invest in any asset of their choice—should automatically satisfy the broad-range requirement.

**Default Investment Funds**

The PPA of 2006 (PPA) extended fiduciary relief under ERISA § 404(c) to investments in certain types of default arrangements in the absence of participant investment direction. To obtain protection, two conditions must be met:

- Participant contributions must be invested in accordance with DOL regulations (i.e., in a qualified default investment alternative (QDIA); and
- Participant notice requirements must be met [ERISA § 404(c)(5)].

According to DOL regulations, a qualified default investment alternative (QDIA) falls under four basic categories:

- Life-cycle or targeted retirement-date funds with mixed investments, usually taking into account the individual’s age or expected retirement date;
- An investment service that allocates the individual’s contributions among existing plan options, designed to result in an asset mix that takes into account the individual’s age or retirement date (this could include a professionally managed account);
- An option that uses a mix of investments taking into account the characteristics of the group of employees as a whole, rather than each individual (such as a balanced fund); and
- A capital preservation product, but only for the first 120 days of participation.

Under these new regulations generated by the PPA’s statutory requirements, plan sponsors seeking safe harbor relief from fiduciary liability for investment outcomes must satisfy the following requirements:

- The plan must offer a “broad range of investment alternatives” as defined in the DOL’s regulation under ERISA § 404(c);
• 401(k) plan assets must be invested in a QDIA as defined in the regulation;
• Participants and beneficiaries must have been given an opportunity to provide investment direction, if they have not done so;
• A notice generally must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. (In fact, given the nuances involved in automatic enrollment and the QDIA rules, a model notice appropriate for most automatic enrollment plans may be all but impossible to create.) However, the regulation requires the notice to include information on:
  o the circumstances that will trigger automatic enrollment, the percentage of salary of such withholdings and the right of the participant to opt out of the plan or to change the contribution percentage and the right to opt out of such withholdings;
  o the right to direct investments;
  o a description of the QDIA, including investment objectives, fees and expenses and risk and return characteristics;
  o a description of the participant’s right to direct the investment of the account in other alternative investments; and
  o an explanation of how to obtain information about other investment alternatives.
• Material, such as investment prospectuses for the QDIA, provided to the plan also must be furnished to participants and beneficiaries;
• Participants and beneficiaries must have the opportunity to move investments out of a QDIA as frequently as from other plan investments, but no less frequently than quarterly; and
• The rule limits the fees that can be imposed on a participant who opts out of participation in the plan or who decides to direct his or her investments.

Qualifying Longevity Contracts (QLAC)

The insurance industry received a July 4th gift from the IRS in the form of a new regulation released on July 1, 2014 that makes it possible to place pension plan investments (and IRAs) into fixed annuities that will enable the participant to avoid the required minimum distribution (RMD) rules that apply after age 70 ½ to the extent that plan assets are held under such vehicles. The maximum amount that can be invested in such fixed annuities under a pension (IRA) will be the lesser of $125,000 or 25% of the value of the pension or IRA account as of the time of the investment. Basically, the value of such contracts will not be considered to be assets of the IRA or pension for purposes of the RMD rules until the owner is age 85.

These rules will also allow QLAC’s to be held under 403(b), and 457(b) plans, but not under defined benefit plans or Roth IRAs.

Under the regulations, these annuity contracts will not be variable or equity indexed annuities, even if they offer a guaranteed minimum rate of return, unless or until explicitly approved by the IRS. Instead, the products available will be ones with a fixed
rate of return, life payment, or other similar contract that can be expected to guarantee a minimum rate of return, and to actually credit a slightly higher rate of return in the same manner that many whole life insurance products now offer. The preamble to the new regulations point out that variable and equity indexed annuities with contractual guarantees provide an unpredictable level of income to the holder, and they are inconsistent with the purpose of the new regulation.

A typical arrangement would be that a taxpayer would invest $125,000 (the maximum that can be invested is the lesser of 25% of the value of the qualified account at the time of the investment or $125,000) into a deferred income annuity contract that would pay-out upon the earlier of the death of the account holder or planned participant or ratably from ages 85-90.

**Example:** If a 65 year old male wants to receive monthly income of $1,000 from his IRA after the age of 80, put $47,920 into an annuity contract under his IRA, and the value of the annuity contract would not be subject to the RMD rules on the value of his IRA until reaching age 80. The contract could allow access to receive payments earlier, if and when needed, based upon the terms of the contract.

The new regulations require that payments from a QLAC must begin to be made by age 85. Therefore, if a 65 year old man wants to receive $1,000 a month for life beginning at age 85, he would only have to put $26,634 into a QLAC contract, and would receive a guaranteed payment for life beginning at age 85.

In both of the above arrangements there is a death benefit, as is permitted under the new regulations, which will provide that if the account holder dies before receiving payments equal to the amount invested, then the deficit amount will be paid into the IRA (typically without interest) shortly after death, or payments might continue for the lifetime of a surviving spouse who could roll the annuity over to his or her own IRA and continue to have the benefit of payment rights.

**IRS Notice 2014 – 66**

In this notice from the IRS, it now allows a set of deferred annuities to be folded into target date funds held in a 401(k) plan. Previously, using an annuity in a target date fund was essentially an all-or-nothing proposition. Now, a participant can choose to use a portion of their savings to purchase guaranteed income for life, while retaining other savings in other investments.

This new rule bypasses anti-discrimination rules if the following four requirements are met:

- The target date fund series is designed to serve as a single integrated investment program "under which the same investment manager manages each date fund and
applies the same generally accepted investment theories across the series of target date funds;”

- The annuities within target date funds offered to older employees cannot feature a guaranteed minimum withdrawal benefit (an arrangement available to annuity buyers outside retirement plans);
- The target date fund cannot invest in employer stock; and
- Each target date fund in the series “is treated in the same manner with respect to rights or features other than the mix of assets.” Therefore, for example, fees and administrative expenses for each target date fund must be set “in a consistent manner.”

When the target date fund reaches its target date, the series of annuity contracts that have accumulated over the years is converted to an annuity certificate “representing the participant’s interest in the annuity contract held in the TDF,” or target date fund, according to the IRS. The participant’s non-annuity target date fund assets can be invested in other investment options in the plan.
Chapter 11
Review Questions

1. Which of the following Acts enacted by congress established the 401(k) plan?
   (   ) A. Tax Reform Act of 1986
   (   ) B. Employee Retirement Income Security Act of 1974
   (   ) C. The Deficit Reduction Act of 2005
   (   ) D. The Tax Revenue Act of 1978

2. Which of the following entities is not allowed to set up a 401(k) plan?
   (   ) A. Corporations
   (   ) B. Sole Proprietors
   (   ) C. State and local governments
   (   ) D. Tax-exempt entities

3. Which of the following kinds of contributions must always be 100% vested?
   (   ) A. Employer non-elective contributions
   (   ) B. Qualified matching contributions (QMACs)
   (   ) C. Elective contributions
   (   ) D. Rollover contributions

4. Which of the following statements about the Roth 401(k) plan is FALSE?
   (   ) A. Must set up separate accounts (designated Roth Accounts)
   (   ) B. Must maintain separate recordkeeping for each account
   (   ) C. Employer contributions cannot be allocated to the Roth accounts in a 401(k) plan.
   (   ) D. The participant is allowed to make a maximum deferral to a regular 401(k) in addition to making Roth contributions.

5. The maximum amount a participant may borrow from his or her plan is 50% of his or her vested account balance or ________, whichever is less.
   (   ) A. $10,000
   (   ) B. $50,000
   (   ) C. $25,000
   (   ) D. $100,000
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CHAPTER 12

TYPES OF 401(k) PLANS

Overview

There are several different types of 401k plans. There is the traditional 401k plan, the safe harbor 401k plan, and the SIMPLE 401k plan. You can also have a ROTH provision in the plan document along with provisions that allow loans, in service withdrawals etc. The plan document may be a prototype, a volume submitter or even a custom plan.

In this chapter, we will examine the various types of 401(k) plans, beginning with the traditional 401(k), then discuss the Safe Harbor 401(k) plan, the SIMPLE 401(k), the Individual (Solo 401(k) plan, and the Automatic Enrollment 401(k) plan.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The features and benefits of the Traditional 401(k);
- The features and benefits of a Safe Harbor 401(k);
- The features and benefit of a SIMPLE 401(k);
- The features and benefits of an Individual (Solo) 401(k); and
- The features and benefits of an Automatic Enrollment 401(k) plan.

Traditional 401(k) Plans

The first option usually considered by employers is a standard or traditional 401(k) Plan. Such plans can be structured either with or without a “matching” employer contribution feature. In addition, such matching contributions can either be mandatory or discretionary, depending upon the employer’s preference. These 401(k) traditional 401(k) plans provide an excellent opportunity for those employees who want to take some initiative towards saving for their own retirement.

In a traditional 401(k) plan, an employee can elect to defer up to $18,000 of their salary which can represent 100% of their salary in 2017. The employee is 100% vested in the amounts deferred as they are considered a form of vested compensation. If the employer makes a contribution to the plan, such as a PS contribution, the employer contribution can be subject to a vesting schedule which may be a 6 year graded vesting schedule or a 3 year cliff vesting schedule.
However, the main drawback of such plans, especially for small business owners, is that many employers find them too restrictive by limiting the amount that owners and HCEs (those making over $120,000 for 2017) can contribute due to required actual deferral percentage (ADP) testing each year. (Such ADP testing is designed to ensure that HCEs do not contribute at a significantly higher percentage than do other NHCEs.) And, in many cases, the employees who are NHCEs do not defer and only the HCEs defer which creates a plan failure of meeting the non-discrimination rules and the contributions are then refunded back to the employees or a qualified non-elective contribution (QNEC) must be made.

Due to these plan failures which will not be known until the end of the year, many companies elect to set up a safe harbor 401(k).

**Safe Harbor 401K**

A “safe harbor 401(k) plan” is similar to a traditional 401(k) plan, but, among other things, must provide for employer contributions that are fully vested when made. This plan is intended to encourage plan participation among rank-and-file employees and to ease administrative burden by eliminating the non-discrimination and top heavy tests ordinarily applied under a traditional 401(k) plan. The safe harbor 401(k) plan is ideal for businesses with HCEs whose contributions would be limited in a traditional 401(k) plan.

**Eligible Entities**

Any non-governmental employer is eligible to establish a safe harbor 401(k) plan. There are no requirements pertaining to the number of employees in the organization; thus, large and small employers are eligible.

With regards to the terms of employees, once they satisfy the age and service requirements stated in the plan, they become eligible employees and are entitled to receive the employer’s matching or non-elective contributions for that particular plan year. Restrictions or conditions cannot be placed on such eligibility.

*Example:* In a safe harbor 401(k) plan an employee who becomes eligible to participate on the last day of the plan year must receive the same matching contribution (or non-elective contribution) as those who have participated for the full year.

**Safe Harbor Plan Requirements**

IRC § 401(k)(12) provides a design-based safe harbor method under which a 401(k) (CODA) is treated as satisfying the ADP test if the arrangement meets certain contribution and notice requirements [Treas. Reg. § 1.401(k)-3(a) through (h)]. If the plan also satisfies the requirements of IRC § 401(m)(11) and does not provide for employee
contributions, it will be treated as satisfying the ACP test as well [Treas. Reg. § 1.401(m)-3].

A plan that uses the safe harbor methods to satisfy the ADP or ACP test is treated as using the current year testing method for that plan year. A plan can satisfy the ADP safe harbor without satisfying the ACP safe harbor, but a plan cannot satisfy the ACP safe harbor without satisfying the ADP safe harbor.

**Safe Harbor Plan Provisions**

Generally, an employer that intends to use the safe harbor provisions for a plan year must adopt those provisions before the first day of that plan year and such provisions must remain in effect for an entire 12-month plan year.

A safe harbor 401(k) plan can have a short plan year:

- In the first year of the plan or CODA;
- If the plan changes plan years; and
- For the plan’s final plan year. (Treas. Reg. § 1.401(k)-3(e)].

Treas. Reg. § 1.401(k)-3(f) provides for what’s sometimes called a "maybe safe harbor plan," whereby a notice is distributed to employees at the normal time prior to a plan year stating that the plan may be amended before the end of the plan year to become a safe harbor plan providing for safe harbor non-elective contributions. To become a safe harbor plan, the plan must be amended no later than 30 days prior to the end of the plan year and distribute a new notice to employees explaining the amendment.

Treas. Reg. § 1.401(k)-3(g) provides that a safe harbor 401(k) plan using safe harbor matching contributions may be amended during a plan year to suspend or reduce the matching contributions prospectively for that plan year. A new notice must be provided to employees and the plan is subject to the ADP (and ACP) test for the entire plan year.

Proposed Regulations, 74 FR 23134, under sections 401(k) and 401(m) permit a safe harbor plan using safe harbor non-elective contributions to be amended to reduce or suspend such contributions mid-year if the employer incurs a substantial business hardship and satisfies certain other requirements.

IRS Announcement 2007-59, 2007-1 C.B. 1448, provides that a plan will not fail to satisfy the requirements to be a safe harbor section 401(k) merely because of the mid-year addition of a designated Roth contribution program or the deemed hardship rules for the designated beneficiary of a participant (under PPA section 826, see Chapter 11).

**Special Compensation Definition for Safe Harbor Plans**

Generally, the same definitions apply as used in other CODAs. However for determining safe harbor matching and non-elective contributions, "safe harbor compensation" must
be used. This is the normal definition of compensation, which incorporates the definition of compensation in Treas. Reg. § 1.414(s)-1, except that the last sentence in Treas. Reg. § 1.414(s)-1(d)(2)(iii) (permitting a plan to disregard all compensation that exceeds a specified dollar amount) does not apply.

**Note:** The annual compensation limit of $270,000 under IRC § 401(a)(17) still applies.

A safe harbor 401(k) plan can restrict the type of compensation that can be deferred, as long as each eligible NHCE may make elective contributions under a "reasonable definition" of compensation as defined under Treas. Reg. § 1.414(s)-1(d)(2). Such definition is not required to satisfy the non-discrimination requirement of Treas. Reg. § 1.414(s)-1(d)(3). However, the plan must permit each eligible NHCE to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions under the plan for the plan year and the employee must be permitted to elect any lesser amount of elective contributions.

**Example:** An employer's 401(k) plan defines compensation as "all salary, wages, bonuses, and other remuneration not exceeding $75,000." The plan does not satisfy the ADP/ACP test safe harbors because the definition of compensation excludes compensation over $75,000.

**Example:** An employer's 401(k) plan allows employees to make elective contributions only from basic compensation, defined as salary, regular time wages, bonuses and commissions, and excluding overtime pay. This is a reasonable definition of compensation within the meaning of Treas. Reg. § 1.414(s)-1(d)(2), but is not necessarily nondiscriminatory. The plan provides for a required matching contribution equal to 100 percent of each eligible employee's elective contributions, up to 4 percent of compensation. For purposes of the matching formula, compensation is defined as compensation under IRC § 415(c)(3). Under the plan, each NHCE who is an eligible employee is permitted to make elective contributions equal to at least 4 percent of the employee's compensation under IRC § 415(c)(3) (that is the amount of elective contributions sufficient to receive the maximum amount of matching contributions available under the plan). This plan's definitions of compensation satisfy the safe harbor rules.

**ADP Test Safe Harbor Requirements**

As was discussed above, in order for the plan to satisfy the ADP safe harbor, a CODA must satisfy the safe harbor contribution requirement and the notice requirement of IRC § 401(k)(12) and Treas. Reg. § 1.401(k)-3.

The safe harbor contribution requirement is satisfied for a plan year if the plan satisfies either:

- The matching contribution requirement; or
• The non-elective contribution requirement.

Safe harbor matching or safe harbor non-elective contributions, whichever is used, must be made on behalf of all eligible employees under the plan; meaning, for example, that the plan cannot restrict these contributions to employees employed on the last day of the plan year or to employees who have at least 1,000 hours of service in the plan year. The safe harbor contribution requirement must be satisfied without regard to the integration provisions of IRC § 401(l).

A plan may satisfy the matching contribution requirement by providing for either:

• The basic matching formula; or
• An enhanced matching formula.

The basic matching formula provides qualified matching contributions (QMACs) on behalf of each eligible NHCE in an amount equal to:

• 100 percent of the employee’s elective contributions up to 3 percent of the employee’s compensation; and
• 50 percent of the employee’s elective contributions between 3 and 5 percent of the employee’s compensation.

The rate of matching contributions for HCEs must not exceed the rates for NHCEs.

An enhanced matching formula provides QMACs for each eligible NHCE under a formula that provides an aggregate amount of QMACs at least equal to the aggregate amount that would have been provided under the basic matching formula at any elective contribution rate, and the rate of matching contributions may not increase as an employee’s rate of elective contributions increases.

**Example:** A plan provides that QMACs will be made at the following rates: 100 percent of an employee's elective contributions that do not exceed 2 percent of compensation and 75 percent of the employee's elective contributions that exceed 2 percent but do not exceed 5 percent of compensation. This formula does not satisfy the enhanced matching formula since the aggregate amount that is provided by this formula is not at least equal to the amount that would have been provided under the basic matching formula at all rates of elective contributions. Under the basic matching formula, QMACs of 100 percent would be made on the amount of the employee's elective contributions that do not exceed 3 percent of compensation. Under the plan's formula, the amount of QMACs at 3 percent is less than 100 percent.

**Note:** A plan that contains a formula that satisfies the ADP test safe harbor will not fail the ADP test safe harbor because the plan also provides for discretionary matches, as long as the discretionary matches are limited to 4% of each employee’s compensation [Treas. Reg. § 1-401(m)-3(d)(3)].
A matching formula does not satisfy the safe harbor if, at any rate of elective contributions, the rate of matching contributions for an eligible HCE is greater than the rate of matching contributions for an eligible NHCE at the same rate of elective contributions.

**Example:** A plan covers Divisions A and B, both of which have NHCEs and HCEs. If the plan provides for a basic matching formula for Division A and an enhanced matching formula for Division B, (such as 100 percent match of each employee's elective contributions up to 4 percent of a Division B employee's IRC § 415(c)(3) compensation), the rate of match for a Division B HCE at a rate of elective contributions of 4 percent is greater than the rate of match for a Division A NHCE at the same rate of elective contributions; therefore, the plan would not satisfy the ADP test safe harbor.

However, a plan may provide that matching contributions be made on a payroll-period basis, without having to "true-up" for the whole year [Treas. Reg. § 1.401(k)-3(c)(5)(ii)].

The matching contribution requirement is not satisfied if elective contributions by NHCEs are restricted. However, the following restrictions on elective contributions are permitted:

- Certain reasonable limits on the periods during which employees can make or change their deferral elections;
- Certain limits on the amount of elective contributions that can be made, for example, an employer can require that elective contributions be made in whole percentages of pay or in whole dollar amounts;
- Certain limits on the types of compensation that may be deferred; and
- Limits on elective contributions to satisfy IRC § 402(g) or IRC § 415 or, after a hardship distribution, to satisfy the 6-month suspension period [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)].

Despite all of the restrictions just described, there are certain conditions that must be satisfied. For example, as discussed earlier, although a plan sponsor may limit the amount of elective contributions, the employer must permit each eligible NHCE to make sufficient elective contributions to receive the maximum amount of matching contributions available under the plan. For an explanation of restrictions on types of compensation that may be deferred, see the definition of compensation above.

In lieu of safe harbor matching contributions, an employer can make safe harbor non-elective contributions. The non-elective contribution requirement is satisfied if, under the terms of the plan, the employer is required to make qualified non-elective contributions (QNECs) on behalf of each eligible NHCE in an amount equal to at least 3 percent of the employee's compensation.
Safe harbor matching and non-elective contributions can be used to satisfy the safe harbor requirements for only one plan and the safe harbor contribution requirements must be satisfied without regard to IRC § 401(l).

**Notice Requirement**

The second requirement necessary to satisfy the ADP test safe harbor is the notice requirement, which is satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement and the timing requirement [Treas. Reg. § 1.401(k)-3(d)]. The notice must be in writing or in such other form as may be approved by the Commissioner.

The content requirement requires that the notice be sufficiently accurate and comprehensive, inform the employee of their rights and obligations under the plan, and be written in a manner understood by the average eligible employee.

The notice must accurately describe:

- The safe harbor matching contribution or safe harbor non-elective contribution formula used under the plan (including a description of the levels of safe harbor matching contributions, if any, available under the plan);
- Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;
- The plan to which safe harbor contributions will be made (if different than the plan containing the CODA);
- The type and amount of compensation that may be deferred under the plan;
- How to make cash or deferred elections, including any administrative requirements that apply to such elections;
- The periods available under the plan for making cash or deferred elections;
- Withdrawal and vesting provisions applicable to contributions under the plan; and
- Information that makes it easy to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of individuals or offices from whom employees can obtain such plan information.

The timing requirement requires that the plan sponsor must provide notice within a reasonable period before each year. The requirement is satisfied if the notice is given to eligible employees at least 30 days and not more than 90 days before the beginning of each plan year. In the case of an employee who does not receive the notice because the employee becomes eligible after the 90th day before the beginning of the plan year, the timing requirement is deemed to be satisfied if the notice is provided no more than 90 days before the employee becomes eligible (and no later than the date the employee becomes eligible). However, if it is not practical to provide the notice on or before the date an employee becomes eligible, a notice will nonetheless be deemed timely if it is
provided as soon as practical after that date and the employee is permitted to defer from all compensation earned from his or her eligibility date. This means, in the case of a new employee who is immediately eligible to participate in the plan, that, if it is not practical to give this employee a notice on or before his or her hire date, the notice must be given (and the employee able to make a deferral election) before the employee’s first payday.

**ACP Test Safe Harbor**

In order to satisfy the ACP test safe harbor with respect to matching contributions, a plan must satisfy the ADP test safe harbor and limit matching contributions in accordance with IRC § 401(m)(11) and Treas. Reg. § 1-401(m)-3(d).

There are three ways to satisfy the matching contribution limitations:

- The plan can provide for the "basic matching formula," described above in the ADP test safe harbor, and for no other matching contributions; and
- The plan can provide for an "enhanced matching formula," described above in the ADP test safe harbor, but under which matching contributions are only made with respect to elective contributions that do not exceed 6 percent of the employee’s compensation, and no other matching contributions are provided under the plan.

The matching contribution limitations satisfy the ACP test safe harbor if matching contributions are not made with respect to elective contributions or employee contributions that in the aggregate exceed 6 percent of the employee’s compensation.

The rate of matching contributions does not increase as the rate of employee contributions or elective contributions increases, and for employees at the same rate of elective contributions or employee contributions, the rate of matching contributions for an HCE does not exceed the rate of matching contributions for an NHCE.

The elective contributions or employee contributions that are used for determining the matching contributions may be restricted only as permitted under the rules for the ADP test safe harbor, above.

A plan that provides for discretionary matches (in addition to nondiscretionary matches needed to satisfy the ADP test safe harbor) can satisfy the ACP test safe harbor if the discretionary matches in the aggregate do not exceed a dollar amount equal to 4 percent of the employee's compensation.

The ACP test (not the safe harbor) still applies to a plan with respect to employee contributions and matching contributions that fail to satisfy the ACP test safe harbor. However, if such plan satisfies the ACP safe harbor, the ACP test can be performed only counting employee contributions (i.e., ignoring all matches) [Treas. Reg. §1-401(m)-2(a)(5)(iv)].
SIMPLE 401(k)

IRC § 401(k)(11) and 401(m)(10) of the Code provide for SIMPLE 401(k) plans. SIMPLE 401(k) plans must be maintained on a calendar-year basis. A SIMPLE 401(k) plan is deemed to satisfy the ADP and ACP tests and is not subject to the top-heavy requirements however, the employer is required to make employer contributions that are fully vested. SIMPLE 401(k) plans closely follow the requirements for SIMPLE IRA plans described in IRC § 408(p) (see Chapter 15), but SIMPLE IRA plans are far more popular with employers because the IRA plans are less burdensome to set up and maintain; for example, Form 5500s are not required for SIMPLE IRA plans.

A SIMPLE 401(k) plan can only be established by an employer that had no more than 100 employees who each received at least $5,000 of SIMPLE compensation (see below) from the employer for the prior calendar year. Also, no employee covered under the SIMPLE 401(k) plan can be covered under another plan of the employer.

Eligible Employers

The SIMPLE 401(k) plan is available to those same employers who are eligible to adopt a traditional 401(k) plan. This includes:

- Self-employed individuals;
- Corporations;
- Partnerships;
- Tax-exempt entities; and
- Indian Tribal governments

An eligible employer who establishes a SIMPLE 401(k) plan cannot maintain any other plan for employees who are eligible to participate in the SIMPLE 401(k) plan and cannot receive any contributions or benefit accruals under any other plans of the employer. By contrast, provided certain requirements are met, an employer who establishes a traditional 401(k) plan may choose to establish a SEP IRA, PS or other DC plan, maintain both plans concurrently and allow eligible employees to participate in both plans.

Contribution Limits

The employee who earned at least $5,000 from the employer in any two preceding years, and is reasonably expected to earn at least $5,000 in the current year, can make salary reduction contributions of up to $12,500 in 2017, (same as in 2016). The catch-up contribution remains $3,000 in 2017.

The employer is required to make a contribution to the employee’s 401(k) account an amount equal to either:
• Dollar for dollar matching contributions equal to the lesser of the eligible employee's elective contributions for the year or 3% of the eligible employee's SIMPLE compensation for the entire calendar year; or
• Non-elective contributions equal to 2% of the eligible employee's SIMPLE compensation for the entire calendar year, but the plan can limit the non-elective contribution to those eligible employees who received at least $5,000 of SIMPLE compensation from the employer for the entire calendar year.

SIMPLE 401(k) plans are subject to the same “annual additions” limits of IRC § 415(c). Additions to a participant’s account cannot exceed the lesser of $54,000 or 100% of compensation. Also, the compensation limit applies to both plans, which means the employer cannot consider compensation in excess of $270,000 for 2017 (indexed) for plan purposes (see Table 12.1).

Therefore, an employee's total contribution to a SIMPLE 401(k) plan for 2017 can be as much as $23,600 (salary deferral ($12,500) + 3% contribution of maximum salary of $270,000 ($8,100), plus catch-up contributions ($3,000)), while contributions to a traditional 401(k) plan can be as much as $60,000 ($54,000 + $6,000 catch-up contribution (see Table 12.1)).

A special, inclusive definition of compensation applies to SIMPLE 401(k) plans [IRC § 408(p)(6); Treas. Reg. 1.401(k)-4(e)(5)]. Basically, SIMPLE compensation is what is reported on an employee's Form W-2 for the year, including elective contributions. Also, compensation is limited to the IRC § 401(a)(17) amount ($270,000 in 2016).

**Note:** Employees are 100% immediate vested in all contributions. Loans are permitted. In-service withdrawals are permitted on account of hardships.

**Deadline to Establish SIMPLE 401(k)**

A SIMPLE 401(k) must be established between January 1 and October 1. An exception applies to businesses that come into existence after Oct. 1. For these businesses, the plan can be established as soon as administratively feasible.

**Annual Notice Requirements**

There are special election and notice requirements for SIMPLE 401(k) plans:

• For an employee’s initial year of participation, he or she must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before; and
• For each subsequent year, the employee must be permitted to make or modify his or her cash or deferred election during the 60-day period immediately preceding such calendar year.
An eligible employee must be permitted to terminate his or her cash or deferred election at any time.

The employer must notify each eligible employee within a reasonable time prior to each 60-day election period that he or she can make or modify a cash or deferred election and whether the employer will be making matching or non-elective contributions for the year. All contributions to the plan must be fully vested at all times and no contributions other than those described above and rollover contributions can be made to the plan.

