

# **BACK-TO-BASICS - MODULE 5**

## **CONTROLLED GROUPS, 415 ANNUAL LIMITATIONS, 404 DEDUCTIONS, ANTIALIENATION AND BANKRUPTCY LAW**

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### **PART ONE - CONTROLLED GROUPS**

#### **I INTRODUCTION**

The controlled group rules were adopted as part of the coverage and the nondiscrimination rules to insure that the plan(s) maintained by an employer do not discriminate in favor of highly compensated employees. The rules provide guidance in connection with the definition of the employer for purposes of the plan(s) maintained by the employer. The rules identify the ways in which separate employers are considered as one for purposes of a qualified plan. For example, a controlled group of business entities can exist on the basis of ownership where one business owns a controlling interest in another business. A controlled group can also exist where five or fewer individuals have an ownership interest in two or more other businesses. A controlled group can also exist in the service industry where an element of control exists and two or more entities are regularly associated in providing services to third parties. Special rules apply to employers who lease some of their employees from a leasing organization. While leased employees are not a controlled group issue, they are considered employees of the recipient employer for plan purposes. In rare cases an employer may also be required to consider shared employees for plan purposes. The rules that follow are designed to identify who an employer's employees are for purposes of maintaining a qualified plan.

##### **A. Controlled Group of Corporations- Code §414(b)**

A controlled group of corporations includes a parent-subsidary controlled group, a brother-sister controlled group or a combination of the two.

##### **B. Partnerships, Proprietorships, Etc. Under Common Control - Code §414(c)**

The statute provides that rules similar to those prescribed for a controlled group of corporations are applicable in connection with a controlled group of unincorporated businesses.

#### **II PARENT-SUBSIDIARY GROUP**

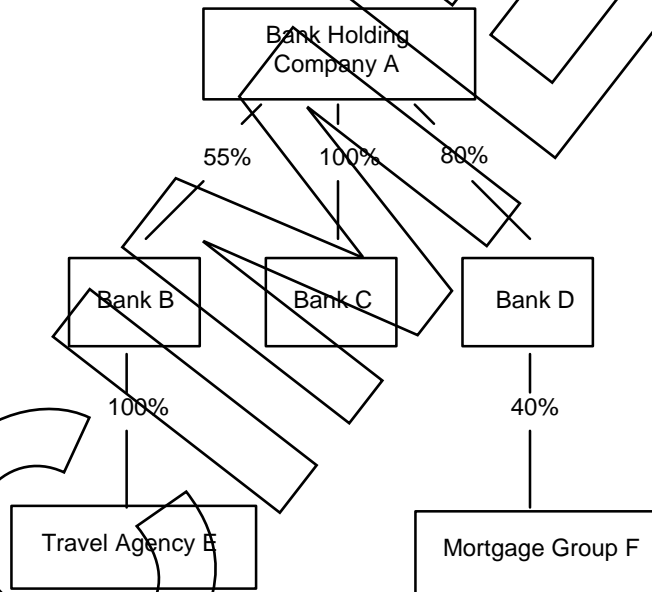
A Such a controlled group exists if one corporation owns a controlling interest in another corporation. For example, if Company A owns 100% of the stock of Company B, a controlled group exists consisting of Companies A and B. The situation is a bit more complex where a holding company exists and the ownership interest varies down the line. A controlled group exists to the extent that one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest by a common parent organization.

B. Control is determined by the following two criteria:

1. at least 80% of each entity's interest must be owned by the common parent or by one or more of the other businesses, and
2. the common parent must own at least an 80% interest in one or more of the other organizations.

The 80% ownership threshold is determined either by owning stock with 80% of the voting power of all classes entitled to vote or 80% of the total value of all shares of all classes of stock.

**Example 1**



Controlled Group 1 - Companies A, C, and D.

Controlled Group 2 - Companies B and E.

**III BROTHER-SISTER GROUP**

Two or more organizations are within a brother-sister group if:

- A. the same five or fewer shareholders, who are individuals, estates or trusts, own at least an 80% controlling interest in each company, and
- B. the same five or fewer shareholders have an identical ownership among all companies which, in the aggregate, is more than