### Table 12.1
**SIMPLE 401(k) and Traditional 401(k) in 2017**

<table>
<thead>
<tr>
<th></th>
<th>SIMPLE 401(k)</th>
<th>Traditional 401(k)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Maximum employee deferral</strong></td>
<td>$12,500, but cannot exceed 100% of compensation ($270,000 cap in 2017, indexed for inflation)</td>
<td>$18,000, but cannot exceed 100% of compensation ($270,000 cap in 2017, indexed for inflation)</td>
</tr>
<tr>
<td><strong>Maximum employee match</strong></td>
<td>Employer can contribute 100% of first 3% of compensation ($270,000 cap in 2017, indexed for inflation)</td>
<td>Employer can contribute a total of up to 25% of annual compensation in addition to elective deferrals and catch up contributions</td>
</tr>
<tr>
<td><strong>Employer contribution formula</strong></td>
<td>Not discretionary</td>
<td>Discretionary: formula is generally tied to profits If it is a stock bonus plan, employer can contribute company stock</td>
</tr>
<tr>
<td><strong>Non-elective contributions</strong></td>
<td>With prior notification, 2%</td>
<td>Qualified non-elective contributions (QNEC)</td>
</tr>
<tr>
<td><strong>Employee elective deferrals</strong></td>
<td>$12,500 (in 2017)</td>
<td>$18,000 (in 2017)</td>
</tr>
<tr>
<td><strong>Catch-up contributions</strong></td>
<td>$3,000 (in 2017)</td>
<td>$6,000 (in 2017)</td>
</tr>
</tbody>
</table>

**Employer eligibility**
- Self-employed
- Corporations
- Partnerships
- Tax-exempt entities
- Indian tribal governments

Employer cannot sponsor another qualified plan and must have 100 or fewer employees who earned $5,000 or more during the preceding calendar year. Governmental employers, except Indian tribal governments, cannot offer a SIMPLE 401(k) plan. All businesses and tax-exempt entities except state and local governments (Note: Governmental employers that had adopted plans prior to May 1986 were grandfathered under TRA 1986 and many Indian governments.
Individual (Solo) 401(k) Plan

The Individual 401(k) is a self-employed retirement plan that is sometimes referred to as an "Individual(k)", "Solo 401k", "Single(k)" and "Self Employed 401k". The Individual 401(k) came about with the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This tax law became effective beginning January 1, 2002 and provides significant advantages to small business owners whose only employee is the owner and the owner’s spouse.

What makes the Individual 401(k) unique is that compared to other self-employed retirement plans greater contributions may be made at identical income levels, therefore maximizing retirement contributions and valuable tax deductions (discussed below).

Eligibility

The Individual (Solo) 401(k) is for owner-only businesses or owner and spouse businesses. The business can be incorporated or unincorporated. Sole proprietors, S Corporations, C Corporations, partnerships and LLCs would qualify.

A business that employs part-time W-2 employees may be able to exclude them from plan participation. Independent contractors (IRS Form 1099 employees) employed by the business are excluded from the plan and would not disqualify the employer from having an Individual (Solo) 401(k). Generally, under federal law, the following types of employees are permitted to be excluded:

- Employees under age 21;
- Employees with less than one year of service;
- W-2 employees who work less than 1000 hours per year;
- Certain union employees; and
- Certain nonresident alien employees.

Plan Benefits

The Individual (Solo) 401(k) plan has several benefits for small business owners and the self-employed. They are:

- Higher contribution limits;
- Tax deductible contributions;
- Tax-deferred growth;
- Contribution flexibility;
- Access to tax-free loans;
- Cost effective administration; and
- Retirement plan consolidation.
Compared to traditional 401(k)s, the Individual (Solo) 401(k) plan is easy, flexible and inexpensive to maintain because administration is minimal, and complex discrimination tests are not required. Fees vary depending on the level of administrative services provided by the Individual 401(k) administrator. If an Individual (Solo) 401(k) is greater than $250,000 IRS Form 5500 needs to be filed and the administrator may charge a fee for its completion or the individual could elect to complete the form himself/herself.

Another important feature of the Individual (Solo) 401(k) plan is the opportunity for small business owner’s to consolidate retirement assets into one account. This includes Traditional IRAs, SEP IRA plans, 401(k) plans, MMP plans, SIMPLE IRAs, PS plans, DB plans, 403(b) plans, and IRA Rollovers.

Consolidating retirement accounts is particularly important if the individual small business owner would like to use the loan provision (discussed below). Other advantages of rolling over and consolidating his/her retirement plans into his/her Individual (Solo) 401(k) are improved financial organization and ease of monitoring the retirement portfolio.

**Contributions**

Individual (Solo) 401(k) retirement plans may provide significant tax savings because in general, the small business owner may deduct 100% of contributions made into an Individual (Solo) 401(k) from their taxable income. Incorporated businesses can generally deduct the salary deferral contribution from W-2 earnings and the profit sharing contribution as a business expense. Unincorporated businesses such as sole proprietors can generally deduct contributions made to an Individual (Solo) 401(k) from personal income (discussed below).

Individual (Solo) 401(k) contribution limits are $54,000 in 2017 ($60,000 in 2017 if age 50 or older). The annual Individual 401(k) contribution consists of two parts:

- A salary deferral contribution; and
- A profit sharing contribution.

The total allowable contribution adds these two parts together to get to the maximum Individual 401(k) contribution limit.

Calculation for an S or C Corporation or an LLC taxed as a corporation:

- *Salary Deferral Contribution:* In 2017, 100% of W-2 earnings up to the maximum of $18,000 or $24,000 if age 50 or older ($6,000 catch up contribution) can be contributed to an Individual 401(k); and
- *Profit Sharing Contribution:* A PS contribution up to 25% of W-2 earnings can be contributed into an Individual 401(k).
Individual (solo) 401(k) contribution calculation for a sole proprietorship, partnership or an LLC taxed as a sole proprietorship:

- **Salary Deferral Contribution:** Although the term salary deferral is used, these businesses do not provide a W-2 salary to the business owner. For businesses of this type, the salary deferral contribution is based on net adjusted business profit. Net adjusted business profit is calculated by taking gross self-employment income and then subtracting business expenses and then subtracting 1/2 of the self-employment tax. In 2017, 100% of net adjusted business profits income up to the maximum of $18,000 or $24,000 if age 50 or older can be contributed in salary deferrals into an Individual 401(k); and

- **Profit Sharing Contribution:** A profit sharing contribution can be made up to 20% of net adjusted businesses profits. Net adjusted business profit is calculated by taking gross self-employment income and then subtracting business expenses and then subtracting ½ of the self-employment tax.

Each year the funding of an Individual 401(k) retirement plan is fully discretionary. The individual can increase or decrease your salary deferral and/or profit sharing contributions depending on the profitability of your business.

**Roth Individual (Solo) 401(k)**

Individual (Solo) 401(k) salary deferral contributions can be made as Roth 401(k) (after tax) or traditional 401(k) (pre-tax). As was discussed in Chapter 11, the basic difference between a Roth 401(k) and a traditional 401(k) is that the Roth 401(k) is funded with after-tax contributions while the traditional 401(k) is funded with pre-tax contributions. In other words, with a Roth 401(k) the individual pays taxes today in return for tax-free withdrawals in retirement. Traditional 401(k) contributions are tax deductible and are made pre-tax to save taxes today, but withdrawals are taxed in retirement.

**Loans**

Similar to a traditional 401(k), an Individual (Solo) 401(k) loan is permitted at any time using the accumulated balance of the 401(k) as collateral for the loan. Individual loans are permitted up to ½ of the total balance of the 401(k) up to a maximum of $50,000. A loan from an Individual 401(k) is received tax free and penalty free. There are no penalties or taxes due provided loan payments are paid on time.

Generally, Individual (Solo) 401(k) loans have a 5 year maximum repayment term. Individual 401(k) loans used for the purchase of a primary residence may extend the loan repayment term up to 10-15 years. Loans must be repaid according to the terms of the loan amortization schedule which is provided when a loan is initiated. Failure to repay the loan according to these terms may result in a loan default causing taxes as well as IRS penalties.
Loan payments are made monthly or quarterly. Loan payments of principal and interest are repaid back into the individual’s own Individual 401(k). Because of this, an Individual (Solo) 401(k) loan may be a favorable option compared to other loans where interest is paid to the bank or lending institution.

The proceeds from an Individual (Solo) 401(k) loan can be used for any purpose and there are no income or credit qualifications to receive the loan. The ease of an Individual (Solo) 401(k) loan is attractive because start-up businesses and self-employed business owners often run into difficulties with qualifying for a self-employed loan through banks and lending institutions.

Note: Loans are not permitted with Traditional IRAs, Roth IRAs, SEP IRAs, or Keogh (MPP/PS Plans).

Automatic Enrollment 401(k) Plans

An automatic enrollment 401(k) plan, also known as an “automatic contribution arrangement” (ACA), is a feature in a plan whereby a plan participant has his or her compensation reduced by a specified amount that is contributed to the plan unless the participant elects not to have compensation reduced or to have it reduced by a different amount. In a CODA, the amounts are contributed to the plan as elective contributions (see Table 12.2).

Background

In 1984, McDonalds was the first American corporation to add automatic enrollment to its 401(k) menu. It wasn’t until 1998 that the IRS gave its first official “ok,” when it approved automatic enrollment features for new employees. During the next six years, the IRS issued a series of automatic enrollment-focused rulings and regulations. The Pension Protection Act of 2006, includes the most expansive set of automatic enrollment rules to date (discussed below). Why all this regulatory and legislative interest in 401(k) enrollment procedures?

As was discussed in Chapter 3, there has been a dramatic shift from employer-sponsored defined benefit pension plans to 401(k) plans in the past two decades. However, many employers who set up a 401(k) plan had many of their eligible employees choose not to “opt in” to participate in the plan. As a result, many employers decided to leverage decision-making apathy by reversing the enrollment process. Rather than having to “opt in” to a plan when they met the eligibility requirements, employees who did not want to participate had to “opt out.” It worked. Plans with automatic enrollment saw their participation rates skyrocket.
Benefits of Automatic Enrollment Plans

An automatic enrollment 401(k) plan can increase plan participation among rank-and-file employees and make it more likely that the plan will pass the discrimination testing [IRC § 401(k)(11)] and top-heavy rules [IRC § 401(m)(10)] as required under a traditional 401(k) plan. Some automatic enrollment 401(k) plans are exempt from the testing. This plan is for employers who want a high level of participation, and who have HCEs whose contributions might be limited under a traditional 401(k) plan.

Employees are automatically enrolled in the plan and contributions are deducted from their paychecks, unless they “opt out” of contributing after receiving notice from the plan. There are default employee contribution rates, which may rise incrementally over the first few plan years, although the employer can choose different amounts. In addition, for certain default investment options provided under the plan, there is relief from liability for the investment results.

IRS requires that the employer notify each employee of the availability of the feature at the time he or she becomes a participant and each year thereafter, and that the employee has a reasonable period of time to elect out of the automatic enrollment feature.

Automatic Enrollment 401(k) Plans after PPA of 2006

In 2006, section 902 of PPA (as amended by WRERA), added IRC § 401(k)(13), IRC § 401(m)(12), and IRC § 414(w) to the Code to facilitate the automatic enrollment of more employees.

Under IRC § 401(k)(13) and IRC § 401(m)(12), effective for plan years beginning on or after January 1, 2008, provided an alternative design-based safe harbor for a CODA that provides for automatic contributions at a specified level and meets certain employer contribution, notice, and other requirements. A CODA that satisfies these requirements, referred to as a “qualified automatic contribution arrangement” (QACA), is treated as satisfying the ADP test (and ACP test with respect to matching contributions).

IRC § 414(w), effective for plan years beginning on or after January 1, 2008, further facilitates automatic enrollment by providing limited relief from the distribution restrictions under IRC § 401(k)(2)(B) in the case of an “eligible automatic contribution arrangement” (EACA) described in IRC § 414(w).

Final Regulations on automatic contribution arrangements, 74 FR 8200, published on February 24, 2009, contains amendments to regulations under 401(k), especially IRC § 401(m) and new regulations under IRC § 414(w) in order to reflect PPA changes.

Rev. Rul. 2009-30, 2009-39 I.R.B 391, provides guidance on how automatic enrollment in a section 401(k) plan can work when there is an escalator feature included. An escalator feature means that the amount of an employee’s compensation that is contributed to the plan, without the employee’s affirmative election, is increased.
periodically according to the terms of the plan. Notice 2009-65, 2009-39 I.R.B. 413, provides two sample amendments that sponsors of section 401(k) plans can use to add automatic enrollment features to their plans. The first sample amendment can be used to add a basic ACA with an escalation feature. The second sample amendment can be used to add an EACA with an escalation feature.

**ACA Defined**

An “automatic contribution arrangement” (ACA) under a 401(k) plan is an arrangement whereby an employee who fails to make an election to defer compensation into the 401(k) plan is treated as having elected to defer a plan-specified percentage of his or her compensation in the plan until the employee affirmatively elects not to defer or to defer at a different percentage. An ACA must also provide that the employee’s account will be invested in a Qualified Default Investment Alternative (QDIA) meeting the requirements of ERISA §404(c)(5) [ERISA § 514(e)(2)] (See Chapter 1).

**EACA Defined**

Similar to the ACA discussed above, an “eligible automatic contribution arrangement” (EACA) under a 401(k) plan is an arrangement whereby an employee who fails to make an election to defer compensation into the plan is treated as having elected to defer a plan-specified percentage of his or her compensation into the plan until the employee affirmatively elects not to defer (“opt out”) or to defer at a different percentage. An EACA must also provide that the employee’s account will be invested in a QDIA meeting the requirements of ERISA § 404(c)(5). [IRC § 414(w)(3)]

The distinct advantage of EACA is that it provides a mechanism for employees to have deferrals returned to them if a timely election is made. The returned deferrals are referred to as “permissible withdrawals.” [IRC § 414(w) 1-(c)] The permissible withdrawals allow a participant to withdraw default contributions without penalty and, under certain circumstances, permits an extra 3½ months to distribute excess contributions and excess aggregate contributions. An EACA has a notice requirement and a uniformity requirement, but there are no mandatory employer contributions nor any required level of default contributions [Treas. Reg. §1.414(w)-1 and 54.4979-1(c)].

Unlike a QACA, an EACA need not cover all employees eligible to make deferrals under the CODA; only those specified in the plan are "covered employees." A "covered employees" is subject to default contributions if no affirmative election is made and will receive the annual EACA notice. The plan must state whether an employee who makes an affirmative election remains covered under the EACA. Thus, if a plan provides that an employee who makes an affirmative election is no longer a covered employee under the EACA, then the employee is not required to receive the notice after he or she makes an affirmative election.
The default elective contribution under an EACA must be a uniform percentage of compensation; however, the percentage can vary in a similar manner to that permitted in a QACA [Treas. Reg. §1-414(w)-1(b)(2)].

All automatic contribution arrangements that are intended to be EACAs within a plan (or within the disaggregated plan under Treas. Reg. §1.410(b)-7, in the case of a plan subject to IRC § 410(b)) must be aggregated.

**Example:** If a single plan within the meaning of IRC § 414(l) covering employees in two separate divisions has two different ACAs that are intended to be EACAs, the two ACAs can constitute EACAs only if the default elective contributions under the arrangements are the same percentage of compensation. However, if the different ACAs covered employees in mandatorily disaggregated portions of the plan, they could have different default percentages and be EACAs.

The EACA notice requirements are similar to the notice requirements for a QACA (discussed below). However, if the EACA permits withdrawal of default contributions, the notice must explain this to covered employees.

The principal value of an EACA is to let employees who had default deferrals made withdraw those amounts. Prior to EACAs, employers would have to deal with disgruntled employees who didn’t realize they were going to have their pay reduced under an ACA and who could not withdraw such deferrals because of the distribution restrictions applicable to elective contributions. And the plan, too, was disadvantaged, having to maintain small account balances when the employees who never wanted deferrals made stopped them with an affirmative election. An EACA provides limited relief from the distribution restrictions under IRC § 401(k)(2)(B), and permits employees to elect to withdraw amounts (permissible withdrawal) equal to the amount of default elective contributions (and attributable earnings) within a specific time period without penalty. The election must be made within 90 days after the date of the first default elective contribution with respect to the employee under the EACA. A plan is permitted to set an earlier deadline for the election to withdraw default elective contributions.

However, if a plan offers a permissible withdrawal for covered employees, the election period for the covered employees must be at least 30 days. The latest effective date of a withdrawal election cannot be after the earlier of:

- Two paydays after the date the election is made; and
- The first payday at least 30 days after the election is made.

The permissible withdrawal amount is not taken into account for purposes of the ADP test nor in determining the limitation on elective deferrals under IRC § 402(g). The withdrawn amount is includible in gross income for the taxable year in which the distribution is made (except to the extent the distribution consists of designated Roth contributions), but is not subject to the additional income tax under IRC § 72(t). The plan
may not charge a higher fee for a permissible withdrawal under IRC § 414(w) than for other withdrawals.

The IRC § 4979 excise tax does not apply to an EACA if excess contributions and excess aggregate contributions for a plan year together with income allocable to the contributions are distributed within 6 months (instead of 2 ½ months) after the close of the plan year. The extension to 6 months applies only if all eligible employees are covered under the EACA.

Matching contributions that have already been allocated to default contributions withdrawn in a permissible withdrawal must be forfeited together with allocable income. The plan is permitted to provide that matching contributions will not be made with respect to any elective contributions withdrawn made under IRC § 414(w).

QACA Defined

Also similar to both the ACA and EACA discussed above, a qualified automatic contribution arrangement (QACA) under which an employee who fails to make an election to defer into the plan is treated as having elected to defer a qualified percentage (minimum of 3% up to a maximum of 10%) of his or her compensation into the 401(k) plan until the employee affirmatively elects not to defer or to defer at a different percentage [IRC § 401(k)(13)(B)].

Although an arrangement that meets the requirements of a QACA may also be, at the same time, an ACA and an EACA, this is not necessarily the case. Unlike ACAs and EACAs, a QACA is not required to permit participants to direct the investment of their accounts or, if employee investment direction is permitted, to provide a QDIA meeting the requirements of ERISA § 404(c)(5).

Thus, a QACA that is not an EACA could not permit a participant to withdraw deferrals made within 90 days after the arrangement first applies to that participant. Similarly, a QACA that is not an ACA does not have the explicit preemption protection that is afforded to ACAs (discussed above). A 401(k) plan that includes a QACA is not required to perform nondiscrimination testing of elective or matching contributions [IRC §§ 401(k) (13)(A) and 401(m)(12)].

QACA Default Contributions

If a participant fails to make an election to defer compensation into the plan the QACA must provide that no less than 3 percent of the participant’s compensation must be deferred into the plan during the plan year in which the employee becomes a plan participant (“initial period”) and the following plan year. After that plan year, the QACA must provide that the deferral percentage will increase by at least one percentage point each plan thereafter until the participant’s rate of deferral equals 6 percent of compensation [Prop. Treas. Reg. § 1.401(k)-3(j)(2)].
The default percentage must be at least:

- 3% during the initial period;
- 4% during the first plan year following the initial period;
- 5% during the second plan year following the initial period; and
- 6% during the third and subsequent plan years following the initial period.

An employee’s "initial period" begins when he or she first has default contributions made under the QACA and ends on the last day of the plan year following the plan year in which the employee first had such contributions made. If an employee makes an affirmative election before the default contribution would have begun, then the initial period has not begun for the employee. Note that a plan could simplify matters by having just one default percentage, for example, 6%, with no increase. The default percentage under the QACA is limited so as not to exceed the limits of IRC §§ 401(a)(17), 402(g) (determined with or without catch-up contributions described in IRC §§§ 402(g)(1)(C) or 402(g)(7)) and 415.

A QACA can provide a qualified percentage of up to 10 percent of compensation [Prop. Treas. Reg. § 1.401(k)-3(j)(2)].

**QACAs Safe Harbor Contribution Requirements**

The employer must also make contributions to the 401(k) plan on behalf of each eligible non-highly compensated employee (NHCE) a safe harbor non-elective contribution equal to 3 percent of compensation or a safe harbor match contribution. The formula under the safe harbor match contribution must match 100 percent of a participant’s deferrals up to 1 percent of his or her pay and 50 percent of deferrals between 1 percent and 6 percent of pay. Thus, a participant who is deferring at the rate of 6 percent of pay (whether by reason of the participant’s affirmative election or otherwise) will receive a matching contribution equal to 3.5 percent of compensation. The QACA safe harbor matching contribution, as a percentage of pay, is less than the maximum amount that would be provided under a safe harbor plan providing a basic match formula (the match contribution would be 4 percent of pay for a participant who defers 5 percent of his or her compensation). [Prop. Treas. Reg. § 1.401(k)-3(k)(2)].

If the employer chooses, a QACA can provide for an alternative match formula as long as the aggregate match contribution produced by that formula at every level of deferral equals or exceeds the amount produced by the formula discussed above. [IRC § 401(k)(13)(D)(ii)].

Also, employer safe harbor contributions to a 401(k) plan containing a QACA are not required to be 100 percent vested. However, the law does require to be vested in those contributions after completing two years of service. [Prop. Treas. Reg. § 1.401(k)-3(k)(3)].
QACAs Notice Requirements

A QACA must satisfy the same notice requirements that apply to safe harbor plans [IRC § 401(k)(12)] but with some additional content and timing requirements. The additional content requirements for a QACA are that the notice must explain:

- The level of default contributions that will be made on the employee’s behalf in the absence of an affirmative election;
- The employee’s right to elect to have no elective contributions made to the plan or to have elective contributions made in a different amount than the default percentage; and
- How contributions under the QACA will be invested.

The timing requirement for the QACA notice is satisfied only if it is provided early enough so that the employee has a reasonable period of time after receipt of the notice to a deferral election. This does not permit a plan to delay a default election beyond the earlier of:

- Two paydays after receipt of the notice; and
- The first payday at least 30 days after the notice is provided.

<table>
<thead>
<tr>
<th>Table 12.2</th>
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<tbody>
<tr>
<td><strong>Automatic Contribution Arrangement Comparison Chart</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Feature</th>
<th>Pre-PPA¹</th>
<th>PPA EACA</th>
<th>PPA QACA</th>
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<tbody>
<tr>
<td>Automatic salary deferral %</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>Automatic annual deferral escalation</td>
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<td>Optional</td>
<td>Required at least at the rates specified under the PPA</td>
</tr>
<tr>
<td>Participant notice requirement</td>
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<td>Yes</td>
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<tr>
<td>Salary deferrals fully vested</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>90-day withdrawal option</td>
<td>No</td>
<td>Yes</td>
<td>Only if the Plan satisfies EACA requirements</td>
</tr>
<tr>
<td>Required employer contributions</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Qualified default investment alternative (QDIA) required</td>
<td>Optional</td>
<td>Yes, unless the Plan is not subject to ERISA</td>
<td>Optional</td>
</tr>
<tr>
<td>ERISA preemption of state anti-garnishment laws for Plans subject to ERISA</td>
<td>DOL says YES</td>
<td>Yes</td>
<td>DOL says Yes</td>
</tr>
<tr>
<td>Nondiscrimination testing safe harbor</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Automatic extension on excise tax for corrective distributions to 6 months</td>
<td>No</td>
<td>Yes</td>
<td>N/A</td>
</tr>
</tbody>
</table>

¹ The Pension Protection Act of 2006 (PPA)

Source: 401(k) Answer Book, Aspen Publishers Borrowing from 401(k)
Chapter 12
Review Questions

1. Which of the following statements about safe harbor 401(k) plans is FALSE?

   ( ) A. Provide for employer contributions that are fully vested when made.
   ( ) B. Eliminates the nondiscrimination and top heavy tests.
   ( ) C. A plan cannot satisfy the ADP safe harbor without satisfying the ACP safe harbor, but a plan can satisfy the ACP safe harbor without satisfying the ADP safe harbor.
   ( ) D. Ideal for businesses with highly compensated employees (HCEs).

2. A safe harbor plan that contains a formula that satisfies the ADP test will not fail the ADP test because the plan also provides for discretionary matches limited to what percent of each employee’s compensation?

   ( ) A. 2%
   ( ) B. 3%
   ( ) C. 4%
   ( ) D. 6%

3. The notice requirement for a safe harbor plan is satisfied if the notice is given to eligible employees at least how many days and not more than how many days before the beginning of each plan year?

   ( ) A. 20/30
   ( ) B. 30/60
   ( ) C. 30/90
   ( ) D. 60/90

4. What is the maximum amount an employee age 50 or older can contribute to a SIMPLE 401(k) in 2017?

   ( ) A. $56,500
   ( ) B. $15,500
   ( ) C. $12,000
   ( ) D. $22,300

5. A Form 5500 must be filed for an Individual 401(k) if the total assets are above what amount?

   ( ) A. $100,000
   ( ) B. $250,000
   ( ) C. $500,000
   ( ) D. $225,000
CHAPTER 13

KEOGH PLANS

Overview

A Keogh plan, also referred to as a HR-10 Plan, is a qualified retirement plan that covers one or more self-employed individuals. A self-employed individual is a sole proprietor or partner who works in his or her unincorporated business. The Keogh plan acts much like an IRA but has different rules, contribution limits, and requirements.

In this chapter, we will examine the various rules and the various types of Keogh Plans available to self-employed individuals and their employees.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- How to identify a Keogh Plan;
- The features and benefits of a Keogh plan;
- The types of Keogh plans; and
- How Keogh plans differ from other qualified plans.

Background

A Keogh plan, sometimes referred to as an HR 10 plan, is a qualified retirement plan that covers one or more self-employed individuals. A self-employed individual is a sole proprietor or partner who works in his or her unincorporated business.

Covered under IRC § 401(c), Keogh plans are named after Congressman Eugene J. Keogh (Congressman from New York 1937 to 1967), who was the chief sponsor of the so-called Keogh Act which was part of the Self-Employed Individuals Tax Retirement Act of 1962. This initial legislation contained certain restrictions which caused many of the self-employed business owners to ignore this new law. However, beginning with the passage of ERISA in 1974, Keogh requirements began to become more liberal. By 1983, by means of the Tax Equity and Fiscal Responsibility Act (TEFRA), Keogh plans were finally established on the same basis with most corporate plans. Today, there are only a few differences between a Keogh plan and corporate pension plans. The primary difference is simply that a Keogh plan is for a non-incorporated form of business.
Types of Keogh Plans

Keogh plans can be structured in a number of ways. Although it is possible to design a Keogh as a DB plan, most Keoghs take the form of a DC plan. The two most common types of Keoghs are PS and MPP plans—each of which falls under the category of DC plans.

A DC Keogh plan allows the business to either put up to 25 percent of the total payroll of plan participants and have it tax deductible [IRC § 404(a)(3)(A)]. If the plan is the PS type, plan contributions can even be omitted entirely in a bad year. However, the IRS requires “substantial and recurring” contributions, or the plan may be deemed to have been terminated [Treas. Reg. § 1.401-1(b)(2)]. This contribution flexibility is very advantageous for a small business, the income of which may fluctuate substantially from year to year.

As with qualified plans, the compensation base is limited to $270,000 (in 2017) [IRC § 401(a)(17)]. This places a limit on Keogh profit sharing plans for self-employed persons with earned income of $270,000 or more—an income level that is not unusual for a successful professional. The annual additions limit effectively limits profit sharing plan contributions to $54,000 in 2017.

Note: Loans are not permitted in a Keogh plan.

A partnership or proprietorship may also establish a 401(k) plan, including an Individual 401(k) plan (discussed in Chapter 12). Matching contributions made to a 401(k) Keogh plan on behalf of a self-employed person are not treated as elective employer contributions, thus they are not subject to IRC § 402(g)(8), annual limit of $18,000 in 2017.

A money purchase plan contains a fixed annual contribution formula of up to 25 percent of earned income, (for self-employed persons 25 percent of compensation) for any regular employees covered under the plan. However, a MPP plan is subject to the minimum funding requirement [IRC § 412]. These require the employer to make contributions to each employee’s and self-employed person’s account each year equal to the percentage of compensation stated in the plan. Such contributions are mandatory, regardless of good or bad business results for the year.

A partnership or proprietorship can adapt other types of qualified plans, as well. A DB plan is attractive to the older self-employed person who is just starting a plan, because the actuarial funding approach allows a greater relative contribution for older plan participants. Often, considerably more can be contributed annually to a DB than the $54,000 maximum in 2017 for DC plans.

Partnership and proprietorships can also adopt cross-tested or other age-weighted plans (as was discussed in Chapter 10) with self-employed persons as participants. These plans
like DB plans allow contributions equal to a higher percentage of compensation for older plan participants, who tend to be the owners of the business.

Determining Earned Income

As mentioned above, the unique feature of a Keogh plan, as compared with qualified plans adopted by corporations, is that the Keogh plan covers self-employed individuals, who are not technically considered “employees.” This leads to some significant special rules for self-employed individuals covered under the plan.

One of those special rules is the definition of earned income. For a self-employed individual, “earned income” takes the place of “compensation” in applying the qualified plan rules. Earned income is defined as the self-employed individual’s net income from the business after all deductions, including the deduction for Keogh plan contributions [IRC § 401(c)(2)]. In addition, the IRS has ruled that the self-employment tax must be computed and a deduction of one-half of the self-employment tax must be taken before determining the Keogh deduction.

To resolve the potential complexity of this computation, IRS Publication 560 specifies the following steps in determining the Keogh deduction:

- Step 1: Determine net income from Schedule C income;
- Step 2: Subtract one-half of the actual amount of the self-employment tax; and
- Step 3: Multiply the result by the “net” contribution rate from the Table 13.1

Example: Tom earns $100,000 of Schedule C income in 2017. His self-employment tax is $14,129.55. (The net income amount of $100,000 is first reduced by 7.65%, leaving $92,350 net earnings subject to the self-employment tax: $92,350 x 15.3 (Combined OASDI and HI rate) = $14,129.55.) The deduction for one-half of the self-employment tax then is $7,064.78 ($14,129.55 ÷ 2). The Keogh contribution base is thus $100,000 minus $7,064.78, or $92,935.23. If the nominal plan contribution rate is 25%, the net contribution rate is 20%. This rate is applied to the Keogh contribution of $18,587.05.

Note: This amount is 25% of “earned income,” which is equal to $74,348.18 (i.e., the Keogh contribution base of $92,935.23 less the Keogh contribution of $18,587.05).

Reporting

The annual reporting requirements for qualified plans are simplified for many Keogh plans and other small plans. If a plan covers only the business owner or partners, or the owner or partners and their spouses, the reporting requirement is satisfied by filing Form 5500 EZ.
### Table 13.1
Self-Employed Persons Rate Table

<table>
<thead>
<tr>
<th>Column A</th>
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<tr>
<td>If the Plan Contribution rate is:</td>
<td>The Self-Employed Person’s Rate is:</td>
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<tr>
<td>(Shown as a %)</td>
<td>(shown as a decimal)</td>
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<tr>
<td>1</td>
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</table>

### Installing a Keogh Plan

A Keogh plan follows the installation procedures for qualified plans. However, in adopting a Keogh plan, it is common to use a “*prototype*” plan designed by a bank, insurance company, mutual fund, or other financial institution. With a prototype, the sponsoring institution does most of the paperwork involved in installing the plan, at low or normal costs to the self-employed individual. In return, the self-employed individual must keep most or all of the plan funds invested with that institution.
Chapter 13
Review Questions

1. A Keogh plan, also referred to as a:

( ) A. 412 (i) plan
( ) B. HR 10 plan
( ) C. SEP IRA plan
( ) D. 414(x) plan

2. The annual additions effectively limits a Keogh profit sharing plan contributions to what amount in 2017?

( ) A. $54,000
( ) B. $22,150
( ) C. $17,500
( ) D. $12,000

3. What is the most common form of a Keogh plan?

( ) A. Defined benefit plan
( ) B. Profit sharing plan
( ) C. Target benefit plan
( ) D. Cash balance plan

4. A defined contribution Keogh plan allows the business to contribute up to what percent of the total payroll of plan participants and have it tax deductible?

( ) A. 15%
( ) B. 25%
( ) C. 10%
( ) D. 6%

5. Which of the following statements about purchasing life insurance in a Keogh plan is FALSE?

( ) A. The entire cost of life insurance for a self-employed individual is deductible.
( ) B. Only the portion of the premium that exceeds the pure protection value of the insurance is deductible.
( ) C. The pure protection value of the insurance is determined using Table 2001.
( ) D. The nondeductible life insurance element in effect becomes additional taxable income to the self-employed individual.
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CHAPTER 14

SIMPLIFIED EMPLOYEE PENSION IRA

Overview

A Simplified Employee Pension-IRA, also known as a SEP IRA, is a written plan that allows small business owners (any business in fact) to make contributions towards his/her own retirement and their employees’ retirement without getting involved in a more complex qualified plan.

In this chapter, we will examine the legislative background and intent of the SEP IRA, the advantages and disadvantages, as well as the myriad of rules, eligibility and contribution limits. This chapter will also review the Salary Reduction Simplified Employee Pension IRA (SARSEP IRA).

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- How to define what is a simplified employee pension plan (SEP IRA);
- How to identify the differences between a SEP IRA and a Traditional IRA;
- The advantages and disadvantages of the SEP IRA for the employer and the employee;
- The steps an employer must take in order to set up a SEP IRA;
- The various rules and requirements the employer and employee must meet for eligibility, participation and contribution limits; and
- The rules for a SARSEP IRA.

SEP IRA Background

The SEP IRA came into law with the passage of the Tax Revenue Act of 1978 (TRA). A SEP IRA is designed to help smaller employers establish a retirement plan for their employees without the administrative costs and governmental paperwork that burden most qualified plans.

Basically, a SEP IRA consists of a special Individual Retirement Account (IRA) established and maintained solely by the employee but to which his or her employer can contribute. Eligibility requirements, contribution limits and many other features associated with a qualified plan are applicable in the case of a SEP IRA but with some
major differences. A SEP IRA has the administrative simplicity of an IRA but also has a higher contribution limit. In some cases, employees can also contribute to the plan through salary deferrals. SEP IRAs are governed under IRC § 408(k).

Advantages of a SEP IRA

SEP IRAs carry three prime advantages. They are:

- First, they have tax advantages for both the employer and the employee;
- Secondly, they are simple to establish and operate; and
- Thirdly, they allow plan participants the ability to select the investment options that most precisely meet their budget and retirement objectives.

Let’s review in greater detail some of the tax advantages and non-tax advantages for both the employer and employee.

Tax Advantages for the Employer

A SEP IRA has some attractive tax advantages. First, all employer contributions to the plan are tax deductible as an ordinary and necessary business expense. In addition, the SEP IRA is a remarkably flexible plan because employer contributions are not required every year. Contributions may vary from year to year in dollar amount, provided that the percentage-of-compensation, which is contributed for each person covered by the plan, is the same for each participant. The compensation on which the deductible contribution is based must be for services actually performed by the employee.

A SEP IRA may be established and receive deductible contributions after the close of the tax year (prior to the due date for the tax return), whereas a regular qualified plan cannot.

Tax Advantages for the Employee

Employer contributions to a SEP IRA are not taxable income to the employee. Contributions under salary reduction SEP IRAs (SARSEP IRAs, discussed later) are also not taxable to the employee [IRC § 402(h)]. Regular SEP IRA contributions are also free of FICA and FUTA taxes, but SARSEP IRA contributions are subject to these payroll taxes [IRC §§ 3121(a)(5)(C) & 3306(b)(5)(C)].

Non-Tax Advantages for the Employer

In addition to the tax advantages, there are several non-tax advantages when an employer establishes a SEP IRA. These advantages are essentially the same as when a qualified plan is offered, but with greater simplicity and lower administrative cost:

- *Having a specialized retirement plan.* Employers who want their employees to have a retirement plan identical in scope and coverage to the pension plans found
in the larger corporations can establish a SEP IRA that meets those expectations. With a SEP IRA, the employer can offer the employee future retirement security;

- *The ability to attract and retain employees.* An employer operating in today’s labor market must be able to provide prospective and current employees with a retirement program similar to, if not better than, the plans being offered by competitors; and.

- *Increasing productivity and reducing turnover.* Costs of production in today’s business arena are a vital factor in determining whether a business will be successful. If an employer can satisfy employee concerns regarding retirement planning, individual and company productivity will increase because employees will stay with that employer. Because of reduced employee turnover, training and recruiting costs are reduced, which leads to higher profit at year-end.

The fact that the employees choose their own investment vehicles means that the employer’s fiduciary duty in that regard is alleviated.

**Disadvantages of a SEP IRA**

Although SEP IRA plans offer advantages of greater simplicity and reduced administrative cost, compared with full-blown qualified plans, they are not totally free of administrative oversight burdens. For example, as discussed below, they are subject to minimum eligibility requirements and testing rules for non-discrimination in favor of HCE. Smaller businesses may not wish to deal with even this level of administrative responsibility.

SEP IRAs have some disadvantages, compared with qualified plans. For example, participants in a SEP IRA must be fully vested in their accounts at all times. Under a qualified plan, the employer can structure the plan to phase in the vesting based upon the employee’s length of service. SEP IRA coverage requirements are generally broader, and thus, a SEP IRA can be more costly since it may require coverage of certain employees that are not required to be covered under a qualified plan. For example, a company that utilizes part-time or seasonal workers on a repeated basis may be required to include them in a SEP IRA plan, whereas they could be excluded from a qualified plan.

**SEP-IRA Participation Requirements**

An employer who establishes and makes annual contributions to a SEP IRA must include all qualifying employees in the plan. Qualifying employees are employees who:

- Have attained age 21 [IRC § 408(k)(2)(A)];
- Performed service for the employer during the last three of the preceding five calendar years (though the employer can elect a shorter waiting period) [IRC § 408(k)(2)(B)]; and
- Received at least $600 compensation in 2017 (same as 2016) [IRC § 408 (k)(2)(C)].

A self-employed person or a partner in a partnership is considered to be an employee for SEP IRA purposes; however, a self-employed person or a partner must satisfy the same participation requirements and receive the same benefits as any other employee.

If an employer has union employees, it may be possible to exclude them from a SEP IRA. The law permits the exclusion of employees who have bargained in good faith under a collective bargaining agreement. It is necessary for an employer to be able to prove that, in fact, such bargaining did take place.

If an employer has an employee who is a nonresident alien situated in a foreign country with no earned income in the United States, the employee may be excluded from a SEP IRA.

**Self-Employed Individuals Defined**

Included in the definition of the term “self-employed individual” is a sole proprietor of an unincorporated trade or business enterprise. Also included is an unincorporated professional individual (e.g., physician, attorney, dentist, accountant, etc.). A partner in a partnership operating a trade or business enterprise or a professional corporation is also included in the term self-employed individual, regardless of the extent of his or her interest in the partnership.

For purposes of a SEP IRA, a self-employed person is considered to be an employee as well as the employer. In the case of a partnership, the partnership is the employer and each partner in the partnership is considered to be an employee for SEP IRA purposes.

**Establishing a SEP IRA Plan**

When an employer decides to establish a SEP IRA, the employer is required to prepare and formally adopt a written program document. This document must specify at least the name of the employer, the requirements for employee participation, the signature of a responsible official, and the formula for allocation of contributions [Prop. Reg. §1.408-7(b)]. The plan may be established by use of the IRS model SEP on Form 5305-SEP, by adoption of a prototype plan (usually offered by financial institutions) that has been reviewed and approved by the IRS, or by adoption of an individually designed plan.

**Depositing Employer Contributions**

Employer contributions can be made on either a calendar year basis or a fiscal year. However, they must follow the following rules:
• If a SEP IRA is maintained on a calendar-year basis, in order to obtain a deduction for employer contributions, such employer contributions must be made to the financial institution maintaining the employees SEP IRA no later than the due date for filing the employer’s tax return (including extensions) for the employer’s tax year with or within which the calendar year for which the contribution is made ends; and

• If the SEP IRA is maintained on the employer’s taxable year that is a fiscal year, contributions must be made by the due date (including extensions) for filing the tax return for that year.

**Example:** If the business’s fiscal year (a corporate entity) ends on December 31 and it filed for the automatic 6-month extension, the company’s tax return for the year ending December 31, 2016, would be due on September 16, 2017, allowing the employer to make the initial SEP IRA contribution no later than September 16, 2017.

**IRS Form 5305-SEP**

The IRS makes available a model SEP IRA plan document for employers who want to adopt a plan with little paperwork and expense. IRS Form 5305-SEP can be used by the employer to satisfy the written arrangement requirement for a SEP IRA. The form must be used without modification or amendments. No approval of the signed Form 5305-SEP by the IRS is required, and the signed form does not need to be filed with the IRS.

A SEP IRA program based on IRS Form 5305-SEP is subject to the following conditions as stated in the instructions to the form:

• An employer cannot use IRS Form 5305-SEP if the employer also has a qualified plan in operation;

• IRS Form 5305-SEP may not be used by an employer that is a member of an affiliated service group [IRC § 414(m)], a controlled group of corporations IRC § 414 (b)], or trades or businesses under common control [IRC §§ 414 (c) and 414 (o)], unless all eligible employees of all members participate in the SEP IRA;

• IRS Form 5305-SEP may not be used by an employer that uses leased employees [as described in IRC § 414 (n)]; and

• Each eligible employee must have established an Individual Retirement Arrangement (IRA).

The model form may not be used if the SEP IRA provides for elective employee contributions.

A SEP IRA prototype provided by a sponsoring financial institution, or an individually designed document, may be used in lieu of the IRS Form 5305-SEP, and must be used if any of the prerequisites to use of the IRS Form 5305-SEP is not satisfied. For example, only prototype (or individually drafted) plans can be used where an employer wishes to use a SEP IRA for a supplemental bonus plan to an existing qualified plan. The plan
provisions vary among different prototypes, but in general they offer features not found in the basic Form 5305-SEP.

For SEP IRAs that are not installed in accordance with IRS Form 5305-SEP, the requirements for information to be provided to employees are more stringent, as discussed below.

**Notice To Interested Parties**

At the time a pension plan is established, ERISA § 3001(a) requires that every “interested party” be given notification. Where the SEP IRA is individually designed, and therefore not eligible for the alternative methods of compliance, it will be necessary for the program administrator to furnish such notification to every interested party. An “interested party” is defined in Treasury Regulation §1.7476-1(b)(1) to be an employee who is eligible to participate and all other present employers with the same principal place of employment.

Notification must be given not less than ten days or not more than 24 days prior to the date the document is filed with the IRS.

In the case of a SEP IRA formed by utilization of IRS Form 5305-SEP, this notification requirement will be satisfied by furnishing the participant with a copy of the completed IRS Form 5305-SEP. The Form also requires the following to be furnished to all eligible employees:

- A statement that Traditional IRA other than the Traditional IRA into which employer SEP IRA contributions will be made may provide different rates of return and different terms concerning, among other things, transfers and withdrawals of funds from the IRA;
- A statement that the administrator of the SEP IRA must furnish each participant, within 30 days of the effective date of any amendment to the SEP IRA, a copy of the amendment and a written explanation of its effects; and
- A statement that the administrator will give written notification to each participant of any employer contributions made under the SEP IRA to that participant’s IRA by the later of January 31 of the year following the year for which a contribution is made, or 30 days after the contribution is made.

If a master or prototype, or individually designed, SEP IRA is used, rather than the IRS Form 5305-SEP model, certain additional requirements are imposed with respect to information to employees. Thus, once an employee becomes eligible to participate, the employer must provide an explanation of participation requirements, an explanation of the formula for allocating employer contributions, the name of the person designated to provide any additional SEP IRA information and an explanation of the terms of the IRA to which SEP IRA contributions will be made.
Annual Reporting

Employers who have established a SEP IRA have furnished eligible employees all of the documents and disclosures referred to above are not required to file the annual information returns required for qualified plans on IRS Forms 5500 or 5500-EZ. However, under Title I of ERISA, this relief from the annual reporting requirements may not be available to an employer who selects, recommends, or influences its employees to choose IRAs into which contributions will be made under the SEP IRA, if those IRAs are subject to provisions that impose any limits on a participant’s ability to withdraw funds (other than restrictions imposed by the IRC that apply to all IRAs).

The trustee of each IRA (or the issuer of each IRA - annuity) is required to make annual calendar year reports on IRS Form 5498 concerning the status of the account or annuity. These reports are to include the amount of contributions made with respect to the calendar year, the amount of any rollover contributions, and the fair market value of the account as of the end of the year. The reports are required to be provided to the IRS and participants by May 31 of the following year.

Additionally, employers are required to report SEP IRA contributions to employees, on form W-2, by the later of January 31 following the year for which the contribution was made, or 30 days after the date of the contribution.

Investment Vehicles

Under a SEP IRA, an employer makes contributions to any IRA annuity or account elected by the employee. SEP IRA plans are established with financial institutions qualified to serve as an IRA custodian, such as a bank, securities brokerage, savings and loan or a life insurance company. An employee may be given authority to select the investments within the IRA account, and is allowed to make trustee-to-trustee transfers in order to utilize a different custodian and different investment choices.

If the participant already owns an existing IRA, it is not necessary to establish a new IRA although, as a practical matter, most employers try to limit the number of carriers receiving such contributions by restricting the enrollment sessions to one or two providers. Even if the employer contribution is applied to one IRA, the amounts can be immediately transferred to another IRA of the employee without tax consequences.

SEP IRA Non-discrimination Rules

Though SEP IRA rules are generally more liberal than those applicable to regular qualified retirement plans under IRC § 401(a)(4), an employer is still bound by the basic nondiscrimination rules imposed by IRC § 408(k)(3). Under IRC § 408(k)(3)(A) contributions to a SEP IRA may not discriminate in favor of HCE and IRC § 408(k)(C) states that contributions shall be considered discriminatory unless they bear a uniform
relationship to participant’s compensation that does not exceed $120,000 for 2017 (same as in 2016), as that term is defined in IRC § 414 (q) for purposes of qualified plans in

<table>
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<th>Highly Compensated Employee as defined under IRC § 414 (q)(1)(B):</th>
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<td>The IRS defines a “Highly Compensated Employee” (HCE) as an individual who:</td>
</tr>
<tr>
<td>Owned more than 5% of the interest in the business at any time during the year or the preceding year regardless of how much compensation that person earned or received; or</td>
</tr>
<tr>
<td>For the preceding year received compensation from the business of more than $120,000 in 2017 (same as in 2016), and if the employer so chooses, was in the top 20% of employees when ranked by compensation.</td>
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</table>

The maximum compensation level to which the uniform percentage may be applied is subject to the same statutory limitation under IRC § 401(a)(17). This limitation will be $270,000 for 2017 (was $265,000 in 2016).

In addition, the rules regarding top-heavy plans (as defined in IRC § 416) are also applicable to SEP IRAs. The dollar limitation under IRC § 416 (i)(1)(A)(i) concerning the definition of a key employee in a top heavy plan is $170,000 for 2017 (same as in 2016). In the case of a top-heavy plan, the employer contributions on behalf of each eligible non-key employee must be not less than the lesser of 3 percent of compensation or the highest percentage allocated to the IRA of a key employee for the year. [IRC § 408 (k)(1) (B), incorporating IRC § 416 (c)(2)].

Rules concerning permitted disparity or integration with social security in determining contributions to a defined contribution qualified plan are applicable to SEP IRA plans.

**Non- Forfeitable and Non- Assignable**

Like any IRA, an IRA established under a SEP IRA must be non-forfeitable and thus provide for immediate vesting. An IRA established under a SEP IRA must be non-assignable, non-alienable, and nontransferable by the participant (except for the tax-free rollover or IRA to IRA transfer privileges). There may be no employer-imposed limits on employee withdrawals or transfers from the individual retirement arrangement, and contributions may not be conditioned upon the employee retaining the funds in the account for any stated period.
Employer Contributions

Employer contributions must be determined by a formula that is specified in the plan document for the SEP IRA program. The formula must be applied equally to all contributions on behalf of all participants. The annual contributions for each participant may be any amount based on a formula (subject to the anti-discrimination-based limitations referred to above).

It is the employer’s obligation to forward contributions to the financial institution/trustee for those employees who participate as described in the plan document. The employer would want to keep their financial institution aware of any changes in the status of those employees in the plan. As the employer hires new employees, for instance, the employer will include them in the SEP IRA if they satisfy the eligibility criteria described in the plan.

Contribution Limits

A SEP IRA is similar to a Profit Sharing plan in that the employer does not have to make a contribution to the plan each year. Contributions may vary from year to year, provided that each person covered by the plan receives the same percentage of income as a contribution.

IRC § 402 (h)(2) imposes a ceiling on annual employer contributions to the account of a participant in a SEP IRA. This limit is the lesser of:

- 25 percent of the compensation (within the meaning of IRC § 414(s)) from such employer includible in the employee’s gross income for the year (determined without regard to the employer contributions to the SEP IRA [IRC § 402(h)(2)(A)]; or
- A statutory dollar amount ceiling (incorporating the same inflation-adjusted dollar amount ceiling as applies, under IRC § 415 (c)(1)(A), to defined contribution plans generally, but reduced in certain cases of highly compensated employees (within the meaning of IRC § 414(q)) [IRC § 402(h)(2)(B)].

Since 2003, the dollar ceiling has been subject to indexing for inflation, in $1,000 increments, using the third quarter of 2001 as the base period [IRC § 415 (d)], the ceiling amounts will be $54,000 in 2017 (was $53,000 in 2016).

Contribution Formulas

The most common formula used is one which allocates contributions based on a percentage of each participant’s compensation, but there are several others, as described below. The actual formula that must be used is dependent upon the plan document that governs the SEP IRA. The various formulas:
• **Pro-rata** – an allocation formula that provides eligible participants with a contribution based on the same percentage of compensation;

• **Flat Dollar** – an employer (plan sponsor) who provides a flat dollar formula in its SEP IRA plan must contribute the same dollar amount to each eligible employee; and

• **Integrated** - allows an employer (plan sponsor) to provide higher contributions for eligible participants who earn amounts over a set threshold, as long as the “permitted disparity rules” of IRC § 401(l) are satisfied. Integrated plans are also known as “Social Security-based” or “permitted disparity” plans. The permitted disparity rules allow the employer (plan sponsor) to give eligible participants who earn compensation above the “integration level” which is typically the Social Security taxable wage base of $127,200 in 2017 (up from $118,500 in 2016), an additional contribution. This additional contribution is equal to the lesser of:
  o Two times the base contribution percentage; or
  o The base contribution percentage plus the “permitted disparity factor;” and
  o If the employer (plan sponsor) sets the integration level at the Social Security taxable wage base, then the permitted disparity factor equals 5.7 percent.

It is the employer’s obligation to forward contributions to the financial institution (custodian/trustee) for those employees who participate as described in the plan document. The employer should keep their financial institution aware of any changes in the status of those employees in the plan. As the employer hires new employees, for instance, the employer will include them in the SEP IRA if they satisfy the eligibility criteria described in the plan.

**Contribution Limits for Self-Employed**

The contribution limit to a SEP IRA for a self-employed individual is calculated a bit differently.

**Example:** Joe, a Schedule C sole proprietor, will have $100,000 net profit on his 2017 Schedule C (after deducting all Schedule C expenses, including a 10% retirement plan contribution made for his common-law employees but not his own contribution). Joe must pay $14,130 in self employment (SE) taxes.

To compute his plan compensation, Joe must subtract from his net profit of $100,000:

- The IRC § 164(f) deduction, which in this case is ½ of his SE tax ($14,130 \times \frac{1}{2}) ; and
- The amount of contribution for himself to the plan.

To determine the amount of his plan contribution, Joe must use the reduced plan contribution rate (considering the plan contribution rate of 10%) of 9.0909% from the rate table in IRS Pub 560 (see Table 14.1).
### Table 14.1
Rate Table for Self-Employed

<table>
<thead>
<tr>
<th>Column A</th>
<th>Column B</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the plan contribution rate is shown as %</td>
<td>Your rate is shown as decimal</td>
</tr>
<tr>
<td>1</td>
<td>.009901</td>
</tr>
<tr>
<td>2</td>
<td>.019608</td>
</tr>
<tr>
<td>3</td>
<td>.029126</td>
</tr>
<tr>
<td>4</td>
<td>.038462</td>
</tr>
<tr>
<td>5</td>
<td>.047619</td>
</tr>
<tr>
<td>6</td>
<td>.056604</td>
</tr>
<tr>
<td>7</td>
<td>.065421</td>
</tr>
<tr>
<td>8</td>
<td>.074074</td>
</tr>
<tr>
<td>9</td>
<td>.082569</td>
</tr>
<tr>
<td>10</td>
<td>.090909</td>
</tr>
<tr>
<td>11</td>
<td>.099099</td>
</tr>
<tr>
<td>12</td>
<td>.107143</td>
</tr>
<tr>
<td>13</td>
<td>.115044</td>
</tr>
<tr>
<td>14</td>
<td>.122807</td>
</tr>
<tr>
<td>15</td>
<td>.130435</td>
</tr>
<tr>
<td>16</td>
<td>.137931</td>
</tr>
<tr>
<td>17</td>
<td>.145299</td>
</tr>
<tr>
<td>18</td>
<td>.152542</td>
</tr>
<tr>
<td>19</td>
<td>.159664</td>
</tr>
<tr>
<td>20</td>
<td>.166667</td>
</tr>
<tr>
<td>21</td>
<td>.173554</td>
</tr>
<tr>
<td>22</td>
<td>.180328</td>
</tr>
<tr>
<td>23</td>
<td>.186992</td>
</tr>
<tr>
<td>24</td>
<td>.193548</td>
</tr>
<tr>
<td>25</td>
<td>.200000*</td>
</tr>
</tbody>
</table>

*The deduction for annual employer contributions (other than elective deferrals) to a SEP plan, a profit-sharing plan, or a money purchase plan cannot be more than 20% of your net earnings (figured without deducting contributions for yourself) from the business that has the plan.

Alternatively, Joe can compute his reduced plan contribution rate by:

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Taking the plan contribution rate</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2</td>
<td>Dividing the plan contribution rate by 100% + plan contribution rate</td>
<td>10%/110%</td>
</tr>
<tr>
<td>Step 3</td>
<td>To get the reduced plan contribution rate</td>
<td>9.0909%</td>
</tr>
</tbody>
</table>
Joe can now compute his own contribution/deduction amount as follows:

<table>
<thead>
<tr>
<th>Step</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
<td>Schedule C net profit</td>
</tr>
<tr>
<td>2</td>
<td>$7,065</td>
<td>½ SE tax deduction ($14,130 x ½)</td>
</tr>
<tr>
<td>3</td>
<td>$92,935</td>
<td>Net profit reduced by ½ SE tax</td>
</tr>
<tr>
<td>4</td>
<td>$8,449</td>
<td>Joe’s reduced plan contribution rate</td>
</tr>
<tr>
<td>5</td>
<td>$8,449</td>
<td>Joe’s allowed contribution and deduction</td>
</tr>
</tbody>
</table>

There is simple way to quickly verify the accuracy of Joe’s contribution/deduction amount:

<table>
<thead>
<tr>
<th>Step</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
<td>Joe's Schedule C net profit</td>
</tr>
<tr>
<td>2</td>
<td>$7,065</td>
<td>½ SE tax deduction</td>
</tr>
<tr>
<td>3</td>
<td>$8,449</td>
<td>Joe's contribution/deduction for himself</td>
</tr>
<tr>
<td>4</td>
<td>$84,486</td>
<td>Amount subject to plan's full rate</td>
</tr>
<tr>
<td>5</td>
<td>x 10%</td>
<td>Plan's full rate</td>
</tr>
<tr>
<td>6</td>
<td>$8,449</td>
<td>Joe's contribution/deduction for himself</td>
</tr>
</tbody>
</table>

If lines 3 and 6 above match, the contribution/deduction calculation is correct.

**Excess Contribution Rule**

Any amount contributed on behalf of an employee in excess of the applicable limitation is treated as an excess contribution. As such, the excess amount is treated as taxable compensation to the employee, followed by a contribution by the employee to the account [IRC § 402 (h)]. In the case of excess IRA contributions, generally the excess amount is subject to a 6 percent excise (penalty) tax, unless the excess amount, together with income allocable thereto, is withdrawn on or before the due date (including extensions) for filing the income tax return for the year with respect to which the excess contributions were made. The 6 percent excise tax is again imposed for the following year unless the excess amount (and income earned thereon) is withdrawn before the due date for that year’s return. Alternatively, it can be applied as part or all of the maximum allowable contribution for such following year [IRC § 4973 (a) and (b)]. Any portion of such excess not fully withdrawn or applied against the maximum allowable contribution for the year following the year of the excess contribution will incur the 6% tax in every succeeding year. When an excess contribution is withdrawn the income attributable to that amount must also be withdrawn, and the entire amount withdrawn is income taxable to the employee.
More Than One Employer

In cases where an employee works for two or more unrelated employers and only one employer has a SEP IRA, only the compensation paid by the SEP IRA employer is used to calculate the maximum SEP IRA contribution. If both employers have SEP IRAs, the contribution limitation applies separately to each SEP IRA. Self-employed individuals (sole proprietors and partners) who are involved in more than one business are treated as being employed by a single employer, thus limiting their annual contribution to a SEP IRA to 25 percent of compensation or the applicable dollar ceiling.

More Than One Plan

Employers can maintain a SEP IRA as well as a qualified retirement plan. In such situations, the employer cannot use the IRS model forms discussed earlier. Additionally, the SEP IRA will be treated as a defined contribution plan, subject to the annual contribution limit of the lesser of:

- The SEP IRA limit; or
- The defined contribution plan limit applied to the SEP IRA and the other plan(s) in the aggregate.

Deduction by the Employer

In general, employer contributions falling within the limitations discussed above are deductible by the employer and are non-taxable to the employee. SEP IRA contributions are not reported on an employee’s W-2 form so employees do not need to take a Traditional IRA deduction for SEP IRA contributions to their account. Excess contributions are deductible in succeeding years, to the extent that the carryover amount, together with the contributions for the carryover year, does not exceed the applicable limit for the carryover year [IRC § 404 (h)(1)(C)].

The employer may deduct the contributions for the taxable year to which they relate, even if made after the close of the year, as long as they are made no later than the due date (including extensions) for filing of the tax return for the year [IRC § 404 (h)(1)].

SARSEP Plans

A Salary Reduction Simplified Employee Pension (SARSEP) is a SEP set up before 1997 that includes a salary reduction arrangement. Under a SARSEP, a small business owner’s employees can choose to have the business contribute part of their pay to their SEP IRAs rather than receive it in cash. This contribution is called an “elective deferral” because employees choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them.
A small business is not allowed to set up a SARSEP after 1996. However, participants (including employees hired after 1996) in a SARSEP set up before 1997 can continue to have the business contribute part of their pay to the plan.

**Note:** One of the eligibility rules for the SARSEP IRA was the number of employees could not exceed 25. If an existing SARSEP IRA has more than 25 employees, it must become a SEP IRA.

**Contributions to SARSEP IRA**

A SARSEP IRA permits an employee to elect to have the employer either:

- Make elective employer contributions to the SARSEP IRA on behalf of the employee; or
- Distribute an amount in cash to the employee.

If the employee takes cash, the distribution is includable in the employee’s income. If the employee chooses salary reduction, the employee excludes the amount of the salary reduction contribution from income for the year of contribution. If the employee chooses salary reduction, taxation is generally deferred until distributions are made from the SARSEP IRA. Thus, salary reduction is a form of elective deferral.

Salary reduction contributions to a SARSEP IRA, as well as all other elective deferrals to retirement plans, are subject to a combined overall limitation for elective deferrals in a year (IRC § 402(h)(2)). The most a participant can choose to defer for calendar year 2017 is the lesser of the following amounts:

- 25% of the participant’s compensation (limited to $270,000 of the participant’s compensation in 2017); or
- $18,000 (in 2017).

The salary reduction limit applies to the total elective deferrals the employee makes for the year to a SEP IRA and any of the following:

- Cash or deferred arrangement (401(k) plan);
- Salary reduction arrangement under a TSA (403(b) plan); and
- SIMPLE IRA.

A SARSEP IRA can permit participants who are age 50 or over at the end of the calendar year to make catch-up contributions. The catch-up contributions limit in remained the same for 2017, at $6,000. Elective deferrals are not treated as catch-up contributions for 2017 until they exceed the elective deferral limit or the plan limit.
Chapter 14
Review Questions

1. The SEP IRA came into law with the passage of which of the following tax Acts

( ) A. Tax Revenue Act of 1978
( ) B. The Small Business Job Protection Act of 1996
( ) C. The Employee Retirement Income Security Act of 1974
( ) D. The Taxpayers Relief Act of 1997

2. Which IRC Section governs the SEP IRA?

( ) A. IRC § 408 (p)
( ) B. IRC § 401 (a)
( ) C. IRC § 408 (k)
( ) D. IRC § 403 (b)

3. In 2017, what is the amount, under IRC § 402 (h)(2), that imposes a ceiling on annual employer contributions in a participant’s SEP IRA?

( ) A. Lesser of 25% of compensation or $54,000
( ) B. Lesser of 25% of compensation or $18,000
( ) C. Lesser of 100% of compensation or $54,000
( ) D. Lesser of 100% of compensation or $18,000

4. Which of the following statements about a SEP IRA is FALSE?

( ) A. They have tax advantages for both the employer and the employee
( ) B. May not discriminate in favor of highly compensated employees (HCE)
( ) C. IRS Form 5305-SEP can be used by the employer to satisfy the written arrangement requirement for a SEP IRA
( ) D. Regular SEP IRA contributions are subject to FICA and FUTA taxes

5. Employers who established SARSEP IRAs before what year are grandfathered?

( ) A. 1981
( ) B. 1997
( ) C. 1986
( ) D. 2001

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CHAPTER 15

SIMPLE IRA

Overview

The passage of the Small Business Job Protection Act of 1996 created a new Individual Retirement Arrangement (IRA), known as the Savings Incentive Match Plan (SIMPLE) IRA. The SIMPLE IRA is designed to help employees working for smaller businesses save for retirement on a tax-favored basis while allowing employers current-year tax deductions. As part of the inducement to attract employers to adopt a SIMPLE IRA, many of the complex rules applicable to traditional qualified plans, such as top-heavy rules and nondiscrimination tests, were eliminated.

In this chapter, we will examine the rules and regulations under IRC § 408(p), which governs the SIMPLE IRA.

Learning Objectives

Upon the completion of this chapter, you will have an understanding of the following:

- The legislative intent of the SIMPLE IRA;
- How to explain what is a SIMPLE IRA;
- How to identify the type of employer who can set up a SIMPLE IRA and what IRS forms are used to set up a SIMPLE IRA; and
- The various eligibility and contribution rules for employers and employees.

SIMPLE IRA Defined

A SIMPLE IRA is a type of retirement plan that can take the form of either an IRA, called a SIMPLE IRA, or cash or deferred arrangement called a SIMPLE 401(k) plan. With a SIMPLE IRA, an employee makes a contribution to his or her individual account through salary reduction and the employer transfers this amount to the employee’s account. The employer, in return, is required to make an annual contribution to each participating employee’s account. The contribution is then deposited into a trust account for the employee where it grows tax-free until distributed.

Only those employers that meet the specific eligibility requirements discussed below may establish a SIMPLE IRA.
Employer Eligibility

Only an eligible employer may adopt a SIMPLE IRA plan. An “eligible employer” is defined as an employer who employed no more than 100 employees earning at least $5,000 from the employer during the preceding year [IRC § 408(p)(2)(C)(i)]. In determining the number of employees for this purpose, the employer must meet the following:

- Employees who earned less than $5,000 are not counted, but employees who are excluded from participation (e.g., union employees and nonresident aliens) must be counted [IRC § 408 (p)(2)(C)(i)]. The term “employer” includes related employers (such as trades or businesses under common control, whether incorporated or not), controlled groups of corporations and affiliated service groups. For example, a business employing 80 eligible employees cannot establish a SIMPLE IRA if it has a subsidiary with more than 20 eligible employees; and.

- An employer cannot create a SIMPLE IRA if it already maintains (or has maintained in the same year) another SIMPLE IRA plan or other qualified plan. A qualified plan includes a qualified retirement plan, qualified annuity plan, a government plan, tax-sheltered annuity or a simplified employee pension (SEP IRA) [IRC §§ 408 (p)(2)(D); 219 (g)(5)].

Two-Year Grace Period

An employer can initially employ fewer than 100 employees but cannot exceed this number over time. In such cases, the employer can continue the SIMPLE IRA for two years after the last year it met the eligibility requirements. At the end of this two-year grace period, the employer must discontinue the SIMPLE IRA plan.

Setting up A SIMPLE IRA

SIMPLE IRAs are easy to adopt and to administer while providing employees with tax-deferred retirement savings benefits much like those of a qualified plan. The employer simply completes IRS Form 5304-SIMPLE or IRS Form 5305-SIMPLE. Form 5304-SIMPLE does not provide for a “designated financial institution” for participant investments, while Form 5305-SIMPLE does, which some plan sponsors and participants may find restrictive. Salary reduction elections must be made by employees during the 60 day period prior to January 1 of the year which the elections are made. The form does not have to be sent to the IRS or any other government agency.

Note: A SIMPLE IRA plan may only be maintained on a calendar-year basis.
Employee Eligibility Requirements

A SIMPLE IRA plan must be open to every employee who:

- Received at least $5,000 in compensation from the employer during any two preceding years; and
- Is expected to receive at least $5,000 in compensation during the current year.

However, an employer can exclude:

- Its nonresident alien employees who receive no U.S. source income;
- Employees covered under a collective bargaining agreement (whose retirement benefits were the subject of good-faith bargaining) from participating in the plan; and
- Certain employees not covered by collective bargaining agreements covering airline pilots [IRC § 408(p)(4)].

An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE IRA.

For Example: An employer could allow participation for employees who received $3,000 in compensation during any preceding calendar year. However, the employer cannot impose any other conditions on participating in a SIMPLE IRA [Notice 98-4, 1998-2 I.R.B. 26, Q & A C-2].

Required Enrollment Periods

An eligible employee must be given the right to enter into a salary reduction agreement during the “60-day period” immediately preceding January 1 of a calendar year (that is, November 2 to December 31 of the preceding calendar year). An eligible employee also must be given the right to enter into a salary reduction agreement for the calendar year or to modify a prior agreement (including reducing the amount to $0 subject to this agreement). However, for the year in which the employee first becomes eligible to make salary reduction contributions, the period during which the employee may enter into a salary reduction agreement or modify a prior agreement is the 60-day period that includes either the date the employee becomes eligible or the day before that date.

Example 1: On November 1, 2017, The Filter Company decides to establish its first retirement plan. It adopts a SIMPLE IRA plan with no service or compensation requirements for its 40 employees. The plan is duly adopted and effective on January 1, 2016. Eligible employees are given a completed summary description, a model notification and a model salary reduction agreement on November 1, 2017. The 60-day period starts on November 2 and ends on December 31, 2017. Here, the 60-day period includes December 31, the “day before” the date the employee becomes eligible (January 1). Although contributions can be discontinued at any time, no
modifications are permitted after the 60-day election period unless the plan provides for additional opportunities to modify (or make) an election to defer compensation.

Example 2: An employer establishes a SIMPLE IRA plan effective July 1, 2017. Each eligible employee becomes eligible to make salary reduction contributions on that date, and the 60-day period must begin no later than July 1 and cannot end before June 30, 2017.

The 60-day election period is the 60-day period before the beginning of any year (and the 60-day period before first becoming eligible to participate). In general, this is the statutory period during which an eligible employee may elect to participate or modify a previous election amount. The employer may allow additional periods for making and changing elections. Thus, for a calendar year, an eligible employee may make or modify a salary reduction election during the 60-day period immediately preceding January 1 of that year. However, for the year in which the employee first becomes eligible to make salary reduction contributions, the period during which the employee may make or modify the election is a 60-day period that includes either the date the employee becomes eligible or the day before. In addition, the plan can provide for additional periods during which an employee may make a salary reduction election or modify a prior election.

During the 60-day period, an employee may modify his/her salary reduction agreements without restrictions. In addition, for the year in which an employee becomes eligible to make salary reduction contributions, he/she must be able to commence these contributions as soon as he/she becomes eligible, regardless of whether the 60-day period has ended.

An employee who commences participation during the election period may cancel or modify a previous election. Any such change is prospective and should be implemented by the employer as soon as possible or in accordance with the documentation submitted to the employer. Nothing precludes a SIMPLE IRA plan from providing additional or longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements.

SIMPLE IRA Contributions

If an employer establishes a SIMPLE IRA it must make salary reduction contributions, to the extent elected by employees, and must make employer matching contributions or employer non-elective contributions, all as described below. These are the only contributions that may be made under a SIMPLE IRA. The following rules regarding contributions are set forth in Notice 98-4, 1998-2 I.R.B. 26, Q&As D1-D6, and in IRC § 14(v).
Employee Salary Reduction Contributions

A salary reduction contribution is a contribution made pursuant to an employee’s election to have an amount contributed to his or her SIMPLE IRA, rather than have the amount paid directly to the employee in cash. An employee must be permitted to elect to have salary reduction contributions made at the level specified by the employee, expressed as a percentage of compensation for the year or as a specific dollar amount. An employer may not place any restrictions on the amount of an employee’s salary reduction contributions (e.g., by limiting the contribution percentage), except to the extent needed to comply with the IRC’s annual limit on the amount of salary reduction contributions. For 2017, the salary reduction amount is $12,500 [IRC § 408 (p)(2) (E)] (same as in 2016).

Catch-Up Provision for Older Participants

Effective since 2002, older participants were allowed to “catch up” with respect to adequate funding of their retirement, the otherwise applicable dollar limit on elective deferrals under a SIMPLE IRA was increased for individuals who have attained the age of 50 by the end of the year [IRC § 414 (v)(2)(B)(ii)]. The catch-up contribution does not apply to after-tax employee contributions. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of any limitation of the IRC (e.g., the annual limit on elective deferrals) or of the plan. The additional amount of elective contributions that may be made by an eligible employee (participant) age 50 in 2017 is $3,000.

The supplemental catch-up contribution is not allowed to the extent that it would result in total elective deferrals for the year exceeding the participant’s compensation for the year. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable non-discrimination rules. However, a plan fails to meet the applicable non-discrimination requirements under IRC § 401 (a)(4) with respect to benefits, rights and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this rule, all plans of related employers are treated as a single plan.

Employer Matching Contributions

Under a SIMPLE IRA, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee’s salary reduction contributions, up to a limit of 3 percent of the employee’s compensation for the entire calendar year. The 3-percent limit on matching contributions is permitted to be reduced for a calendar year at the election of the employer, but only if:

- The limit is not reduced below 1 percent;
- The limit is not reduced for more than 2 years out of the 5-year period that ends with (and includes) the year for which the election is effective; and
• Employees are notified of the reduced limit within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements.

For purposes of applying the foregoing rule, in determining whether the limit was reduced below 3 percent for a year, any year before the first year in which an employer (or a predecessor employer) maintains a SIMPLE IRA will be treated as a year for which the limit was 3 percent. If an employer chooses to make non-elective contributions (discussed below) for a year, that year also will be treated as a year for which the limit was 3 percent.

**Employer Non-elective Contributions**

As an alternative to making matching contributions under a SIMPLE IRA, an employer may make non-elective contributions equal to 2 percent of each eligible employee’s compensation for the entire calendar year. The employer’s non-elective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit non-elective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year. For purposes of the 2-percent non-elective contribution, the compensation taken into account must be limited to the amount of compensation that may be taken into account under Code §401(a)(17) for the year ($270,000 in 2017).

So, the maximum total contribution allowed for employer non-elective contributions in 2017 is $5,400 (2% x $270,000).

An employer may substitute the 2-percent non-elective contribution for the matching contribution for a year, only if:

• Eligible employees are notified that a 2-percent non-elective contribution will be made instead of a matching contribution; and
• This notice is provided within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements.

**Tax Consequences of Contributions**

Contributions to a SIMPLE IRA are excludable by the employee from federal income tax, and not subject to federal income tax withholding. Salary reduction contributions to a SIMPLE IRA are subject to tax under the Federal Insurance Contributions Act (“FICA”), the Federal Unemployment Tax Act (“FUTA”), and the Railroad Retirement Act (“RRTA”), and must be reported on Form W-2, Wage and Tax Statement. Matching and non-elective contributions to a SIMPLE IRA are not subject to FICA, FUTA, or RRTA taxes, and are not required to be reported on Form W-2 [Notice 98-4, 1998-2 I.R.B. 26, Q&A I-1].
Pursuant to IRC § 404(m), contributions under a SIMPLE IRA are deductible in the taxable year of the employer with or within which the calendar year for which contributions were made ends (without regard to the limitations of IRC § 404(a)).

An individual cannot make deductible contributions to his or her own IRA after attaining age 70 ½. However, employers can make contributions to SIMPLE IRAs (including both matching contributions and salary reduction reductions) for employees who are over age 70 ½. In fact, the age discrimination law, if applicable, would generally require such contributions to be made.

An employee covered under a SIMPLE IRA would be considered an active participant in any year in which salary reductions or employer contributions were allocated to his or her account. However, in a year in which no allocation was made to the individual’s account, the individual would have any otherwise-available IRA deduction (up to $6,000 in 2017 [IRS Notice 87-16, 1987-1 CB 446, I]). The higher SIMPLE IRA limit is not available for individual IRA contributions, only for employer contributions or salary reductions under a SIMPLE IRA plan.

**Vesting Requirements**

All contributions under a SIMPLE IRA must be fully vested and non-forfeitable when made. An employer may not require an employee to retain any portion of the contributions in his or her SIMPLE IRA or otherwise impose any withdrawal restrictions [Notice 98-4, 1998-2 I.R.B. 26, Q &As F-1 & F-2].

**Distribution Rules**

Distributions to employees are generally treated as distributions from a Traditional IRA [IRC §§ 402(k) and 402(h)(3)]. All the restrictions on Traditional IRA distributions apply, and the distributions are taxed the same; however, the 10% penalty on early distributions [IRC 72(t)(1)] is increased to 25% during the first two years of participation [IRC § 72(t)(6)]. Furthermore, while a rollover may be made at any time from one SIMPLE IRA to another SIMPLE IRA, a rollover from a SIMPLE IRA to a Traditional IRA during the first two years of participation is permitted only in the case of distributions to which the 25% early distribution penalty does not apply [IRC § 408(d)(3)(G)].

**Note:** During the two year period that the 25% penalty is imposed, such transfer (rollover) would be treated as a distribution from the SIMPLE IRA and a contribution to the regular IRA that does not qualify as a rollover contribution [IRS Notice 97-6, 1997-1CB 353].
ERISA Requirements

The reporting and disclosure requirements for SIMPLE IRA plans are simplified, particularly if the employer uses IRS Form 5304-SIMPLE or IRS Form 5305-Simple. The annual report forms (5500 series) are not required for SIMPLE IRA plan.
1. The SIMPLE IRA is governed under which Section of the Internal Revenue Code?

   ( ) A. IRC § 401(k)
   ( ) B. IRC § 408(p)
   ( ) C. IRC § 408(k)
   ( ) D. IRC § 401(a)

2. An “eligible employer” is defined as an employer who employed no more than 100 employees earning at least what amount from the employer during the preceding year?

   ( ) A. $5,000
   ( ) B. $550
   ( ) C. $2,500
   ( ) D. $5,500

3. Salary reduction elections must be made by employees during what time period prior to January 1 of the year which the elections are made?

   ( ) A. 180 days
   ( ) B. 90 days
   ( ) C. 30 days
   ( ) D. 60 days

4. For the tax year 2017, what is the catch-up contribution limit for a SIMPLE IRA?

   ( ) A. $5,000
   ( ) B. $3,000
   ( ) C. $1,000
   ( ) D. $ 500

5. Under a SIMPLE IRA, an employer can make a matching contribution on behalf of each eligible employee in an amount equal to the employee’s salary reduction contributions, up to a limit of what percent of the employee’s compensation for the entire calendar year?

   ( ) A. 2 percent
   ( ) B. 1 percent
   ( ) C. 3 percent
   ( ) D. 5 percent
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CHAPTER 16

INDIVIDUAL RETIREMENT ARRANGEMENTS

Overview

It is crucial for many small business owners and their employees to take advantage of all available tax-deferred savings vehicles to save for retirement. Of course, one of those tax-advantage vehicles is the Individual Retirement Arrangement (IRA).

In this chapter, we will examine the background and the dual purpose of the Individual Retirement Arrangement (IRAs), as well as the rules pertaining to the Traditional IRA and Spousal IRA.

Learning Objectives

At the conclusion of this chapter, you will have an understanding of the following:

- The intent and purpose of Congress in developing the IRA;
- The various legislative changes that have affected the IRA since its inception;
- How to set up a Traditional IRA and the eligibility rules for contributing to a Traditional IRA;
- The rules for making either deductible or nondeductible contributions to a Traditional IRA; and
- The Spousal IRA.

History of IRAs

The Employee Retirement Income Security Act (ERISA), signed into law in 1974, established the first comprehensive standards to help protect the retirement programs of Americans. It also created the Individual Retirement Account, or IRA.

Dual Purpose of IRAs

To give the new account flexibility in accumulating assets for retirement, Congress designed a dual role for the individual retirement arrangements (IRAs).

- First, to give individuals not covered by retirement plans at work an opportunity to save for retirement on their own in tax-deferred accounts made available through private financial institutions; and
• Secondly, to give retiring workers or individuals changing jobs a means to preserve employer-sponsored retirement plan assets by allowing them to transfer, or rollover, plan balances into IRAs.

Eligible workers under the age of 70 ½ annually could contribute to an IRA the lesser of $1,500 or 15 percent of compensation. Individuals did not pay income taxes on these contributions (after-tax, non-deductible, contributions were not allowed), but rather the contributions and investment earnings were taxed when withdrawn from the IRA.

To facilitate the preservation of retirement savings accrued in the workplace, the original IRA legislation also permitted workers in employer-sponsored retirement plans to transfer, or rollover, plan assets into Traditional IRAs, when retiring or changing jobs. This feature continues to be very important to preserve assets accumulated in employer-sponsored plans for retirement in tax-advantaged specially earmarked accounts.

**IRA Assets**

IRAs continue to gain in importance as a retirement asset for individuals. IRAs have become the number #1 retirement investment vehicle with $7.5 trillion in assets at the end of the second quarter of 2016 (see Figure 16.1). Forty-eight percent of IRA assets, or $3.6 trillion, was invested in mutual funds, predominantly in equity funds ($1.9 trillion).

![Figure 16.1](https://www.ici.org/research/stats/retirement/ret_16_q2)

According to ICI, individual retirement accounts (IRAs) represented 33 percent of U.S. total retirement market assets of $24.5 trillion, at the end of the second quarter of 2016, compared with 18 percent two decades ago.
Traditional IRAs are the oldest and most common type of IRA. In mid-2015, 30.4 million, or 24.4 percent of U.S. households owned Traditional IRAs. In addition to being a repository for contributions, the Traditional IRA is a vehicle for rollovers from employer sponsored retirement plans. Indeed, more than half of U.S. households with Traditional IRAs indicated their IRAs contained rollover assets. Roth IRAs, which were first available in 1998, are the second most frequently owned type of IRA, owned by 20.3 million, or 16.3 percent of U.S. households, followed by employer sponsored IRAs, which include SEP IRAs, SARSEP IRAs, and SIMPLE IRAs (see Figure 16.2).

### Figure 16.2
**Millions of U.S. Households Own IRAs**
*Percentage of U.S. Households, 2015*

<table>
<thead>
<tr>
<th>TYPE OF IRA</th>
<th>YEAR CREATED</th>
<th>Number of U.S. Households with Type of IRA¹, 2015</th>
<th>Percentage of U.S. Households with Type of IRA¹, 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional IRA</td>
<td>1974 Employee Retirement Income Security Act (ERISA)</td>
<td>30.4 million</td>
<td>24.4%</td>
</tr>
<tr>
<td>SEP-IRA²</td>
<td>1978 Revenue Act</td>
<td>6.7 million</td>
<td>5.4%</td>
</tr>
<tr>
<td>SAR-SEP IRA²</td>
<td>1986 Tax Reform Act</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIMPLE IRA²</td>
<td>1996 Small Business Job Protection Act</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Roth</td>
<td>1997 Taxpayer Relief Act</td>
<td>20.3 million</td>
<td>16.3%</td>
</tr>
<tr>
<td>Any IRA¹</td>
<td></td>
<td>40.2 million</td>
<td>32.3%</td>
</tr>
</tbody>
</table>

¹ Households may own more than one type of IRA ²SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs are employer sponsored IRAs.


### Traditional IRA

The Traditional IRA, also known as the Original IRA and/or the Contributory IRA, was the first type of IRA authorized by Congress back in the early 1970’s. The thinking was that Social Security benefits were not going to be adequate for most Americans to retire on.

### Setting Up a Traditional IRA

A Traditional IRA, also known as a Regular IRA or Contributory IRA, is any type of IRA, except a Roth IRA, SIMPLE IRA and/or an Educational IRA.
There are two types of Traditional IRAs a participant may set up and invest in. They are:

- Individual Retirement Account; and
- Individual Retirement Annuity.

Although the abbreviation “IRA” may refer to either an “individual retirement account” or an “individual retirement annuity,” it is used primarily to refer to the far more popular form, the “Individual Retirement Account” (as discussed below). Thus, the term “IRA annuity” may be used for convenience in distinguishing the annuity from its more popular counterpart.

**Individual Retirement Account**

An “Individual Retirement Account” (IRA), by definition [IRC § 408 (a); Reg. §1.408-2] is a trust or custodial account set up in the United States for the exclusive benefit of an individual taxpayer (participant) and his or her beneficiaries.

The Individual Retirement Account is created by means of a written IRA document approved by the IRS, which can be either a custodial account or a trustee account (non-bank).

To be a custodial account, the IRA must meet the following requirements:

- The custodian must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the IRS. (Brokerage and Insurance companies generally fall into this general category). Note: An individual cannot be the trustee of an individual retirement account;
- The custodian generally cannot accept regular annual contributions greater than the statutory ceiling amount of $5,500 in 2017 (IRC § 219). However, IRA rollover contributions and employer contributions to simplified employee pensions (SEP IRAs) can be more than the ceiling applicable to Traditional IRAs;
- Contributions that do not involve rollovers must be in cash, which includes checks or money orders;
- The IRA participant must be fully “vested” in the amount in his or her IRA. This means that the participant has a non-forfeitable right to the total assets in his or her account at all times;
- Money in the IRA participant’s account cannot be used to invest in a life insurance contract;
- Assets in an IRA cannot be commingled with other property, except in a common trust fund or common investment fund;
- The IRA participant must begin receiving life expectancy or annuity payments no later than April 1 of the year following the year when he or she turns 70½; and
- Participants’ age 50 and older by the end of the tax year can make an additional catch-up contribution of $1,000 to their individual IRAs.
A non-bank trustee, in addition to meeting the requirements mentioned above, must demonstrate the following characteristics to the IRS:

- Fiduciary ability (including continuity of life, an established place of business in the United States where it is accessible during every business day, fiduciary experience, fiduciary responsibility, and financial responsibility);
- Capacity to account for the interest of a large number of individuals;
- Fitness to handle retirement funds;
- Ability to administer fiduciary powers; and
- Adequacy of net worth.

In addition, the non-bank trustee must also provide the following:

- That audit will be conducted by a qualified public accountant at least every 12 months;
- That funds will be kept invested as long as reasonable for the proper management of the account;
- That investments will not be commingled with other investments except in a common trust fund and investments will be safely maintained; and
- That separate fiduciary records will be maintained.

The IRC states that, for purposes of an IRA account, a custodial account is treated as a trust and that the custodian for such account is treated as a trustee [IRC § 408(h)]. The IRS maintains a list of entities approved to act as a non-bank IRA Trustee or Custodian.

The IRS has issued a prototype trust agreement (IRS Form 5305) and a prototype custodial agreement (IRS Form 5305A). If a banking institution or other entity wishes to use one of these agreements in lieu of preparing its own prototype agreement, the IRS prototype may be used without prior approval. On the other hand, if the institution prepares its own agreement, it must be submitted to the IRS for approval.

**Individual Retirement Annuity**

The Individual Retirement Annuity has the same essential tax characteristics as the individual retirement account, as was discussed above, except that it is structured in the form of an annuity contract with a duly licensed life insurance company. Thus, the contributions are in the form of premiums, the accumulating assets are the cash surrender values, and the disbursements are the annuity payments (or the prior death benefit).

Each insurance company is required to submit to the IRS a copy of the annuity contract that it wishes to use. After review, the IRS gives its approval and assigns a code number to the contract. For the purposes of securing this approval, IRS Form 5306 must be completed and submitted to the IRS. Because the contract will have received prior approval, it is not necessary for an individual to submit his or her particular IRA annuity to the IRS for approval.
The type of annuity contract most frequently used for IRA annuity purposes is the “flexible premium retirement annuity contract” with a normal retirement age of 65. Retirement age can, however, be any age from 60 to 70. The contract normally calls for level premiums payable periodically (monthly, quarterly, semi-annually or annually) over the full period from issue date to retirement date. However, under the flexible premium provision, the premiums may increase or decrease in size and the frequency of premium payments may be changed from time to time. Also, the premium may be temporarily suspended or terminated completely, at the option of the owner of the contract, under what is called a stop-and-go provision.

To assure that the contract selected is an investment vehicle qualifying as an IRA annuity, the following restrictions must be incorporated into the contract and made an integral part of it [IRC § 408(b)]:

- The annual premium on behalf of any individual must not exceed the dollar amount of $5,500 in 2017 (same as in 2016) (IRC § 219(b)(1)(A));
- The contract must be non-assignable, non-alienable and non-transferable by the individual (except as to the tax-free rollover privilege);
- The entire value of the contract must be non-forfeitable to the individual;
- Any and all dividends (called “refunds of premiums”) must be applied before the end of the succeeding calendar year to purchase additional benefits or to reduce future premiums; and
- Distributions from the contract prior to or at retirement or at death must be made in accordance with the distribution rules applicable to qualified plans generally [under IRC § 401(a)(9)].

Annuity payments may commence at any age from 59½ to April 1 of the year following the attainment of age 70½, usually on a monthly basis. Of course, various optional types of annuity settlements are usually available on request. The amount of the annuity payment depends upon the amount of the premiums actually paid. The death benefit prior to the commencement of the annuity payments is most often the aggregate of the premium payments or the cash surrender value, if greater.

**Note:** For an IRA annuity, in lieu of a single life annuity contract on the life of the individual, it is permissible for the contract to be applied for and issued in the form of a joint and survivor annuity on the lives of the contract owner and his or her spouse. Under a regular qualified pension plan, ERISA requires the normal type of retirement settlement to be a joint and survivor annuity, unless the retiring employee specifically elects otherwise. This requirement, however, is not imposed upon an IRA annuity.

**Eligibility Requirements**

There are two requirements a participant must meet to be eligible for a Traditional IRA.
• First, he/she must be under age 70½. A participant cannot establish or contribute to a Traditional IRA during or after the tax year in which he/she reaches age 70½; and

• The second requirement is that an individual must also have taxable compensation in order to establish a Traditional IRA (also includes a Roth IRA).

**Compensation Defined**

Under IRC § 219(f)(1), the categories of compensation are defined as follows:

• *Wages, salaries, etc.* Wages, salaries, tips, professional fees, bonuses, and other amounts a participant receives for providing personal services are compensation. The IRS treats as compensation any amount properly shown in Table 16.3 (Wages, tips, other compensation) from Form W-2, Wage and Tax Statement, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans). Scholarship and fellowship payments are compensation for IRA purposes only if shown in box 1 of Form W-2;

• *Commissions.* The amount a participant receives that is a percentage of profits or sales price is compensation;

• *Self-employment income.* If the participant is self-employed (a sole proprietor or a partner), compensation is the net earnings from their trade or business (provided your personal services are a material income-producing factor) reduced by the total of:
  o The deduction for contributions made on their behalf to retirement plans; and
  o The deduction allowed for one-half of their self-employment taxes.

Compensation includes earnings from self-employment even if the participant is not subject to self-employment tax because of their religious beliefs. When a participant has both self-employment income and salaries and wages, their compensation includes both amounts;

• *Self-employment loss.* If a participant has a net loss from self-employment, do not subtract the loss from their salaries or wages when figuring their total compensation. However, net losses from one self-employed business may be aggregated with net income from another self-employed business;

• *Alimony and separate maintenance.* For Traditional IRA purposes (also Roth IRA), compensation includes any taxable alimony and separate maintenance payments one may receive under a decree of divorce or separate maintenance; and

• *Nontaxable combat pay.* If the taxpayer was a member of the U.S. Armed Forces, compensation includes any nontaxable combat pay he/she received. Under the Heroes Earned Retirement Opportunities (HERO) Act, signed into law by President Bush May 29, 2006, military personnel can now count tax-free combat pay when determining whether they qualify to contribute to a Traditional (or Roth IRA). Before this change, members of the military whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for
retirement. This amount should be reported in box 12 of their Form W-2 with code Q.

Table 16.3
Compensation for purposes of an IRA*

<table>
<thead>
<tr>
<th>Includes…</th>
<th>Does not include…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages, salaries, etc.</td>
<td>Interest and dividend income</td>
</tr>
<tr>
<td>Self-employment income</td>
<td>Earnings and profits from property</td>
</tr>
<tr>
<td>Commissions</td>
<td>Pension and annuity income</td>
</tr>
<tr>
<td>Alimony separate maintenance</td>
<td>Deferred compensation</td>
</tr>
<tr>
<td>Non-taxable combat pay</td>
<td>Income from certain partnerships</td>
</tr>
</tbody>
</table>

*Source: IRS Publication 590

On the other hand, compensation does not include any of the following items:

- Earnings and profits from property, such as rental income, interest income, and dividend income;
- Pension or annuity income;
- Deferred compensation received (compensation payments postponed from a past year);
- Income from a partnership for which the individual does not provide services that are a material income-producing factor;
- Any amounts excluded from income, such as foreign earned income and housing costs; and
- Unemployment compensation.

Regular Annual IRA Contributions

Under IRC § 219(b)(1)(A), there is a limit on the amount of a regular contribution the participant may make to a Traditional IRA each tax year. The rule states that any participant with taxable compensation can contribute to their Traditional IRA up to 100 percent of their taxable compensation up to a maximum. Table 16.4 shows the maximum contribution limits for 2016 and 2017.

Table 16.4
Regular Annual Contribution Limit 2016-2017

<table>
<thead>
<tr>
<th>Year</th>
<th>Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$5,500</td>
</tr>
<tr>
<td>2017</td>
<td>$5,500</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590
Under IRC § 219 (b)(5)(B), there is a catch-up provision that allows individuals who have reached age 50 and older to make an additional contribution. Table 16.5 shows the maximum catch-up contribution limits for 2016 and 2017.

### Table 16.5
**Catch-up Contribution Limit**

<table>
<thead>
<tr>
<th>Year</th>
<th>Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$1,000</td>
</tr>
<tr>
<td>2017</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

For 2017 (same as in 2016), the maximum contribution for a participant age 50 and older will be $6,500.

**Note:** Regular annual contributions must be in the form of money (cash, check, or money order). Property cannot be contributed. However, an individual may transfer or roll over certain property (other than cash) from one retirement plan to the other.

**Date of Regular Annual IRA Contributions**

Regular annual contributions can be made to a Traditional IRA for a year at any time during the year or by the due date for filing the return for that year, not including extensions. For most people, this means that contributions must be made as follows:

- For tax year 2016 must be made by April 18, 2017; and
- For tax year 2017 must be made by April 17, 2018.

**Contributions Returned Before Due Date of Return**

If an IRA participant makes a regular annual contribution to his or her Traditional IRA, the participant can withdraw those contributions tax free by the due date of their return. If the participant has an extension of time to file their return, the participant can withdraw them tax free by the extended due date. The participant can do this if, for each regular annual contribution he/she withdraws, both of the following conditions apply:

- Participant did not take a deduction for the contribution; and
- Participant withdraws any interest or other income earned on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.
IRA Deductible Contributions

Deductible regular annual contributions a taxpayer can take for contributions made to his/her Traditional IRA depends on whether he/she (and spouse if applicable) is covered for any part of the year by an employer retirement plan. If the taxpayer (and spouse, if applicable) is not covered by a qualified retirement plan, he/she is allowed to deduct 100% of his or her maximum allowable contribution. However, an employee who participates in a qualified retirement plan, his/her deduction will be subject to the phase-out rules. But, let’s first define an active participant.

Active Participant Defined

Special rules apply to determine whether a participant (employee) is covered by (active participant) an employer-sponsored retirement plan for a tax year. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

- **Defined Contribution Plan.** Generally an employee is considered covered by a defined contribution plan if amounts are contributed or allocated to the employee’s account for the plan year that ends within their tax years. Types of defined contribution plans include profit-sharing plans, stock bonus plans, money purchase plans, 401(k) plan, 403(a) plan, 403(b) plan, a SEP IRA and SIMPLE IRA. **Note:** If an amount is allocated to the employee’s account for a plan year, the employee is considered covered by the plan (active participant) even if they are not vested in the plan; and

- **Defined Benefit Plan.** If an employee is eligible (meets minimum age and years of service requirements) to participate in their employer’s defined benefit plan for the plan year that ends within their tax year, they are considered covered by the plan. This rule applies even if the employee declined to be covered by the plan, they did not make a required contribution, or they did not perform the minimum service required to accrue a benefit for the year. A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on a computation of what contributions are necessary to provide definite benefits to plan participants. Defined benefit plans include pension plans and annuity plans.

**Note:** If the employee accrues a benefit for a plan year, the employee is covered by that plan even if the employee has no vested interest in (legal right to) the accrual. For those who would not be considered covered by an employer plan are the following:

- **Social Security or Railroad Retirement.** Coverage under Social Security or Railroad Retirement (Tier I and Tier II) does not count as coverage under an employer retirement plan;

- **Reservists.** If the only reason an employee participates in a plan is because he or she is a member of a reserve unit of the armed services, they may not be considered covered by a plan. The reservist will not be considered covered by the plan if both of the following conditions are met:
The plan he or she participates in is established for its employees by:
  - The United States
  - A state or political subdivision of a state, or
  - An instrumentality of either both of the above.

 o Volunteer Firefighters. If the only reason an employee participates in a plan is because they are a volunteer firefighter, they may not be considered covered by the plan. The volunteer firefighter would not be considered covered by the plan if both of the following conditions are met:
  - The plan the volunteer firefighter participates in is established for its employees by:
    - The United States,
    - A state or political subdivision of a state, or
    - An instrumentality of either both of the above.
  - The accrued retirement benefits at the beginning of the year will not provide more than $1,800 per year at retirement.
  - The employee has not served more than 90 days on active duty.

A simpler way to find out if the participant is an active participant in an employer sponsored qualified retirement plan is to review their Form W-2 they received from their employer. On the Form W-2 there is a “Retirement Plan” box (Box 13) used to indicate whether or not the employee is covered (active participant) for the year. If the box is checked, then the employee is an active participant for the current tax year.

**Deduction Phase-out**

If the participant is an “active participant” in certain employer retirement plans, the total regular annual contribution limit is subject to phase-out based upon adjusted gross income for purpose of the deductible contribution limit [IRC § 219(g)]. Their deduction is also affected by how much income they had and by their filing status. The deduction may also be affected if they received any Social Security benefits.

The deduction will begin to decrease (phase-out) when their income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These income limits will vary depending on their filing status [IRC § 219(g)(3)(b)].

To determine if a participant’s regular annual contribution deduction is subject to the phase-out, you must first determine their modified adjusted gross income (MAGI) and their filing status. Once you have determined their MAGI and filing status you can use Tables 2.4 and 2.5 to determine if the phase-out applies.

Thus, in the case of an active participant, the total contribution limit amount is phased-out by an amount equal to such amount multiplied by the ratio of the individual’s modified adjusted gross income (MAGI) in excess of an applicable dollar amount to $10,000 ($20,000 in case of a joint return).
Total contribution limit \times MAGI – applicable dollar amount = reduction 
\$10,000

Whenever the phase-out reduction is other than a multiple of $10, the reduction is rounded to the next lowest multiple of $10. However, where the total contribution limit amount adjusted for phase-out based upon adjusted gross income (AGI) is between $0 and $200, $200 is allowable as a deduction.

Table 16.6
Effect of MAGI * on Deduction If an Active Participant*

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>And MAGI is…</th>
<th>Allowed Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>Single, Head of Household, or Qualifying</td>
<td>$61,000 or</td>
<td>$62,000 or less</td>
</tr>
<tr>
<td>Widow(er)</td>
<td>less</td>
<td>less</td>
</tr>
<tr>
<td></td>
<td>More than $61,000 but less than $71,000</td>
<td>More than $62,000 but less than $71,000</td>
</tr>
<tr>
<td></td>
<td>More than $71,000</td>
<td>More than $72,000</td>
</tr>
<tr>
<td>Married Filing Jointly or Qualifying Widow(er)</td>
<td>$98,000 or less</td>
<td>$99,000 or less</td>
</tr>
<tr>
<td></td>
<td>More than $98,000 but less than $118,000</td>
<td>More than $98,000 but less than $119,000</td>
</tr>
<tr>
<td></td>
<td>$118,000 or more</td>
<td>$119,000 or more</td>
</tr>
<tr>
<td>Married Filing Separately **</td>
<td>Less than $10,000</td>
<td>Less than $10,000</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>$10,000 or more</td>
</tr>
</tbody>
</table>

*Modified AGI (adjusted gross income) ** If the individual did not live with his or her spouse at any time during the year, their filing status is considered Single for this purpose.

Source: IRS Pub. 590

MAGI Defined

Modified adjusted gross income (MAGI) is a measure of income used to determine how much of a deductible contribution can be made to a Traditional IRA. The IRS says that MAGI for Traditional IRA purpose is adjusted gross income (AGI) as shown on line 37 of the 1040 adding the following items:

- Adjusted gross income (AGI) shown on line 21, Form 1040A, or line 37, Form 1040 figured without taking into account line 17, Form 1040A, or line 32, Form 1040;
- Add any student loan interest deduction from line 18, Form 1040A, or line 33, Form 1040;
• Add any tuition and fees deduction from line 19, Form 1040A, or line 34, Form 1040;
• Add any domestic production activities deduction from line 35, Form 1040;
• Add any foreign earned income exclusion and/or housing exclusion from line 18, Form 2555-EZ, or line 43, Form 2555;
• Add any foreign housing deduction from line 48, Form 2555;
• Add any excluded qualified savings bond interest shown on line 3, Schedule 1, Form 1040A, or line 3, Schedule B, Form 1040 (from line 14, Form 8815); and
• Add any exclusion of employer-provided adoption benefits shown on line 30, Form 8839. This is your Modified AGI for Traditional IRA purposes.

Table 16.7 shows the effect of the modified adjusted gross income (MAGI) phase-out rule when a married couple, who either live with their spouse, or file a joint return and only one spouse is an active participant.

Table 16.7
Effect of MAGI on Deduction
When One Spouse is not an Active Participant*

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>And MAGI is…</th>
<th>Allowed Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>Married Filing Jointly or Separately with a spouse who is not covered by a plan at work.</td>
<td>$184,000 or less</td>
<td>$186,000 or less</td>
</tr>
<tr>
<td></td>
<td>More than $184,000 but less than $194,000</td>
<td>More than $186,000 but less than $196,000</td>
</tr>
<tr>
<td>Married Filing Jointly with a spouse who is covered by a plan at work.</td>
<td>$194,000 or more</td>
<td>$196,000 or more</td>
</tr>
<tr>
<td>Married Filing Separately with a spouse who is covered by a plan at work.</td>
<td>$10,000 or less</td>
<td>A Partial Deduction</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>No deduction</td>
</tr>
</tbody>
</table>

*Modified AGI (adjusted gross income) **Entitled to a full deduction. If participant did not live with his/her spouse at any time during the year. Source: IRS Pub. 590.

Non-Deductible Annual IRA Contributions

The Tax Reform Act of 1986 opened the door for any taxpayer under the age of 70 ½ with earned (income) compensation to make non-deductible (after-tax) contributions (irrespective of retirement plan coverage).
Similar to making deductible regular contributions to a Traditional IRA (as discussed above), non-deductible regular annual contributions to Traditional IRAs (and non-deductible employee contributions to a SEP IRA) are subject to the same combined overall limitation equal to the lesser of the total contribution limit or compensation includable in income. This amount is reduced by any deductible contributions to a Traditional IRA or SEP IRA. However, nondeductible contributions to a Traditional IRA or SEP IRA are not subject to any phase-out based upon modified adjusted gross income even if the participant (employee) is an active participant in certain employer retirement plans.

**Reminder:** Non-deductible regular annual contributions cannot be made to a Traditional IRA or SEP IRA in taxable years once the individual has attained age 70½.

When an individual makes non-deductible IRA regular annual contributions they must file IRS Form 8606 even if they do not have to file a tax return for the year. If not, all of the contributions to their Traditional IRA will be treated as deductible. All distributions taken from their Traditional IRA will be taxed. Also, there will be a $50 penalty for failure to file the required Form 8606.

### Excess Contributions

What is an excess contribution? IRC § 4973(b) defines an excess contribution to a Traditional IRA as the portion of an individual’s regular annual contribution amount for a taxable year that exceeds the maximum allowable contributions under IRC § 219.

Excess contributions typically occur when:

- A contribution to a Traditional IRA exceeds the 100 percent of compensation or the maximum contribution limit of $5,500 ($6,500 with catch-up contribution) in 2017 (same as in 2016). Similar rules for spousal IRA;
- Contributions are made to a Traditional IRA after the participant has attained the age of 70½;
- Regular annual contributions to a SEP IRA or SIMPLE IRA plan exceeds allowable limits or a contribution is made for an ineligible employee; and
- An improper rollover contribution is made.

### Penalty for Excess Contribution

Under IRC § 4973 it imposes a six (6) percent penalty tax on an excess contributions to a Traditional IRA if the excess contributions for the year are not withdrawn by the date of filing the federal tax return for the year (including extensions). The penalty applies for each year the excess remains in the IRA. In addition, the earnings on the excess contribution may be subject to a 10% penalty (under age 59 ½). The additional tax is figured on IRS Form 5329.
Note: Earnings include both price fluctuations and fund distributions (dividends and capital gains). This method requires that the excess contribution earnings be calculated based on the entire value of all IRAs.

Procedure

Once an excess contribution has been made to a Traditional IRA, the participant has until the tax-filing deadline (plus extensions) to remove excess contributions [IRC § 408(d)(4)]. Earnings must also be removed.

If the participant misses the deadline, he/she will owe an excess penalty tax of 6% of the excess amount annually until the excess (and interest earned on the excess) is removed. If the participant filed his/her taxes on time without requesting an extension, he/she can still remove the excess and file a technical correction to their tax return by October 15th. This does not apply to taxpayers who were simply late filing taxes and did not request an extension.

Frequently, a participant will make a regular annual contribution to his/her Traditional IRA, which is then invested, and then wish to remove the specific quantity of the investment to correct the excess. This is incorrect. Gains and losses are allocated according to a pro-rated formula for the entire account. Once the dollar amount that must be removed is determined, the individual may then choose to correct the excess by removing cash or any combination of securities that will total the amount that must be removed.

Note: IRS Form 8606 must be completed when taking withdrawals from the Traditional IRA.

For Example: On January 1, 2017, an individual had a Traditional IRA with a value of $56,000. The individual made a $4,000 contribution for 2017 that day, bringing the total account value to $60,000 and also bought 400 shares of Ace Company at $10 a share. On January 2, 2018 the individual realizes that he cannot make a 2017 contribution, and would like to withdraw the 400 shares of Ace Company (worth $2,000). Ace stock is currently trading at $5 dollars a share, and the total value of the Traditional IRA is $63,000.

- Step 1: Determine the percentage gain/loss on the entire account:
  \[
  \frac{\$63,000 - \$60,000}{\$60,000} = 0.05 = 5\% \text{ gain since the contribution was received}
  \]

- Step 2: Determine the amount that must be withdrawn:
  \[
  \$4,000 \times 1.05 = \$4,200
  \]
It is important to note if only a portion of the contribution was an excess, apply the gain/loss percentage only to the amount that represents the amount of the excess.

The participant must withdraw $4,200. $200 will be subject to tax, and possibly, a 10% penalty depending on whether the individual is age 59 ½ or younger. In this case, removing the 400 shares of Ace (worth $2,000) would not be enough to correct the excess contribution.

The excess may be reallocated to a contribution for an open tax year (i.e. current or prior year contribution) if the maximum for that contribution year has not yet been met. In this example, the participant could ask to reallocate the $4,200 to a 2017 contribution. Most custodians would not make the participant take a distribution of excess and then write them another check. However, this would still be reported as 2 transactions: a distribution of excess ($4,000 contribution plus $200 earnings), and a 2017 contribution for $4,200.

Other important things you need to remember about the excess tax penalty:

- It is cumulative and imposed each year the excess remains in the IRA;
- It is non-deductible; and
- It is always imposed on the participant, not the IRA custodian or trustee.

**Tax Reporting**

To pay the 6 percent penalty tax under IRC § 4973, the participant must complete IRS Form 5329, *Additional Taxes on Qualified Plans (including IRAs) and Other Tax Favored Accounts*, and attach it to his or her federal income tax return. Part III is for Traditional IRA excess contributions.

Also, IRS Form 1099-R, will be issued for the year in which the excess contribution was removed from the IRA. For a withdrawal of an excess contribution, plus earnings, there is a distribution code of either “8” or “P” reported on IRS Form 1099-R. If an excess contribution is removed without earnings, then a code of “1” or “7” is used, depending on the age of the participant. These codes are explained in the IRS instructions for Forms 1099-R, 5498 and 5329. Additional information can be found in IRS Publication 590.

**Spousal IRA**

The Spousal IRA, also considered a Traditional IRA or Roth IRA, allows a married participant with taxable compensation whose spouse has no taxable compensation, to contribute to a Traditional IRA for the benefit of both the individual and his or her spouse. The Spousal IRA is subject to special contribution limits, which are different from those that may apply to Traditional IRAs or Roth’s.
Contributions Limits to Spousal IRA

For 2017 (same as in 2016), a married individual can contribute the lesser of their earnings or $5,500 to a Spousal IRA. If their spouse is 50 years old or over, he or she can contribute an additional $1,000.

An exception to the Spousal IRA, is that a contribution can be made by the spouse with compensation who is over age 70½ for the benefit of the spouse who is under age 70½.

Deduction Limits for Spousal IRA

If a spouse is not covered by a retirement plan at work, she/he may be able to deduct the full amount of their Spousal IRA from their income tax return. If the spouse is covered by a retirement plan, their Spousal IRA is fully deductible if their MAGI is less than $186,000 in 2017 (increased from $184,000 in 2016); and partially deductible if their MAGI is $186,000 - $196,000 in 2017 (increased from $184,000 - $194,000 in 2016).

Setting up the Account

A Spousal IRA must be in the spouse’s name. Joint accounts are not allowed even though the spouse with compensation is making the contribution.

Deduction of Fees

Brokers’ commissions paid in connection with a Traditional IRA are subject to the contribution limit. These commissions are part of an IRA contribution and, as such are deductible subject to the limits.

Note: Trustees’ administrative fees are not subject to the contribution limit.
Chapter 16
Review Questions

1. Which of the following Individual Retirement Arrangements is not considered a Traditional IRA?
   ( ) A. Roth IRA
   ( ) B. Regular IRA
   ( ) C. Spousal IRA
   ( ) D. SEP-IRA

2. An individual cannot establish or contribute to a Traditional IRA during or after the tax year in which he/she reaches what age?
   ( ) A. 59½
   ( ) B. 70 ½
   ( ) C. 70
   ( ) D. 72

3. Which of the following is not considered taxable compensation when contributing to a Traditional IRA?
   ( ) A. Bonuses
   ( ) B. Alimony
   ( ) C. Pension and annuity income
   ( ) D. Wages

4. For any taxable year, contributions to a Traditional IRA can generally be made up until which of the following dates?
   ( ) A. April 15th of the following taxable year (not including extensions)
   ( ) B. April 15th of the following tax year (including extensions)
   ( ) C. December 31st of the current tax year
   ( ) D. October 15th of the tax year following the tax year required for filing the tax return

5. What is the maximum amount of the catch-up provision for a Traditional IRA in 2017?
   ( ) A. $ 600
   ( ) B. $2,500
   ( ) C. $1,500
   ( ) D. $1,000
CHAPTER 17

ROTH IRA

Overview

The Roth IRA, the nondeductible alternative to Traditional IRAs, was enacted into the Internal Revenue Code in 1988. According to the Investment Company Institute (ICI), the Roth IRA has become the fastest growing IRA. Contributions to a Roth IRA are not tax deductible, and distributions are potentially tax and penalty-free if certain requirements are met. The Roth IRA is governed under IRC § 408A.

In this chapter, we will examine the background of the Roth IRA, the differences between a Roth IRA and a Traditional IRA, as well as the contribution and conversion rules for Roth IRA. The Chapter will also review the distribution rules for Roth IRAs.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Explain how to set up and create a Roth IRA;
- Understand the three methods to fund a Roth IRA;
- Understand the rules for Roth IRA contributions and conversions;
- Identify the assets eligible for a Roth IRA conversion;
- Identify the opportunity and prospects for a Roth IRA conversion;
- Explain the uses of Roth IRA recharacterizations and reconversions;
- Explain the Roth IRA distribution rules; and
- Understand the rules of the designated Roth 401(k) plan.

Roth IRA Background

Prior to 1998, all IRAs had the same basic tax structure, as we discussed in Chapter 2. All of that changed with the passage of The Taxpayer Relief Act of 1997 (TRA-97), and specifically Section 302(a), which created IRC § 408A, and the Roth IRA. The Roth IRA, named after former Senate Finance Committee Chairman William Roth, Jr. (R-Del.), created an individual retirement arrangement providing tax advantages for “eligible” taxpayers, which became effective January 1, 1998.
Creating a Roth IRA

Many of the rules governing the Roth IRA are similar to those rules of the traditional IRA under IRC 408, except for those rules explicitly defined in IRC § 408A (see Table 17.1).

Similar to a Traditional IRA, a Roth IRA can be either an account [IRC § 408(a)] or an annuity [IRC § 408(b)]. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. A deemed-IRA can be a Roth IRA, but neither a SEP IRA nor a SIMPLE IRA can be designated as a Roth IRA.

<table>
<thead>
<tr>
<th>Traditional IRA [IRC § 408]</th>
<th>Roth IRA [IRC § 408A]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions made with pre-tax and after-tax dollars</td>
<td>Contributions made with after-tax dollars IRC § 408A(c)(1)</td>
</tr>
<tr>
<td>Principal grows tax-deferred</td>
<td>Principal grows tax-free</td>
</tr>
<tr>
<td>No contributions allowed after age 70½</td>
<td>Contributions allowed after age 70½ with earned income [IRC § 408A(c)(4)]</td>
</tr>
<tr>
<td>Required Minimum Distributions (RMDs) at age 70½</td>
<td>No Required Minimum Distributions for participant [IRC § 408A(c)(5)]</td>
</tr>
<tr>
<td>Distribution of pre-tax dollars 100% taxable; after-tax dollar recovery limited by pro-rata rules.</td>
<td>“Qualified” distributions are tax-free; “Nonqualified” distributions follow the “ordering rules” (first from contributions, next from converted amounts and last from earnings, which may have tax implications and penalty).</td>
</tr>
</tbody>
</table>

To be considered “qualified,” a distribution of earnings must meet the following two criteria: the distribution must be made after a five-year holding period, and the individual must have reached age 59½. Earnings are tax-free only if withdrawn as qualified distributions.

Funding a Roth IRA

There are three ways to fund a Roth IRA. They are:

- Regular annual contributions on behalf of an individual who has compensation;
- Conversion (rollover) of a traditional IRA and/or a qualified plan to a Roth IRA; and
- Designated Roth IRA (DRAC) rollover from a qualified plan to a Roth IRA.

Each method to fund a Roth IRA has its own rules and eligibility requirements, let’s review those requirements beginning with annual contributions.
Regular Annual Contributions

In order for an individual to make a regular annual contribution to a Roth IRA, the individual must have compensation [Reg. § 1.408A-3]. The individual’s contribution to a Roth IRA will be limited to the amount of such individual’s earned income for such year (or, if less, the dollar limit described below). Similar to all IRAs, contributions to a Roth IRA must be made in cash [IRC § 219(e)(1)].

The major difference between regular annual contributions to a Traditional IRA and a Roth IRA is that Roth IRA contributions are not deductible [IRC § 408A(c)(1)]. Accordingly, contributions to a Roth IRA are made with after tax non-deductible dollars instead of pre-tax deductible dollars.

Also, any individual regardless of his or her age, even if over age 70 ½, and regardless of whether he or she participates in a company retirement plan, may make a regular annual contribution to a Roth IRA. But of course, they must have compensation (similar rules for a Traditional IRA).

Applicable Dollar Limit Defined

The amount that can be contributed depends on whether a contribution is made only to a Roth IRA or Traditional IRAs and Roth IRA.

- **Roth IRAs only.** If a contribution is made only to a Roth IRA, the maximum contribution limit is the lesser of:
  - $5,500 ($6,500 if participant is age 50 or older) in 2017 (same as in 2016);
  - Taxable compensation.

  However, if the participant’s modified adjusted gross income (MAGI) is above a certain amount, the contribution limit may be reduced (phased-out) as explained below;

- **Roth IRAs and Traditional IRAs.** If contributions are made to both Roth IRAs and Traditional IRAs established for the participant’s benefit, their contribution limit for Roth IRAs generally is the same as their limit would be if contributions were made only to Roth IRA but then reduced by all contributions (other than employer contributions under a SEP IRA and SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs. [IRC § 408A(c)(2)(B)]. This means that a participant’s contribution limit in 2017 is the lesser of:
  - $5,500 ($6,500 if participant is age 50 or older) minus all contributions (other than employer contributions under a SEP IRA or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs;
  - Participant’s taxable compensation minus all contributions (other than employer contributions under a SEP IRA or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.
Table 17.2
Roth IRA Applicable Dollar Limits (ADL)

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Basic Dollar Limit</th>
<th>Catch-up Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$5,500</td>
<td>$1,000</td>
</tr>
<tr>
<td>2017</td>
<td>$5,500</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

However, if the participant’s modified AGI is above a certain amount, their contribution limit may be reduced (phased-out) as explained below (see Table 17.3); and

- **Catch-Up Contribution.** The $1,000 catch-up contribution to the basic dollar amount is available to a participant who has attained age 50 by the end of the taxable year [IRC § 219(b)(5)(B)]. After the year 2008, IRC § 219(b)(5)(D) applies a cost of living adjustment (COLA) to the basic dollar limit (but not to the over 50 catch-up contribution amount) in increments of $500 per year. As a result of the Pension Protection Act of 2006, the above contribution limits will not “sunset” after 2010. The catch-up contribution is $1,000 for 2017 (same as in 2016).

**MAGI Defined**

Modified adjusted gross income (MAGI) is a measure of income used to determine how much of a nondeductible contribution can be made to a Roth IRA. The IRS says that MAGI for Roth IRA purpose is adjusted gross income (AGI) as shown on line 37 of the 1040 modified as follows:

- Subtract the following:
  - Conversion income. This is any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA; and
  - Minimum required distributions from qualified retirement plans, including IRAs, (for conversions only).

- Add the following:
  - Traditional IRA deduction;
  - Student loan interest deduction;
  - Tuition and fees deduction;
  - Foreign earned income exclusion;
  - Foreign housing exclusion or deduction;
  - Exclusion of qualified bond interest shown on Form 8815;
  - Exclusion of employer-provided adoption benefits shown on Form 8839; and
  - Domestic production activities deduction from Form 1040, line 35, or Form 1040NR, line 33.
For purposes of the income limits applicable to both regular Roth IRA contributions and Roth IRA conversions, MAGI does not include the deemed distribution amount that results from converting a traditional IRA to a Roth IRA [IRC §408A(c)(3)(C)(i)].

So if, in the year being tested, the participant converts a Traditional IRA to a Roth IRA, resulting in the inclusion of some or all of the conversion amount in his/her gross income, the gross income resulting from the conversion is disregarded solely for purposes of determining whether the taxpayer’s MAGI is low enough to make him or her eligible to contribute.

**Roth IRA Annual Contribution Phase-out Rules**

Table 17.3 shows the MAGI phase-out rules for making a regular annual contribution to a Roth IRA [IRC § 408A(c)(3)(C)]:

![Table 17.3](image)

<table>
<thead>
<tr>
<th>If you have taxable compensation and your filing status is...</th>
<th>And your MAGI is... 2016</th>
<th>And your MAGI is... 2017</th>
<th>Then...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Filing Jointly or Qualifying Widow(er)</td>
<td>$184,000 or less</td>
<td>$186,000 or less</td>
<td>You can contribute up to $5,500 ($6,500 if age 50 or older).</td>
</tr>
<tr>
<td></td>
<td>At least $184,000 but less than $194,000</td>
<td>At least $186,000 but less than $196,000</td>
<td>The amount you can contribute is reduced.</td>
</tr>
<tr>
<td></td>
<td>$194,000 or more</td>
<td>$196,000 or more</td>
<td>You cannot contribute to the Roth IRA.</td>
</tr>
<tr>
<td>Single or Head of Household or Married Filing Separately (and did not live with spouse at any time during the year)</td>
<td>$117,000 or less</td>
<td>$118,000 or less</td>
<td>You can contribute up to $5,500 ($6,500 if age 50 or older).</td>
</tr>
<tr>
<td></td>
<td>At least $117,000 but less than $132,000</td>
<td>At least $118,000 but less than $133,000</td>
<td>The amount you can contribute is reduced.</td>
</tr>
<tr>
<td></td>
<td>$132,000 or more</td>
<td>$133,000 or more</td>
<td>You cannot contribute to the Roth IRA.</td>
</tr>
<tr>
<td>Married Filing Separately and lived with your spouse at any time during the year</td>
<td>Less than $10,000</td>
<td>Less than $10,000</td>
<td>You can contribute up to $5,500 ($6,500 if age 50 or older).</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>You cannot contribute to the Roth IRA.</td>
<td></td>
</tr>
</tbody>
</table>

Source: IRS Publication 590
The general maximum contribution formula is as follows:

\[
\text{Maximum Possible Contribution} = \frac{\text{Maximum Compensation} - \text{MAGI}}{\text{Maximum Compensation Threshold} - \text{Minimum Compensation Threshold}} = \text{Maximum Allowable Contribution}
\]

**Example:** Tom, age 45, files as a single taxpayer with MAGI of $121,000 in 2017. The maximum contribution he can make to a Roth IRA for 2017 is $4,400 computed as follows:

\[
\begin{align*}
\text{Maximum Possible Contribution} & = \frac{\$5,500}{\$133,000 - \$121,000} \quad \text{Maximum Allowable Contribution} \\
& = \frac{\$5,500}{\$133,000 - \$118,000} \\
& = \frac{\$5,500}{\$15,000} = \$4,400
\end{align*}
\]

Above the phase-out levels, taxpayers can still contribute to a Traditional, nondeductible IRA, even if their AGI exceeds the phase-out amounts for deductible or Roth IRAs.

There is no maximum age limit for contributing to a Roth IRA, as there is for contributions to a Traditional IRA; an individual (who earns compensation) can contribute to a Roth IRA even after age 70½ [IRC § 408(c)(4)].

Also, a person who meets the income test and has compensation income may contribute to a Roth IRA regardless of whether he or she is an “active participant” in an employer plan during the same year.

**Spousal Roth IRA Contributions**

An individual is allowed to make Roth IRA contributions on behalf of his or her spouse, only if they meet the income eligibility requirements (as discussed above). The same contribution amounts are allowed for a Spousal Roth IRA.
Excess Contributions to Roth IRAs

Excess contributions to a Roth IRA will be subject to the same 6% excise tax as a Traditional IRA. Excess contributions are considered to be contributions made by a participant to his or her Roth IRA for a year that equals the total of:

- Amounts contributed for the tax year to the Roth IRA (other than amounts properly and timely rolled over to a Roth IRA or properly converted from a Traditional IRA) that are more than the participant’s contribution limit for the year, plus
- Any excess contributions for the preceding year, reduced by the total of:
  - Any distributions out of the participant’s Roth IRAs for the year, plus
  - Participant’s contribution limit for the year minus their contributions to all their IRAs for the year.

Withdrawals of Excess Contributions

For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing the participant’s tax return for the year is treated as an amount not contributed. This treatment only applies if any earnings on the contributions are also withdrawn. The earnings are considered earned and received in the year the excess contribution was made.

Example: Tom makes a $5,500 contribution to a Roth IRA early in 2017, and later realized that his income would only allow him to make a contribution of only $4,300. His excess contribution was $1,200. If he does not correct the excess contribution for 2017, he’ll have to pay $72 excess contribution tax (6% of $1,200). And, if he left the problem uncorrected beyond the end of 2018, he will owe another $72. Tom will continue to owe this tax each year until he corrects the excess contribution.

Corrective Action

There are four ways to correct an excess contribution to a Roth IRA. Two of them can be used to completely avoid the excess contribution penalty, and the other two prevent it from applying to later years after it has applied to one or more years. Depending on the specific situation, you may find that one or more of these correction methods are unavailable:

- First, withdrawing excess by due date of return. If a contribution to a Roth IRA was improper or too large, the participant (owner) can avoid the 6% penalty tax by taking the money out. Relief from the penalty is available only if the following are true:
  - The participant receives a distribution from the Roth IRA on or before the due date (including extensions) for filing the tax return for the year of the contribution; and
The distribution includes the amount of the excess contribution and the amount of net income attributable to the excess.

Choosing this method of correction, the participant must report and pay tax on the net income attributable to the excess in the year of the contribution, even if the participant takes it out during the following year, before the return due date. The earnings will be taxed like any other taxable distribution of earnings from a Roth IRA, and will be subject to the early distribution penalty if under age 59½ unless one of the exceptions applies;

- **Second, do a recharacterization.** Another way to correct an excess contribution is to have the trustee of the Roth IRA make a direct transfer from the Roth IRA to a Traditional IRA. To avoid penalties, there are requirements that must be met (as was discussed above):
  - The transfer must occur on or before the due date (including extensions) for filing your return for the year of the contribution; and
  - The transfer must include the amount of the excess contribution and the amount of net income attributable to the contribution.

If the participant can meet these requirements, he/she will be treated as if the contribution went to the Traditional IRA in the first place. That means the participant will not have to pay tax on the earnings that are transferred from one IRA to another. The IRS calls this a recharacterization.

**Example:** Suppose you contribute $5,500 to a Roth IRA early in 2017, expecting your MAGI to be below the income limitation for Roth IRA contributions. At the end of the year you find that your MAGI is higher than expected and your Roth IRA contribution limit is $3,500. Before October 15, 2017 you have the trustee of your Roth IRA transfer $2,000 plus the earnings attributable to that $2,000 directly to a Traditional IRA. You’re treated as if you originally contributed $3,500 to the Roth IRA and $2,000 to the Traditional IRA.

**Note:** Many people mistakenly believe a recharacterization can be used only as a way to undo a Roth conversion, but it can also be used to change the type of IRA to which a contribution was made.

A recharacterization transfer provides a bonus. Besides eliminating the 6% penalty tax, it allows you to keep the earnings you may have built up during the year in an IRA, instead of taking the earnings out and paying tax on them. But you’ll benefit from a recharacterization only if you’re permitted to contribute to a regular IRA. If your excess contribution to the Roth IRA would also be an excess contribution in a regular IRA you can’t use this method to avoid a penalty. For example, if you waited more than 60 days to complete a rollover, or didn’t have enough earned income to support your contribution, you won’t be able to fix the problem by making a recharacterization;

- **Third, make a later withdrawal.** If the participant fails to take a corrective distribution within the time period described above, he/she will incur the excess
contribution penalty for the year of the contribution and incur it again for each subsequent year it remains uncorrected. The participant can prevent it from applying to a subsequent year by withdrawing the excess from his/her Roth IRA, but the rules here are different than for the type of correction described earlier:

- The participant needs to act by the end of the year, not by the due date of the return for that year. If the participant’s excess contribution was made in 2016, he/she must act by December 31, 2017 to avoid a penalty for 2017. Note that this is only 2½ months after the deadline for correcting the original year, as described earlier. When using this correction method the participant doesn’t have to withdraw earnings. The participant simply withdraws the amount of the excess contribution.

- Fourth, contribute less than maximum. The last way to correct an excess contribution is to contribute less than the maximum in a subsequent year.

Example: If the participant has a $2,000 excess contribution in 2016 and he/she contributes at least $2,000 less than the maximum allowed to contribute in 2017, the participant will incur the excess contribution penalty for 2016 but not for 2017 or later years. The nice thing about this particular method of correction is that it sometimes happens purely by accident: people sometimes discover an excess contribution from a few years earlier and find that it was automatically corrected in a subsequent year when they contributed less than the maximum.

Roth IRA Conversions

The second way to get funds into a Roth IRA is to rollover/convert funds [IRC § 408A(d)(3)]. But before we get into the specifics of the Roth conversion, let’s clear something up: the difference between a rollover and a conversion. Prior to the arrival of Roth IRAs, “rollovers” were always tax-free, and most people still associate that word with tax-free transfers from one retirement plan to another. In contrast, the rollover of funds from an individual retirement plan (like a Traditional IRA) to a Roth IRA is taxable. Therefore, the term “conversion” is often used for the rollover of funds from a Traditional IRA to a Roth IRA, which is a taxable event, as a way to distinguish that type of rollover from a “normal” rollover, which is nontaxable.

When doing the conversion, the amount converted is included in the participant’s gross income and is subject to tax as if it were distributed from the Traditional IRA or qualified retirement plan and not re-contributed to another IRA [IRC § 408A(d)(3)(A)(ii)]. But, the conversion will not be subject to the 10% penalty for premature distribution from a QRP under IRC § 72(t)(1) [IRC § 408A(d)(3)(A)(ii)]. And since there is no limit on the amount that can be converted, a conversion contribution can be a greater amount than the normal maximum regular annual contribution amount to a Roth IRA.
Eligibility Requirements for Conversion

Prior to 2010, a participant could only convert from a Traditional IRA into a Roth IRA, if they met the following requirements:

- **Income Limit.** Participant’s adjusted gross income (AGI) is not more than $100,000 [IRC § 408A(c)(3)(B)(i)]. For a married couple filing jointly, the $100,000 limit applies to the MAGI of the couple, not of each spouse. [Reg. § 1.408A-4, A-2(b)];

- **Filing Status.** Generally no conversion is permitted if the taxpayer is married filing a separate return for the year [IRC § 408A(c)(3)(B)(ii)]. However, if a married individual has lived apart from his or her spouse for the entire taxable year, then such individual can treat himself or herself as not married for purposes of the income test, file a separate return and be subject to the $100,000 limit on his or her separate MAGI; and

- **Age.** A participant who meets the income and filing status tests can convert his/her Traditional IRA to a Roth IRA regardless of his or her age even after the individual for whom the account is maintained has attained age 70 ½ [IRC § 408A(c)(4)].

*New rules effective January 1, 2010.* Under Section 512 of the *Tax Increase Prevention and Reconciliation Act* (TIPRA) of 2005, the $100,000 income conversion limit was repealed effective January 1, 2010. Roth IRA conversions are now permitted if adjusted gross income exceeds $100,000. All taxpayers are now allowed to convert, including those who file married filing separately (MFS).

Also, if a Roth IRA conversion was made during 2010, the income from the conversion was recognized ratably over 2011 and 2012, unless the taxpayer elected to recognize all of it in 2010.

Conversion Methods

According to Reg. Sec. 1.408A-4 Q&A-1(b), there are three methods that a participant can use to effect the conversion from a Traditional IRA to a Roth IRA. They are:

- **Rollover (Indirect).** A distribution from a Traditional IRA may be contributed (rolled over) to a Roth IRA within 60 days after the distribution is made [IRC §408(d)(3)(A)(i)];

- **Trustee-to-Trustee Transfer (Direct).** You can direct the trustee of the Traditional IRA to transfer an amount from the Traditional IRA to the trustee of the Roth IRA; and

- **Recharacterized.** All or part of a Traditional IRA can simply be “recharacterized” (redesignated) as a Roth IRA maintained by the same trustee or custodian [Treas. Reg. § 1.408A-4, A-1(b)(3)] (discussed below).
A participant can withdraw all or part of the asset from a Traditional IRA and reinvest (within 60 days) in a Roth IRA. If properly (and timely) rolled over, the 10% additional tax penalty for premature distributions will not apply.

The one-rollover-per-year limitation in IRC § 408(d)(3)(B) does not apply to a conversion to a Roth IRA, so such conversions may occur even if it is within 12 months of a tax-free Traditional IRA-to-IRA rollover [Treas. Reg. § 1.408A-4, A-1(a)].

You must roll over into the Roth IRA the same property the participant received from the Traditional IRA. The participant is allowed to rollover either all or part of the withdrawal into a Roth IRA, or keep the part not rolled over. The amount the participant keeps will generally be taxable (except for the amount that is a return of nondeductible contributions) and generally may be subject to the 10% tax on early distributions.

Other types of allowable conversions are:

- **Periodic Distributions.** An individual who has started taking a series of substantial equal periodic payments (SOSEPP) from a Traditional IRA can convert the account to a Roth IRA and then continue the periodic payments. The 10% early distribution tax will not apply even if the distributions are not qualified distributions as long as it is part of a series of substantial equal periodic payments (SOSEPP); and

- **Simple IRA to a Roth IRA.** Generally, a participant in a SIMPLE IRA can convert to a Roth IRA, under the same rules discussed above. However, the participant cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date the participant first participated in any SIMPLE IRA plan maintained by his/her employer (25% penalty).

Conversions not allowed:

- **Required Minimum Distributions.** Amounts that must be distributed to a participant from a Traditional IRA for a particular year (including the calendar year in which the participant reaches age 70½) under the required minimum distribution (RMD) rules cannot be converted; and

- **Inherited IRA.** If an individual inherited a Traditional IRA from someone other than a spouse, you cannot convert it to a Roth IRA.

**“Backdoor” Roth IRA Conversion Strategy**

As discussed above, for many of your high-income clients, the IRS phase-out rules preclude them from making direct Roth IRA contributions. For single tax filers the income phase-out threshold is $133,000 for 2017 (up from $132,000 in 2016); for married couples filing jointly $196,000 in 2017 (up from $194,000 in 2016).
The “Backdoor” Roth IRA conversion strategy suggests workaround for those clients who earn too much money, allowing them to make non-deductible $5,500 (or $6,500 non-deductible catch-up contributions for those over age 50) annually to their non-deductible IRA, and then convert the IRA to a Roth. Since neither transaction has an income limit, and the non-deductible IRA includes after-tax contributions, the end result is that the client annually completes the equivalent of a Roth contribution, neatly dodging the existing Roth IRA contribution income limits, while having no immediate tax impact (since the non-deductible IRA contributions has no tax consequences, nor does the Roth IRA conversion whose non-deductible contributions equal its current value).

However, there are a couple of rules to take into consideration. They are:

- The IRA “aggregation rules” under (IRC § 408(d)(s); and
- The “step transaction” doctrine rule.

**IRA Aggregation Rule**

Under IRC § 408(d)(2), the “IRA aggregation rule,” the rule stipulates that when a Roth IRA conversion occurs, the taxpayer must calculate the income tax consequences of a Roth IRA conversion by aggregating together all of the taxpayer’s IRAs; as a result, other pre-tax IRA funds can distort the tax consequences of the contribute-then-convert strategy.

**Example:** Assume your client contributes $5,500 to a non-deductible IRA with the intention of converting it. However, your client also has a $150,000 pre-tax IRA, the accumulation of several prior 401(k) rollovers, and $12,000 of non-deductible contributions from many years ago. When your client converts his newly created $5,500 non-deductible IRA, he cannot simply convert at a tax cost of $ 0. Instead, the IRA aggregation rule applies. His total non-deductible contributions are $12,000 + $5,500 = $17,500, and his total IRAs are $150,000 + $5,500 = $155,500. Accordingly, when your client converts the $5,500 non-deductible IRA contribution, the portion that is non-taxable will be $17,500 / $155,500 = 11.25%, or $619. The remaining $4,881 will be taxable income, due to the application of the IRA aggregation rule; this result occurs even if all the new non-deductible contributions are made to a separate account which is converted.

**The Step Transaction Rule**

There is some controversy over the “backdoor” Roth conversion strategy in that it may involve the risk that the IRS will apply the “step transaction doctrine,” invalidating the strategy entirely.

The “step transaction doctrine” is the legal principle that a series of related steps in a transaction should be taxed based on the overall economic nature of the transaction, not “just” based on the separate individual steps. In the context of the “backdoor” Roth IRA
conversion strategy, the step transaction doctrine would examine the overall result of the transaction—dollars came out of a taxable account and ended up in a Roth IRA—and tax it according to the substantive result that occurred; that the taxpayer constructively made a contribution to a Roth IRA. After all, the taxpayer contributed to the non-deductible IRA for the sole-purpose of converting it to a Roth IRA, and did those two steps together for the sole purpose of getting a new annual contribution into a Roth IRA. In the end, the net result is that the taxpayer constructively made a Roth IRA contribution. According to the step transaction doctrine, if that’s really what happened, then the IRS can tax it accordingly.

Of course, Roth IRA contributions themselves are not actually taxable anyway. They are a contribution of after-tax funds in the first place. But treating the transaction as being substantively the same as a Roth IRA contribution does mean that the client now made a Roth IRA contribution while his/her income is too high (assuming that's the case; otherwise the client would simply make a direct Roth IRA contribution in the first place!). And if income exceeded the limits when the Roth contribution was made, the client has made an excess contribution that must either be unwound or be subject to the 6% excess contribution penalty tax.

So does the strategy of contributing to a non-deductible IRA and converting it to a Roth IRA to avoid the Roth IRA contribution income limit constitute a step transaction scenario? The reality is that the application of the step transaction doctrine is done on a case-by-case basis, and depends on a subjective interpretation of the facts and circumstances of the client's particular situation. What do the courts look for in evaluating the potential of a step transaction? Simply put, they are looking for a series of transactions, all inter-related, where the final outcome of the overall series of transactions was to accomplish the equivalent of another single-step (or fewer steps) transaction. In the case of a client who contributes to a non-deductible IRA, specifically for the purpose of converting it, and does those multiple steps precisely because it is a way to try to avoid the Roth IRA contribution income limits, then it seems clear that the step transaction doctrine could be applied. In point of fact, it is exactly these kinds of scenarios—multiple related transactions done to obfuscate the tax consequences of the same event in a single transaction—that the step transaction doctrine was designed to address (in the interests of reducing "abusive" tax avoidance strategies).

However, there are a number of financial professionals that have suggested that the step transaction does not apply to the backdoor Roth IRA conversion strategy and that the transaction should happen immediately. While other financial professional recommend allowing a certain period of time (12 months) to lapse between the two steps.

**Note:** As the advisor it is very important for you to understand that every taxpayer has a unique set of facts and circumstances and they should seek advice from their own tax and legal representatives. And, also, the various companies that offer IRAs may have their own rules on conversions.
Eligible Assets to Be Converted

Following are the eligible assets that can be converted (rolled over) to a Roth IRA:

- Traditional IRAs [IRC § 408A(c)(3)(8)]. Except Inherited IRAs and Educational IRAs;
- SEP IRAs;
- SIMPLE IRAs (after 2nd year due to 25% penalty [Reg. § 1.408A-4]); and
- Qualified retirement plans (IRC § 401(a), IRC § 403(a)(b), and IRC § 457).

Prior to 2008, only IRAs, and no other kinds of retirement plans, could be “converted” into Roth IRAs. So to convert money in a qualified plan to Roth status there was a two-step process:

- Step 1: Participant had to convert the qualified retirement plan to a Traditional IRA; and
- Step 2: Once QRP is converted to a Traditional IRA. The Traditional IRA would then be converted to the Roth IRA.

**Drawback for the two-step process:** When doing the conversion from the Traditional IRA to the Roth IRA the participant has to take into considerations the following rules:

- Aggregation Rule: Must aggregate all Traditional IRAs as one; and
- The Pro-rata rule must be used when making a conversion that has basis in the Traditional IRA.

All that changed with the passage of the Pension Protection Act of 2006 (PPA), Section 824, which amended the definition of qualified rollover contribution under IRC § 408A(e) to allow a Roth IRA to accept rollovers from other eligible retirement plans directly, effective for distributions made after December 31, 2007.

Those “eligible retirement plans” [as defined in IRC § 402(c)(8)(B)] include:

- Defined benefit plans;
- Defined contribution plans (including an IRC § 401(k) plan);
- Annuity plans [IRC § 403(a)];
- Tax-sheltered annuity plans [IRC § 403(b) plan]; and
- Governmental deferred compensation plans [IRC § 457 plans].

This new tax law change creates the opportunity to complete the Roth conversion transfer directly by allowing the entire process to be accomplished much more efficiently. It eliminates an extra transfer (two-step process), and extra financial account and institution that could potentially make a mistake, and expedites the timeliness of the process, which may be particularly useful for those wishing to complete an end-of-year Roth conversion transaction by December 31st.
Although the expedited administrative ease of the direct Roth conversion is a substantial benefit, the new rules provide another significant planning opportunity as well. Direct Roth conversions create the ability to avoid the IRC § 408(d)(2) aggregation rules that require all IRAs to be considered a single IRA when determining the tax consequences of a distribution (including a Roth conversion). These rules are particularly troublesome where the retirement accounts hold substantial after-tax contributions that could otherwise be recovered tax-free in the Roth conversion process.

An example can help to best illustrate the additional planning flexibility provided by the opportunity to avoid the aggregation rules:

**Example: John Smith Accounts:**

<table>
<thead>
<tr>
<th>401 (k)</th>
<th>IRA (existing)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$150,000 (including $30,000 of after tax contributions)</td>
<td>$500,000 (no after-tax contributions)</td>
</tr>
</tbody>
</table>

**Old Rules:** IRC § 401(k) plan is rolled over to a new IRA account. The new $150,000 IRA account with the $30,000 of after-tax contributions is converted to a Roth IRA. However, because of the IRC § 408(d)(2) aggregation rules, the $150,000 Roth conversion is treated as being a partial conversion of the aggregate $650,000 of IRA accounts with an aggregate $30,000 of after-tax contributions. Since the after-tax contributions are recovered on a pro-rata basis, the distribution is considered to be only 4.615% tax-free ($30,000 / $650,000).

Thus, the $150,000 conversion will be taxed as a $6,923 return of principal (4.615% x $150,000) and $143,077 of ordinary income.

**New Rules:** IRC § 401(k) plan is rolled directly to a Roth IRA account. Since the funds are never held in an IRA, they are not subject to the IRC § 408(d)(2) aggregation rules.

Consequently, the $150,000 Roth conversion is treated as a $30,000 return of principal (since there were $30,000 of after-tax contributions in the 401(k) account), and a $120,000 ordinary income conversion.

Thus, by completing the Roth conversion directly, the taxpayer has the opportunity to recover the entire $30,000 of after-tax contributions, instead of only $6,923 as would be required due to the aggregation rules. Taxable income on the conversion is only $120,000, instead of $143,077, to create the same $150,000 Roth IRA account.

Despite the need for caution to ensure that the Roth conversion is otherwise still appropriate, the new provisions of Section 824 of PPA 2006 are beneficial to those interested in completing Roth conversions from employer retirement plans.
Beyond mere administrative ease, the new rules actually create a particularly appealing opportunity for Roth conversion with employer retirement plans that hold substantial after-tax contributions, due to the ability to avoid the IRA aggregation rules.

**IRS Notice 2008-30**

On March 5th, 2008, the IRS issued further guidance regarding certain distribution-related provisions of the Pension Protection Act of 2006 (PPA). Surprisingly, this Notice appears to allow beneficiaries of inherited IRAs to convert to a Roth IRA. As discussed above, prior to amendment by the PPA, a Roth IRA could only accept a rollover contribution of amounts distributed from a “qualified rollover” and non-spouse beneficiaries who inherited an IRA could not rollover to a Roth IRA. However, Q&A #7 of Section II in Notice 2008-30, appears to expand this conversion power to non-spousal beneficiaries. Q&A #7 specifically states as follows:

- Q-7. Can beneficiaries make qualified rollover contributions to Roth IRAs?
- A-7. Yes. In the case of a distribution from an eligible retirement plan [which includes an IRA and 403(a) annuity, a 403(b) annuity, a qualified trust under 401(a), and a deferred compensation plan under 457 (b)] other than a Roth IRA, the MAGI and filing status of the beneficiary are used to determine eligibility to make a qualified rollover contribution to a Roth IRA. Pursuant to IRC § 402(c)(1), a plan may but is not required to permit rollovers by non-spouse beneficiaries and a non-spouse beneficiary that is ineligible to make a IRA may re-characterize the contribution pursuant to IRC § 408A(d)(6).

This provides amazing planning opportunities for beneficiaries. While the non-spousal beneficiary will still have to begin taking required minimum distributions (RMDs) from the Roth IRA during his/her lifetime, for many clients a substantial benefit continues to exist.

**Prospects for Roth IRA Conversion**

The consensus view is that the Roth IRA conversion route should be considered by taxpayers who:

- Have a number of years to go before retirement (and are therefore able to recoup the dollars that are lost to taxes on account of the conversion);
- Anticipate being taxed in a higher bracket in the future than they are now; and
- Can pay the tax on the conversion from non-retirement-account assets (otherwise, there will be a smaller buildup of tax-free earnings in the depleted retirement account).

When considering whether a conversion to a Roth IRA is appropriate, it is important to consider the IRA owner’s current and future expected tax bracket during retirement. Table 17.4 and Table 17.5 display the 2016 and 2017 federal income tax tables.
Table 17.4
2016 Federal Income Tax Brackets

<table>
<thead>
<tr>
<th>FIT TB</th>
<th>MFJ</th>
<th>Single Filers</th>
<th>Head of Household</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.0%</td>
<td>$0 – $18,550</td>
<td>$0 – $9,275</td>
<td>$0 – $13,250</td>
</tr>
<tr>
<td>15.0%</td>
<td>$18,551 – $75,300</td>
<td>$9,276– $37,650</td>
<td>$13,251- $50,400</td>
</tr>
<tr>
<td>25.0%</td>
<td>$75,301 – $151,900</td>
<td>$37,651– $91,150</td>
<td>$50,401- $130,150</td>
</tr>
<tr>
<td>28.0%</td>
<td>$151,901– $231,450</td>
<td>$91,151 – $190,150</td>
<td>$130,151- $210,800</td>
</tr>
<tr>
<td>33.0%</td>
<td>$231,451– $413,350</td>
<td>$190,151 – $413,350</td>
<td>$210,801 - $413,350</td>
</tr>
<tr>
<td>35.0%</td>
<td>$413,351– $466,950</td>
<td>$413,351 – $415,050</td>
<td>$413,351– $441,000</td>
</tr>
<tr>
<td>39.6%</td>
<td>Over $466,950</td>
<td>Over $415,050</td>
<td>Over – $441,000</td>
</tr>
</tbody>
</table>

Table 17.5
2017 Federal Income Tax Brackets

<table>
<thead>
<tr>
<th>FIT TB</th>
<th>MFJ</th>
<th>Single Filers</th>
<th>Head of Household</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.0%</td>
<td>$0 – $18,650</td>
<td>$0 – $9,325</td>
<td>$0 – $13,350</td>
</tr>
<tr>
<td>15.0%</td>
<td>$18,651 – $75,900</td>
<td>$9,326– $37,950</td>
<td>$13,351- $50,800</td>
</tr>
<tr>
<td>25.0%</td>
<td>$75,901 – $153,100</td>
<td>$37,951– $91,900</td>
<td>$50,801- $131,200</td>
</tr>
<tr>
<td>28.0%</td>
<td>$153,101– $233,350</td>
<td>$91,901 – $191,650</td>
<td>$131,201- $212,500</td>
</tr>
<tr>
<td>33.0%</td>
<td>$231,351– $416,700</td>
<td>$191,651 – $416,700</td>
<td>$212,501 - $416,700</td>
</tr>
<tr>
<td>35.0%</td>
<td>$416,701– $470,700</td>
<td>$416,701 – $418,400</td>
<td>$416,701– $444,550</td>
</tr>
<tr>
<td>39.6%</td>
<td>Over $470,700</td>
<td>Over $418,400</td>
<td>Over – $444,550</td>
</tr>
</tbody>
</table>

Conversion Advantages

The principal advantage to converting to a Roth IRA is that, by paying the income tax on the conversion out of other assets, you are effectively making a substantial additional contribution to your IRA.

**Example:** Suppose you have a $1 million Traditional IRA, and $300,000 of other money. Assume a 30% income tax rate. If you convert to a Roth IRA and use your $300,000 of other money to pay the income tax, you will have a $1 million Roth IRA. Over some period of time, it grows to $2 million.

Over the same period of time, if you do not convert to a Roth IRA, your $1 million Traditional IRA will grow to the same $2 million or $1.4 million after income tax. But since your taxable account is subject to income tax each year, it will grow to something less than $600,000. Therefore, you would end up with less than $2 million in total.
Conversion of an Annuity Contract

If a Traditional IRA is being converted to a Roth IRA, and one of the IRA assets being converted is an annuity contract, a “special valuation rule” applies: you cannot use the fair market value (FMV) of the account for the value of the annuity.

Background

Prior to August of 2005, annuity contracts were valued according to either their cash surrender value or current market value, if the back-end sales charge surrender schedule had expired. This method of valuation provided annuity carriers with the opportunity to try and artificially lower the value of their annuity contracts by assessing enormous surrender penalties in the first year or two of the contract. The participant (owner) would then convert the contract during this period so that the greatly reduced surrender value would be taxed instead of the current value of the contract.

Example: A carrier would levy a 20% surrender charge on a contract during the first year. IRA owners would then purchase an annuity inside their IRAs and convert them to Roth IRAs. A participant who purchased a $50,000 contract would only have to pay taxes on $40,000 after the 20% surrender penalty was deducted.

But the IRS eventually closed this loophole, issuing a temporary ruling against this practice that was eventually finalized. Annuity contracts inside Traditional IRAs are still valued according their cash surrender value, but there are now limitations on how much less that amount can be than its fair market value.

Current Valuation Rules

The IRS issued final regulations on the valuation of the annuity contracts in Roth conversions in July of 2008 (T.D. 9418). These regulations outline three separate methods that can be used to value annuity (fixed, index and variable) contracts for conversion purposes. They are listed as follows:

- **Surrender Method.** To the extent that an individual retirement annuity or an annuity contract held by an IRA is surrendered and no rights are retained or transferred the amount treated as a distribution is limited to the surrender value (the amount actually deposited into the Roth IRA);

- **Comparable Contract Method.** This type of valuation can be used for contracts where the participant (owner) purchased the contract at an earlier date and will receive a payout on the contract at some point in the future. Then the contract is valued at the fair market value of a comparable current contract with the same future payout schedule, assuming that the annuity carrier offers a contract that matches those parameters:
  - For example, assume that a participant purchases an annuity at age 50 and converts it to a Roth IRA at age 60. The contract is scheduled to pay the
owner $1,000 per month beginning at age 65. The value of the contract at the time of conversion will be considered equal to the fair market value of a new contract from the annuity carrier that pays the same amount at age 70 that is purchased by a 60-year old. If the conversion is made within a short period of time of the initial purchase, then the actual value of the current contract is used instead.

- **Reserve Method.** This method is used if no comparable contract is available for the conversion in question. When this is the case, an interpolation is made of the contract's terminal reserves, and the fair market value of the contract is then based upon this amount; and

- **Accumulation Method.** This method is the simplest of the three methods, and is used only for annuity contracts that have not annuitized. This method simply takes into the account the accumulated value of the contract (known as the Entire Interest calculation contained in Treas. Reg 1.409(a)(9)-6, Q&A -12), including any one-time sales charges or fees that were assessed over the prior year. Future distributions of any kind are disregarded under this method.

### Guaranteed Living Benefit Riders

Owners of variable annuities with guaranteed living benefit (GLB) riders may be in for a surprise when they convert their contracts to Roth IRAs. The net present value of the payout from an income rider is usually added to the value of the contract. The exact amount that is factored in is actuarially determined by the annuity carrier and will vary somewhat from one company to another as there are several methods of doing this. But it cannot be computed by the owner.

Owners of variable contracts with guaranteed riders of any kind should therefore expect the assessed value of their contracts to exceed the fair market value if the value of the contract has declined due to adverse market conditions.

### Reporting and Recharacterization

Regardless of the valuation method used, annuity owners can always rely on IRS Form 1099-R to report the correct amount for their Roth conversions. In most cases, this form will reflect one of the valuation methods described above. But those who are unpleasantly surprised by the amount reported on their tax form have the option to recharacterize their conversions before October 15 of the following year (see discussion below).

### Recharacterizations

The tax code allows broad relief to taxpayers who wish to “undo” their IRA contributions by switching the regular annual contribution or conversion from a Roth IRA to a Traditional IRA or vice versa. This relief is called “recharacterization” [IRC § 408A(d)(6)].
Reasons to Do a Recharacterization

Anyone can do a recharacterization for any reason. After the recharacterization, the funds are treated as if they never left the IRA. Here are some of the reasons why a participant would consider a recharacterization:

- **Failed conversion.** Taxpayer converted a Traditional IRA to a Roth IRA and later found out that he/she could not qualify;
- **Bad Planning.** Taxpayer qualified but later found out that for planning purposes the conversion was not a good idea. For example, the taxpayer did not have the funds available to pay the tax on the conversion. Or the additional income disqualified the taxpayer’s child from receiving financial aid in college; and
- **Market losses after conversion.** Taxpayer qualified for the conversion, and after converting the funds, the market value of those funds converted sustained significant losses, forcing the taxpayer to pay taxes on a much higher value (value at conversion).

Recharacterization Requirements

To recharacterize a contribution/conversion, the participant must have the contribution transferred from the Roth IRA back to the Traditional IRA (or vice versa) in a trustee-to-trustee transfer (plan-to-plan), not by an indirect transfer (60-day rollover). If the transfer is made by the due date (including extensions) for the tax return for the year during which the contribution was made, the participant can elect to treat the contribution as having been originally made to the Roth IRA instead of the Traditional IRA. If a participant re-characterizes their contribution, they must do all three of the following:

- Include in the transfer any net income allocable to the contribution. If there was a loss, the net income the participant must transfer may be a negative amount;
- Report the recharacterization on the participant’s tax return for the year during which the contribution was made; and
- Treat the contribution as having been made to the Roth IRA on the date that it was actually made to the Traditional IRA.

It is important to note if a participant receives a distribution from a Traditional IRA in one tax year and rolls it over into a Roth IRA in the next year, but still within the 60 days of the distribution from the Traditional IRA, it may be treated as a contribution to the Roth IRA in the year of the distribution from the Traditional IRA. Also, the re-characterization of a contribution is not treated as a rollover for purposes of the 12-month waiting period. This is true even if the contribution would have been treated as a rollover contribution by the second IRA if it had been made directly to the second IRA rather than as a result of a re-characterization of a contribution to the first IRA.
Recharacterization Deadlines

Generally, the deadline for recharacterizing a Roth IRA regular annual contribution or conversion is the due date of the tax return (April 15) for the year of the contribution that is being recharacterized, including extensions (October 15) [IRC § 408 A(d)(6), (7)].

The taxpayer does not actually have to get an extension of his/her tax return in order to receive an extension beyond the tax filing date (April 15) for a recharacterization decision. That is because Reg. § 301.9100-2(b) provides an automatic 6-month extension (from April 15) for all “regulatory or statutory elections whose due dates are the due date including extensions provided the taxpayer timely filed his/her tax return for the year the election should have been made and the taxpayer takes the necessary steps” (discussed below).

Steps to Take for Recharacterization

In order to be able to do a recharacterization the taxpayer must complete the following necessary steps:

- File tax return by April 15 and pay any necessary taxes; and
- File IRS Form 4868 for a request for an extension.

Notifying the Custodians

Roth rules apply to all funds that are converted to a Roth IRA, including SEP IRA, SIMPLE IRAs, and employer plan funds. The custodians of both the Roth IRA (where the money currently is) and the Traditional IRA (where the recharacterized funds will go) must be notified in writing of the recharacterization. Although the custodian for both the Roth IRA and the Traditional IRA may be the same, they are often different institutions.

The recharacterized funds do not have to go back to the original account. In fact, if 401(k) funds were converted to a Roth IRA, they are recharacterized to a Traditional IRA, not back to the 401(k).

In all situations, the custodial notification must include the following information:

- The type (“conversion” in this case) and dollar amount of the contribution (conversion) to the Roth IRA that is to be recharacterized. The number of shares and the specific assets that were converted are irrelevant for this purpose, as is the present value of those assets. What is important is only the value at the time the conversion took place. For a full recharacterization of a $200,000 conversion, the amount to be recharacterized is $200,000, even if the value is now only $20,000;
- The date on which the retirement funds were converted to the Roth IRA;
- A direction to the Roth IRA custodian to do a trustee-to-trustee transfer to the Traditional IRA custodian (reminder: assets can remain with the same custodian). As mentioned above, the recharacterization must be done as a trustee-to-trustee
transfer. It cannot be done as a rollover (indirect transfer). Clients can request that shares or specific assets be transferred back to the Traditional IRA; however, after doing the math for the net income calculation, it may not be the same number of shares that were converted in the first place;

- A direction to the Roth IRA custodian to transfer the amount of the conversion and any net income (or loss) allocable to the conversion. This is where the adjustment is made for the loss of value on the converted amount. The custodian should determine the gains or losses on the entire account balance and determine how much of that gain or loss is attributable to the conversion amount that is being recharacterized, but not all custodians will do the calculation; and

- The name of the Roth IRA and the Traditional IRA custodian (they may be the same). The recharacterization does not have to go back to the same IRA that it came from. It simply must go back to any Traditional IRA.

Be careful. Recharacterizations get a bit more complicated when the Roth IRA has other funds in it.

**Example:** Let’s assume Bill has $300,000 in a Traditional IRA. In July of 2017, he decided to convert 500 shares of Ace Company stock, worth $40,000, from the IRA to an existing Roth IRA with a balance of $120,000. By January 2018, those shares are only worth $10,000, and the account as a whole has decreased to $100,000.

Here’s how to calculate the net amount in a Roth recharacterization:

- **Step 1:** $40,000 Converted amount of Ace Corp
  + $120,000 Roth IRA balance the day before the conversion
  $160,000 Adjusted opening balance
- **Step 2:** $100,000 Balance on the day before recharacterization
  $100,000 Adjusted closing balance
- **Step 3:** $40,000
  $160,000 = 0.25 ratio
- **Step 4:** $100,000 Adjusted closing balance
  - $160,000 Adjusted opening balance
  $60,000 Net account (losses)
- **Step 5:** $(60,000) Net account (losses)
  x 0.25 Ratio
  $(15,000) Losses (attributable to conversion)
- **Step 6:** $40,000 Converted amount
  + $(15,000) Earnings (losses) attributable to conversion
  $25,000 Amount to be recharacterized to traditional IRA

**Note:** Recharacterizations are not treated as rollovers for purposes of the one-rollover per year limitations under IRC § 408(d)(3)(B).
Assets That Cannot Be Converted

It is important to note a tax-free rollover from an employer plan (or from another Traditional IRA) or a Traditional IRA may not be recharacterized as a Roth IRA conversion or contribution, because “an amount contributed to an IRA in a tax-free transfer cannot be recharacterized” [Treas.Reg. § 1.408A-5, A-10, Example 4].

Similarly, employer contributions to a SEP IRA or SIMPLE IRA may not be recharacterized as contributions to a Roth IRA, because the employer could not have made direct contributions to a Roth IRA in the first place [Treas. Reg. 1.408A-5,A-5]. But the employee may be able to convert (rollover) the SEP IRA or SIMPLE–IRA to a Roth IRA.

Reconversion

Once a participant does a recharacterization he or she may be in a situation where it could be advantageous to do a reconversion. However, the IRS has placed various limits on the ability to use the recharacterization rules to flip back and forth between a Traditional IRA and a Roth IRA.

In Treas. Reg. § 1.408A-5, A-9, the IRS banned same year IRA-to Roth IRA reconversions, effective in 2000 and later years. Once a recharacterization of an amount converted from a Traditional IRA to a Roth IRA occurs, a participant “may not reconvert that amount” to a Roth IRA until the taxable year following the taxable year of the original conversion, or until at least 30 days have elapsed since the characterization, whichever is later. If the participant defies this rule and attempts to reconvert before the prescribed time period ends, the result is a failed conversion.

Example: If a participant converts an amount from a Traditional IRA to a Roth IRA and then transfer that amount back to a Traditional IRA in a re-characterization in the same year, the participant may not reconvert that amount from the Traditional IRA to a Roth IRA before:

- The beginning of the year following the year in which the amount was converted to a Roth IRA or, if later; and
- The end of the 30-day period beginning on the day on which the participant transferred the amount from the Roth IRA back to a Traditional IRA in a re-characterization.

Converting different money. The waiting period discussed above doesn’t apply if the taxpayer is converting different money. This could be money from a different IRA, for example. It can even be money in the same IRA from which you made the original conversion, if you converted only part of that IRA.
Time Line for Conversion, Recharacterization and Reconversion

What follows is a potential timeline for the conversion and recharacterization process.

Year One:

- Make a conversion before 12/31. Please note that many custodians require at least a week or two to process the paperwork for the distribution. Therefore, I would recommend the practical deadline to be 12/15 of year one to make the conversion. **REMINDER:** The distribution must take place by 12/31 but the funding of the Roth IRA it can be made after the year of the conversion.

For planning purposes, it is highly recommended that you do a Roth IRA conversion at the beginning of the year as opposed to the end of the year, to take advantage of the maximum “look-back” period to undo the conversion, if necessary. This gives the taxpayer an additional 11-months or so of hindsight.

Year Two:

- April 15: File tax forms, pay any taxes owed and file for an extension. This automatically extends the decision to make a recharacterization until October 15;
- October 15: This is the final deadline to “undo” undesirable Year One conversions and file by the close of the “automatic” extension period;
- November 16: This is the first opportunity to reconvert a recharacterized Traditional IRA (This could be done earlier if the recharacterization was done earlier than the October 15th deadline); and
- December 15: This is the last chance for initiating additional Roth IRA conversions for Year Two, assuming 16 days are needed to accomplish the conversion.

This timeline does not project beyond Year Two, but barring other tax law changes, the same logic would continue to apply for future years.

Roth IRA Distributions

When a Roth IRA participant takes a distribution from his or her Roth IRA, he or she must apply the following rules in order to determine the tax consequences, if any, of the distribution. The rules are:

- Qualified distribution rules,
- Non-qualifying distribution (ordering) rules,
- Conversion distribution rules, if applicable, and
- Earnings.
Qualified Distributions

“Qualified distributions” from a Roth IRA are not includable in the recipient’s gross income for federal tax purposes, regardless whether the recipient is the participant or a beneficiary [IRC § 408A(d)(1)(B)]. While a Roth IRA participant may request a distribution from his or her Roth IRA at any time, distributed earnings are exempt from taxes only if they are distributed as part of a “qualified distribution.” To be a qualified distribution, the distribution must meet both of the following events:

- The participant’s Roth IRA must have met the “waiting period” of five taxable years, also known as the “five-year non-exclusion period.” The Technical Corrections Act of 1998 (TTCA-98) defined the Roth IRA non-exclusion period as the five-taxable-year period beginning with the first taxable year for which the individual made a contribution of any kind to a Roth IRA [I.R.C. §408A (d)(2)(B)] [Treas. Reg. 1.408A-6, A-2]. This rule eliminates the necessity of physically segregating Roth IRA contributory assets from conversion assets; and
- After meeting one of the following four qualifying events:
  - After the individual attains age 59½;
  - After the death of the individual;
  - On account of the total and permanent disability of the individual;
  - Made in a manner eligible as a qualifying first time home purchaser ($10,000 maximum lifetime limit).

Example: Computing the Five Year Waiting Period: On April 14, 2013 Tom invests $2,000 into his Roth IRA. Tom’s five-year period started January 1, 2012 and is completed on December 31, 2016. The first year in which he can possibly have a qualified distribution is 2017. If he makes further contributions (either regular or rollover) to the same (or any other) Roth IRA, those contributions DO NOT start a new five-year period running.

In 2017, Tom converts his $100,000 Traditional IRA to a new Roth IRA. This new Roth IRA instantly meets the five-year period requirement, because Tom has already completed the five-year period for every Roth IRA he will ever own. If Tom is already over age 59½, he can immediately take qualified distributions from his newly created Roth IRA.

Nonqualified Distributions

Distributions from Roth IRAs that are not qualified distributions are treated as made first from already-taxed dollars (i.e., contributions, rollovers and conversions). Therefore, until the total of all distributions from an individual’s Roth IRA exceeds the amount of already-taxed dollars, the distribution(s) will not be includable in income. Also, for purposes of determining the tax treatment of IRA distributions, Roth IRAs and Traditional IRAs are treated separately.
Ordering Rules

The TTCA of 1998 amended IRC § 408A(d)(4)(B), thereby imposing strict “ordering rules” on distributions of Roth IRA contributions for tax purposes. First, the distribution ordering rules require a Roth IRA participant to treat all of his or her Roth IRAs as one. This is similar to, but separate from, the rule, which requires a Traditional IRA participant to treat all of his or her Traditional IRAs as one for determining the taxable portion of a distribution when the Traditional IRAs contain both deductible and nondeductible contributions. Then the Roth IRA distribution ordering rules require a Roth IRA holder to separately track Roth IRA assets according to three basic categories.

The categories are:

- **Contributory Assets.** Contributory assets represent the total amount of assets contributed as regular Roth IRA contributions to all Roth IRAs of the participant up to the point of distribution;

- **Conversion Assets.** Conversion assets represent the total amount of assets converted from Traditional IRAs to Roth IRAs up to the point of distribution. The distribution ordering rules require the Roth IRA holder to identify all conversion assets by tax year of conversion, and further subdivide each tax year’s conversion amount into taxable pre-conversion assets (i.e., amounts which were pre-tax assets, such as deductible Traditional IRA contributions and eligible rollover contributions, held in the Traditional IRA prior to conversion) versus nontaxable pre-conversion assets (i.e., nondeductible contributions held in the Traditional IRA prior to conversion); and

- **Total earnings.** The amount of total earnings is the aggregate amount of earnings, which have accumulated on all Roth IRA contribution sources within all Roth IRAs. In other words, total earnings would be the aggregate value of Roth IRAs at the point of distribution, minus undistributed regular Roth IRA contributory amounts and conversions amounts.

Once the Roth IRA assets have been categorized by source, the distribution ordering rules require the Roth IRA participant to treat any amounts distributed as coming from the following sources in the following order listed:

- First, from contributory assets;

- Secondly, from conversion (rollover) assets, chronologically by tax year of conversion (i.e., first-tax-year in, first out), and, within each tax year’s conversion, taxable pre-conversion assets first, followed by nontaxable pre-conversion assets; and

- Finally, from total earnings.

Fortunately, the ordering rules will have to be consulted only in certain unusual situations namely:
• For most people, the Ordering Rules matter only for purposes of determining whether a nonqualified distribution is subject to income tax (see Table 17.6); the ordering rules essentially mean that the distribution is NOT taxable until all contributions have been distributed; and

• The ordering rules matter also for someone who converts a Traditional IRA to a Roth IRA before reaching age 59½, and then takes a distribution within five years of the conversion and before reaching age 59½. The ordering rules will apply in determining whether the 10 percent penalty applies to the distribution.

Table 17.6
Summary of Tax Implication of a Roth IRA Distribution

<table>
<thead>
<tr>
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<th>Qualified Distribution</th>
<th>Non-Qualified Distribution</th>
</tr>
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<tr>
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</tr>
<tr>
<td>Taxable Pre-conversion Assets</td>
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</tr>
<tr>
<td></td>
<td>No penalty</td>
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</tr>
<tr>
<td>Nontaxable Pre-conversion Assets</td>
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</tr>
<tr>
<td></td>
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</tr>
<tr>
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<td>Tax</td>
</tr>
<tr>
<td></td>
<td>No penalty</td>
<td>No penalty</td>
</tr>
</tbody>
</table>

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|                        |  |                          |
|                        |  |                          |

Aggregation Rules. For determining taxation of distributions the following Ordering and Aggregation rules will apply:

• All direct contributions for the same year are aggregated [Treas. Reg. §1.408A-6, Q&A-9(b)];
• Each rollover contribution is treated separately and successively on a first-in first-out (FIFO) basis for ordering withdrawals and assessing penalties [Treas. Reg. §1.408A-6, Q&A-8(a)(6)];
• All conversions within the same year are aggregated [Treas. Reg. §1.408A-6, Q&A-9(c)];
• All Roth IRAs are treated as one Roth IRA [IRC 408A(d)(4)(A)]; and
• All distributions from all of an individual’s Roth IRAs made during the year are aggregated [Treas. Reg. §1.408A-6, Q&A-9(a)].
In applying the Section 72(t) penalty, all Roth IRAs are treated as one Roth IRA and all distributions during the tax year are treated as one distribution and the value of the contract (IRA), income and investment are computed as of the close of the calendar year [IRC § 408(d)(2)].

All previous distributions, contributions, conversions must be known to determine how much remains of each category to correctly compute the taxation and penalties for the distribution.

5-Year Holding Period for Conversions

It is important to note that each Roth IRA conversions have their own “5-year holding period” which begins January 1 of the year of the conversion. However, a participant who is age 59 ½ or older does not need to worry about keeping records of the dates and amounts of conversions/rollovers. Such a participant can withdraw all conversions/rollovers as qualified distributions as long as 5-taxable years have passed beginning with the first year for which the participant made a Roth IRA contribution. Since the participant is 59 ½ or older, there is no 10% penalty tax.

Roth IRA Distributions after Participant’s Death

When the Roth IRA participant dies, the required minimum distribution rules that apply to Traditional IRAs will apply to the Roth IRAs as though the Roth IRA participant died prior to his or her required beginning date (RBD).

Distributions from an inherited Roth IRA generally must be entirely distributed by the end of the 5th calendar year of the Roth IRA participant’s death unless the interest is payable to a designated beneficiary over the life or life expectancy of the designated beneficiary. If there is more than one beneficiary, the oldest beneficiary’s life expectancy is used for the designated beneficiary. However, there are special rules for the spouse (discussed below).

Required minimum distributions are calculated for Roth IRAs separately from other IRAs. Required minimum distributions for plans other than a Roth IRA cannot be made from a Roth IRA, nor can required minimum distributions for Roth IRAs be made from other plans. Furthermore, where minimum required distributions can be made from another Roth IRA, required minimum distributions can be made from another Roth IRA only if the two Roth IRAs were inherited from the same decedent.

The required minimum distribution for each year is generally calculated by dividing the Roth IRA account balance as of the end of the previous year (12/31) by the life expectancy of the designated beneficiary. Life expectancies are based upon the RMD Single Life Table.
For a non-spouse beneficiary who inherits a Roth IRA, you must make sure to keep the account in the decedent’s name, with the name of the beneficiary. Otherwise, it’ll be disqualified as a Roth IRA, and the account will lose the potential for tax-free growth.

Example: Suppose that Mary Jones dies on January 1, 2017, and leaves her Roth IRA to her son, Joe. Joe should tell the financial institution to rename, or re-title, the Roth IRA this way: “Mary Jones Roth IRA (deceased January 1, 2017), FBO Joe Jones, beneficiary.” This identifies the inherited Roth IRA as a beneficiary Roth IRA (“FBO” means “For the Benefit Of”), and the account continues to qualify as a Roth IRA.

Spouse as Sole Designated Beneficiary

A surviving spouse who is the sole designated beneficiary of the account has an important advantage over any other beneficiary: the ability to do a rollover to a new Roth IRA. This can be done most easily by “electing to treat the decedent’s Roth IRA as his or her own,” thereby qualifying the surviving spouse for a lifetime exemption from RMDs. Treas. Reg. § 1.408A-2, Q&A-4.

Tax Reporting of Roth IRA Distributions

While financial organizations must report Roth IRA distributions to the IRS based on information gathered from completed withdrawal statements, the burden for determining the tax consequences of a Roth IRA distribution lies with the Roth IRA participant or beneficiary, except for the return of an excess contribution (plus earnings) before the Roth IRA participant’s tax return due date. To assist the Roth IRA participant in determining the taxability of a Roth IRA distribution, the IRS requires the participant to file IRS Form 8606, Nondeductible IRAs (Contributions, Distributions, and Basis).

DRAC-to Roth IRA Rollover

The DRAC to a Roth IRA is the third way to get funds into a Roth IRA. What is a DRAC? A Designated Roth Account (also known as a Roth 401(k) or Roth 403(b)) is an option that is allowed to individuals who participate in a 401(k) or 403(b) plan after January 1, 2006. It is not a stand-alone retirement plan. It is governed by the same rules as other IRC §§ 401(k) and 403(b) plans.

DRAC Contributions

Contributions to the DRAC are made with after-tax dollars. The maximum amount of contribution to a DRAC is the same amount as allowed by the 401(k): $18,000 in 2017 (same as in 2016). The catch-up contribution limit for age 50 and over is $6,000 in 2017 (same as in 2016). The DRAC option does not increase the amount the employee may contribute to a plan through elective deferrals. Rather, the employee may choose to put
his/her total permitted elective deferral into a DRAC, or into a “regular” 401(k) account, or partly to each. The total annual elected salary deferral contributions to a 401(k) including DRAC contributions is $18,000 in 2017 (same as in 2016).

The deferred amount to the DRAC is subject to the same income tax withholding as the employee’s take home pay, unlike deferrals to the 401(k), which are not taxed. However, “qualified distributions” from the DRAC during the participant’s lifetime will generally be tax-free [IRC § 402A (d)(1)].

In contrast to a Roth IRA, there is no income ceiling above which an employee is not allowed to make designated Roth contributions [IRC § 402A]. There is no age limit above which the employee cannot contribute to a Roth 401(k). An employee can contribute to a Roth 401(k) even if he/she is also a participant in other retirement plans offered by the same or another employer.

**DRAC Rollovers**

IRS permits DRAC–to Roth IRA rollovers that can be accomplished by either direct rollover (trustee-to-trustee transfer) or indirect (60-day rollover). Rollover from a DRAC to a Roth IRA is permitted even if the participant is not eligible to make annual contributions to a Roth IRA or to convert his/her Traditional IRA to a Roth IRA. This means that a participant can establish a Roth IRA purely for the purpose of receiving a rollover of his or her DRAC, even if their income is too high to otherwise allow him or her to contribute to a Roth IRA.

- *Direct Rollover* (trustee-to-trustee transfer) – the entire plan balance can go to an employer Roth plan or to an individual Roth IRA; and
- *Indirect Rollover (60-day rollover)* – only taxable amounts can be rolled over to another Roth employer plan or the entire plan balance can go to an individual Roth IRA and the rollover must be completed within 60 days.

If the employee does a partial 60-day rollover of a non-qualified distribution to his individual Roth IRA, the amount rolled into the Roth IRA is deemed to come first from taxable amounts distributed from the Roth 401(k). This means that the employee is rolling the taxable earnings portion into the Roth IRA first, and the balance of the distribution comes from the tax-free part (see Table 17.7).

<table>
<thead>
<tr>
<th>Direct Rollover (trustee-to-trustee transfer)</th>
<th>All or any part of the plan balance can go to another Roth 401(k), or Roth 403(b), if the receiving plan allows, or to a Roth IRA.</th>
</tr>
</thead>
</table>

**Table 17.7**

Allowable Rollovers from Roth 401(k)s
The Five-Year Holding Period for Qualified Distributions

Roth 401(k)s have their own 5-year holding rules. Unlike individual Roth IRAs where there is only one 5-year period that starts with the establishment of the owner’s first Roth IRA, Roth 401(k)s have a separate 5-year holding period for each employer’s Roth account. If you work for two different companies and participate in the Roth 401(k) plan at each company, you will have two separate 5-year periods, one for each plan.

Also, the 5-year holding period is never carried over to an individual Roth IRA. The Roth 401(k) funds will be governed by the 5-year rule applicable to the Roth IRA. If the Roth IRA has already satisfied the 5-year period, then the employer funds are deemed to have also met the 5-year period, even if they were only in the Roth 401(k) for a year. This is just one more reason for qualifying individuals to establish a Roth IRA. If they don’t qualify this year, they will qualify in 2010 and later years when all the restrictions on converting to a Roth IRA are lifted and they can establish a Roth IRA by doing a conversion.

Roth IRA Documents Must Be Amended

On May 31, 2007 IRS released Announcement 2007-55 to remind Roth IRA sponsors that Roth IRA documents will need to be amended if they are to allow for the acceptance of rollover contributions from Roth 401(k) or Roth 403(b) accounts. All advisors working with clients who are thinking of rolling over Roth 401(k) balances to Roth IRA accounts should first be sure that the Roth IRA document allows for this type of rollover. A Roth IRA that has already accepted rollover contributions from a Roth 401(k) must have been amended by December 31, 2007 (Rev. Proc. 2002-10).

DRAC-To-Roth-IRA Rollovers Allowed For High-Income Employees

The Worker, Retiree, And Employer Recovery Act of 2008 (WRERA) fixed a glitch created by Congress when they allowed direct rollovers from a qualified plan to a Roth IRA under IRC § 408A(e)(1)(B) beginning in 2008. In order to make clear that the income and filing status limitations on Roth IRA conversions also applied to these direct plan-to-Roth-IRA conversions, Congress provided that NO rollover to a Roth IRA from any eligible plan (other than a Roth IRA) was allowed if the taxpayer’s adjusted gross income exceeded $100,000 (or if the taxpayer was “married filing separately” under IRC § 408A(c)(3)(B).

Unfortunately Congress failed to notice that the way it had worded this section, NO money could be rolled from a QRP to a Roth IRA by an individual who exceeded the
income limit (or was married filing separately)...not even from a designated Roth account (DRAC; also called “Roth 401(k)”). It was obvious that this made no sense because a rollover from a DRAC to a Roth IRA would not be a “conversion” of the rolled funds since they were ALREADY in a Roth-type account prior to the rollover.

WRERA fixed this glitch by adding the following sentence to IRC § 408A(c)(3)(B), effective for the years 2008 and 2009:

“this subparagraph shall not apply to a qualified rollover contribution from a Roth IRA or to a qualified rollover contribution from a designated Roth account which is a rollover contribution described in IRC § 402A(c)(3)(A).”

Accordingly, a participant in a DRAC can now roll that money directly to a Roth IRA regardless of his or her income level or filing status.

Small Business Job Protection Act of 2010

Under sections 2111 and 2112 of this new legislation, effective for distributions made after September 27, 2010, 401(k) 403(b) and governmental 457 plans under the IRC may now permit participants to make in-plan Roth conversions of their pre-tax employee contributions.

The in-plan Roth conversion provision was included in the Act because it is expected to raise more than $5.5 billion over the next 10 years from participants who perform in-plan rollovers to designated Roth programs. The implementation of this feature is discretionary.

ATRA of 2102 Expands “In-Plan” Roth 401(k) Conversions

The American Taxpayer Relief Act of 2012 (the "fiscal cliff" bill) allows employers to amend 401(k), 403(b) and governmental 457(b) plans to permit participants to convert pre-tax account balances to Roth account balances. Previously, such conversions were permitted only when the pre-tax amounts could be distributed.

Background

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act (ATRA) of 2012. The new law permits 401(k), 403(b) and governmental 457(b) plan sponsors to amend their plans to permit any amount under the plan to be converted to a Roth amount within the plan, even if the amount is not otherwise distributable. Converted amounts are treated as distributions and taxable in the year of conversion. The new law is effective January 1, 2013, but permits conversions of balances accumulated before 2013.
Prior to the new law, 401(k), 403(b) and governmental 457(b) plan sponsors could amend their plans to permit vested account balances to be converted to Roth amounts within the plan, but only if those amounts were otherwise distributable under the terms of the plan and qualified as eligible rollover distributions. This generally meant amounts were convertible only upon the participant’s severance from employment, death, disability or attainment of age 59½ or, in the case of profit sharing or matching contributions, upon a stated age, stated event or fixed number of years, although traditional after-tax and rollover contributions and their earnings are generally freely distributable at any time. As under the new law, converted amounts were generally treated as distributions and taxable in the year of conversion (subject to a special rule for 2010).

**Expansion of In-Plan Roth Conversions**

Now, 401(k), 403(b) and governmental 457(b) plan sponsors may permit participants to make in-plan Roth conversions for any amounts held in the plan, regardless of whether they are otherwise distributable. A plan may (but is not required to) permit in-plan Roth conversions only if the plan is a 401(k), 403(b) or governmental 457(b) plan that has a Roth elective deferral arrangement. So, for example, a plan that consists only of profit sharing contributions would not be eligible to offer in-plan Roth conversions. If an eligible plan does not already have a Roth feature, it must add one to the plan before participants can be permitted to make in-plan Roth conversions.

Moreover, plans that currently permit Roth contributions must be amended if the employer wants to permit amounts that are not otherwise distributable to be converted to Roth amounts. As noted above, once the plan is amended, employees may convert amounts already in the plan to Roth amounts.

Once the plan has been amended to permit amounts that are not otherwise distributable to be converted to Roth amounts, the plan sponsor will need to set up and administer separate Roth accounts for participants who make conversions and don’t already have them. For participants who already have Roth accounts, the converted amounts would be transferred to the Roth accounts.

**Note:** Because the ATRA was signed into law so recently, there is not yet any IRS guidance on questions employers may have on establishing or administering this expansion of in-plan Roth conversions. Similarly, no “model” form of plan amendment has been circulated by the IRS. However, you can visit the IRS website to view FAQs on Designated Roth Accounts (http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-on-Designated-Roth-Accounts).

**Benefits to Participants**

The ability to convert plan assets into Roth assets may be popular with plan participants because they can choose to convert plan assets into Roth assets and later take a tax-free distribution, provided the participant meets the requirements for a qualified Roth distribution (as was discussed above). Participants who are unsure about future tax rates...
or their future tax bracket can hedge their risks by converting some retirement plan assets into Roth assets and maintaining other assets as traditional pre-tax assets.

Conversion may be particularly appealing for participants who expect their tax rate to be higher when amounts are distributed, as well as those who are younger and whose accounts will have more time to grow after they are converted.

Converted amounts are not subject to the 10 percent early distribution tax under IRC § 72(t) of the Internal Revenue Code (generally applicable to distributions to participants under age 59½ that are not rolled over to an IRA or another qualified employer plan).
Chapter 17
Review Questions

1. Roth IRAs are defined under which Section of the Internal Revenue Code (IRC)?
   (   ) A. IRC § 401(k)
   (   ) B. IRC § 457(b)
   (   ) C. IRC § 408(A)
   (   ) D. IRC § 457

2. Which of the following statements about Roth IRAs is FALSE?
   (   ) A. Contributions to a Roth IRA are made with after tax dollars.
   (   ) B. Roth IRAs must be designated as such when set up.
   (   ) C. A Roth IRA can be either an account or an annuity.
   (   ) D. A SEP IRA and a SIMPLE IRA can be designated as a Roth IRA.

3. The $1,000 catch-up contribution is available to participants’ who reach age _____ by the end of the taxable year.
   (   ) A. 50
   (   ) B. 55
   (   ) C. 60
   (   ) D. 65

4. What is the maximum allowable contribution to a Roth IRA for a taxpayer age 50 and older in 2017?
   (   ) A. $6,500
   (   ) B. $6,000
   (   ) C. $4,000
   (   ) D. $5,500

5. If proper steps are taken, a taxpayer can “undo” or “recharacterize” a Roth IRA conversion up until which of the following dates?
   (   ) A. December 31st of the tax year of conversion
   (   ) B. April 15th of the tax year after the conversion
   (   ) C. October 15 of the tax year after the conversion
   (   ) D. October 1st of the tax year of conversion
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CHAPTER 18

PAYROLL DEDUCTION IRA

Overview

Even if a small business owner does not want the responsibility to adopt a retirement plan, the employer can allow its employees to contribute to an IRA through payroll deduction, providing a simple and direct way for employees to save in a tax-deferred vehicle for their retirement.

In this Chapter, we will examine the background of payroll deduction IRA plans, their benefits, how to set up, and recent legislative proposals to expand them.

Learning Objectives

Upon completion of this chapter, you will have an understanding of the following:

- The features and benefits of a payroll deduction IRA;
- The advantages for employees and employers who set up a payroll deduction IRA plan;
- How to establish and operate a payroll deduction IRA; and
- Recent legislation for automatic payroll deduction IRAs.

Background

A payroll deduction individual retirement account (IRA) is an easy way for businesses to give employees an opportunity to save for retirement. The employer sets up the payroll deduction IRA program with a bank, insurance company or other financial institution, and then the employees choose whether and how much they want deducted from their paychecks and deposited into the IRA. Employees may also have a choice of investments depending on the IRA provider (see Table18.1).

Many people not covered by an employer retirement plan could save through an IRA, but do not do so on their own. A payroll deduction IRA at work can simplify the process and encourage employees to get started.

Under Federal law, individuals saving in a Traditional IRA may be able to receive some tax advantages on the money they save, up to a certain amount, and the investments can
grow tax-deferred. If the individual selects a Roth IRA, the employee’s contributions are after-tax, and the investments grow tax-free.

Advantages of a payroll deduction IRA:

- The payroll deduction IRA is a simple way for employees to set up an IRA and save for their retirement;
- The employee makes all of the contributions. There are no employer contributions. By making regular payroll deductions, employees are able to contribute smaller amounts to their IRAs each pay period, rather than having to come up with a larger amount all at once;
- Administrative costs are low, and there are no annual filings with the government;
- There is no requirement that an employer have a certain number of employees to set up a payroll deduction IRA;
- The program will not be considered an employer retirement plan subject to Federal requirements for reporting and fiduciary responsibilities as long as the employer keeps its involvement to a minimum; and
- Providing a payroll deduction IRA for employees may assist an employer in attracting and retaining quality employees.

Establishing a Payroll Deduction IRA

As mentioned above, a payroll deduction IRA program is easy to set up and operate. The employer sets up the payroll deduction IRA program with a financial institution, such as a bank, mutual fund or insurance company. The employee establishes either a traditional or a Roth IRA (based on the employee’s eligibility and personal choice) with the financial institution and authorizes the payroll deductions. The employer withholds the payroll deduction amounts that the employee has authorized and promptly transmits the funds to the financial institution. After doing so, the employee and the financial institution are responsible for the amounts contributed.

As long as the employer keeps its involvement to a minimum, the program will not be treated as an employer retirement plan under Federal law, and the employer will not be subject to the requirements for such plans, including annual filings with the government. In setting up a program, the employer can limit the number of IRA providers to which it will remit contributions. The employer can designate as few as one IRA provider to receive contributions.

However, it must disclose any limitations or costs associated with an employee’s ability to transfer contributions to another IRA provider before the employee begins to participate in the program.

The employer needs to remain neutral about the IRA provider. It cannot negotiate with an IRA provider to obtain special terms for its employees, exercise any influence over the investments made or permitted by the IRA provider, or receive any compensation in
connection with the IRA program except reimbursement for the actual cost of forwarding the payroll deductions.

The employer can:

- Encourage its employees to save for retirement by providing general information on the payroll deduction IRA program and other educational materials that explain why it is important to save, including the advantages of contributing to an IRA;
- Answer employees’ questions about the payroll deduction program and refer inquiries to the IRA provider; and
- Provide informational materials written by the IRA provider, as long as the materials do not suggest any endorsement by the employer.

However, the employer should make clear that its involvement in the program is limited to collecting employee contributions and promptly sending them to the IRA provider.

**Operating a Payroll Deduction IRA**

Generally, any employee who performs services for the business (or “employer”) can be eligible to participate. The decision to participate is up to the employee, and an IRA may not be appropriate for all individuals. The employees should understand that they have the same opportunity to contribute to an IRA outside the payroll deduction program and that the employer is not providing any additional benefit to employees who participate. Each employee determines the amount they want deducted for contribution to their IRA. Participants are always 100 percent vested in (have ownership in) all of the funds in their IRAs.

Participant loans are not permitted. Withdrawals are permitted anytime, but they are subject to income taxes (except for certain distributions from nondeductible IRAs and Roth IRAs). If the employee is under age 59½, there may also be a 10 percent additional tax.

Employees’ tax-deferred contributions are limited to $5,500 for 2017. Additional “catch-up” contributions are permitted for employees age 50 or over. This special catch-up amount is currently limited to $1,000 per year. No changes from 2016.

The employee’s control where their money is invested and they also bear the investment risk. The financial institution holding the IRA manages the funds. An employee may move the IRA assets from one IRA provider to another. The employee should be made aware that the employer does not guarantee or promise any rate of return. The employer is merely acting as a conduit.
The employer’s costs are low because the program is not subject to the government filing, administrative and fiduciary requirements imposed on employer retirement plans (such as 401(k) plans).

The employer may pay fees charged by the IRA provider for services in connection with establishing and operating the payroll deduction process. The employer may pay its own internal costs (such as bookkeeping and overhead) for setting up and operating the program. However, the employee must pay the fees related to setting up and maintaining the IRA.

**Terminating a Payroll Deduction IRA**

A payroll deduction IRA program can be terminated at any time. If the employer decides that a payroll deduction IRA program no longer suits its business needs, it simply notifies the payroll department. The employer also should notify its employees that the program is being terminated. The employer may need to notify the IRA provider(s) that it will no longer be making such deposits. No termination notice is required for the IRS. Although the employer’s involvement will end, the employees can continue to save through their IRAs working directly with the IRA provider.

**Table 18.1**

**Payroll Deduction IRA**

<table>
<thead>
<tr>
<th>Key Advantage</th>
<th>Easy to set up and maintain.</th>
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<tr>
<td>Employer Eligibility</td>
<td>Any employer with one or more employees.</td>
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<tr>
<td>Employer’s Role</td>
<td>Arrange for employees to make payroll deduction contributions. Transmit contributions for employees to IRA. No annual filing requirement for employer.</td>
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<tr>
<td>Contribution to the Plan</td>
<td>Employee contributions remitted through payroll deduction.</td>
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<tr>
<td>Maximum Annual Contribution (per participant)</td>
<td>$5,500 for 2017. Participants age 50 or over can make additional contributions up to $1,000.</td>
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<td>Contributor’s Options</td>
<td>Employee can decide how much to contribute at any time.</td>
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<td>Minimum Employee Coverage</td>
<td>There is no requirement. Can be made available to any employee.</td>
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<tr>
<td>Withdrawals, Loans and Payments</td>
<td>Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to an additional tax (special rules apply to Roth IRAs).</td>
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<tr>
<td>Vesting</td>
<td>Contributions are immediately 100% vested.</td>
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**Automatic IRA Legislation Is Reintroduced**

Rep. Richard Neal (D-MA) has reintroduced payroll withholding automatic IRA legislation from the 112th Congress, with some minor changes. The legislation is
intended to make available an employer-coordinated retirement saving opportunity to those workers whose employers do not offer a more typical retirement plan.

The Automatic IRA Act of 2013 (H.R. 2035) includes the following provisions.

- Most employers with more than 10 employees earning at least $5,000 in the preceding calendar year and not offering an employer-sponsored retirement plan would be required to offer such an arrangement. Employers below this threshold would be exempt, as would employers with 10 or fewer employees on a “typical business day” in the preceding calendar year and certain new businesses. Also, exempt would be government entities and churches;
- As an alternative to automatically enrolling all eligible employees, an employer could comply by requesting an affirmative employee election to contribute (or not contribute) and automatically enrolling only those employees who do not make such an affirmative election;
- Certain employees need not be covered under such an arrangement, including those under age 18, those who have worked less than three months for the employer, certain collectively-bargained or nonresident alien employees, and those whose age, income, or service to their employer would not qualify them to participate in a SEP or SIMPLE IRA plan;
- A $100 penalty would be imposed on the employer for each otherwise eligible employee not covered by the arrangement unless due to reasonable cause and corrected within 90 days;
- Amounts withheld under the automatic IRA program would be at a rate of three percent of compensation, or such other percentage specified in regulations and not less than two percent or greater than six percent. If the Act is enacted, future Treasury regulations also could specify conditions for an automatic increase of withheld amounts;
- Automatically withheld amounts would be required to be placed in certain classes of investments, including certificates of deposit, mutual funds, insurance contracts, etc.;
- The employer could, but would not be required to, permit employees to choose the IRA trustee, custodian, or issuer where contributions would be made. An alternative inflation-protected retirement bond investment would be made available. The legislation provides for a study to be conducted as to the merits of automatically transferring retirement bond accumulations to diversified private sector investments once a threshold bond balance is reached;
- An automatic IRA arrangement is assured of not being considered a “pension plan” if contributions are made to a provider included in the website list established under a new section 408B(h)(3), to an IRA designated by the employee, or are invested in the above-described retirement bonds;
- Employees who elect out of the arrangement and have automatic IRA contributions distributed to them within 90 days would not be subject to the 10 percent additional tax for early withdrawal;
- Automatic IRA contributions would be required to be remitted by the last day of the month following the month of withholding or if later, by a deadline prescribed
under Treasury regulations, but in no case later than the deadline for income tax withholding for the period. Fiduciary liability would apply for failure to meet the requirement;

- Notice and election period requirements would apply and generally would require notification at least 30 days before the beginning of such year or before an employee becomes eligible;

- An annual account statement (much like all IRAs) would be required and would include a notice that the Department of Labor’s website offers information on investing and diversification of assets. In general, all IRA rules would apply;

- For purposes of limiting fiduciary liability for investment performance, a participant or beneficiary would be treated as having exercised control over assets on and after the 7th day after notice was provided that an automatic IRA account had been set up;

- Small employers (100 or fewer employees) could receive a business tax credit for maintaining an automatic IRA arrangement for up to six years to a maximum of $750 for the first year and $500 for the following years. The automatic IRA program credit would generally not be available for a year in which the employer claimed a small employer new plan start-up credit under current law;

- The small employer new retirement plan start-up credit would increase from the current maximum of $500 per year to $5,000 per year, determined by a formula based on eligible non-highly compensated employees;

- The legislation provides for a study to determine the merits of extending the spousal consent requirements of the federal Thrift Savings Plan (TSP) program to these automatic IRA arrangements;

- An automatic IRA advisory group would be formed to make recommendations regarding suitable investment options, investment-related notices and disclosures, and establishing a website list of IRA custodians, trustees or issuers suitable for an automatic IRA program; and

- Any state laws in conflict with provisions of this act would be preempted.

MyRA Retirement Program

President Obama announced a new retirement savings program called the MyRA, which stands for My Retirement Account. The MyRA is described by the Obama Administration as a, “simple, safe, and affordable starter retirement savings account.” The MyRA is primarily aimed at individuals who don’t have an employer sponsored retirement account, such as a 401(k) plan, 403(b), thrift savings, or similar retirement account. Let’s review some of the rules.

MyRA Rules

- The account will be set up through pay roll deductions. They are available now, after a full rollout during 2015. Anyone with direct deposit will be able to open an account. Right now it looks like accounts will be opened online and self-administered by workers. This will not be run by employer;
• Workers will be able to start with a minimum contribution of $25, and can continue making contributions for as little as $5 per pay check. It’s a very affordable way to begin contributing to a retirement account;
• The MyRA will follow many of the same rules as Roth IRAs. For example, there are no tax deductions for contributions. All contributions are made with after tax dollars, and withdrawals in retirement will be tax free;
• The MyRA will also follow the same contribution limits as Roth IRAs ($5,500 in 2017), and the same income phase-out limits ($133k MAGI for single, $196k MAGI for couples in 2017);
• Accountholders could accrue balances of up to $15,000, at which point they’d have to roll the balance over into a regular, private Roth IRA. Voluntary rollover and withdrawal would be available anytime, and it looks like normal Roth IRA withdrawal penalty rules would apply; and
• The accounts would be invested in a security similar to the "G Fund" available to federal employees participating in the Thrift Savings Plan (TSP). This fund has all the advantages of short-term Treasury bills (no credit risk or interest rate risk) but pays an interest rate based on the average of outstanding long-term Treasury bond rates.

Note: It seems that Roth IRAs and MyRA accounts share a combined contribution limit, meaning you can’t double dip and contribute the maximum amount to both accounts.
Chapter 18
Review Questions

1. Which of the following statements about a payroll deduction IRA plan is FALSE?
   ( ) A. The payroll deduction IRA is a simple and easy to set up.
   ( ) B. The employee makes all of the contributions.
   ( ) C. The employer is required to make contributions
   ( ) D. Administrative costs are low, and there are no annual filings with the IRS.

2. The employer may set up a payroll deduction IRA plan with what type of financial institution?
   ( ) A. Banks
   ( ) B. Mutual fund companies
   ( ) C. Insurance companies
   ( ) D. All of the above

3. Employees’ tax-deferred contributions to a payroll deduction IRA are limited to what amount in 2017?
   ( ) A. $5,500
   ( ) B. $17,500
   ( ) C. $5,100
   ( ) D. $51,000

4. What is the amount of the catch-up contribution for employees’ age 50 or older that can be contributed to a payroll deduction IRA in 2017?
   ( ) A. $500
   ( ) B. $1,000
   ( ) C. $1,500
   ( ) D. $2,500

5. Under the proposed Automatic IRA Act of 2013, employers with how many employees earning $5,000 or more per year will be required to set up a payroll deduction IRA plan?
   ( ) A. 10+
   ( ) B. 25+
   ( ) C. 50+
   ( ) D. 100+
## CHAPTER REVIEW

### ANSWERS

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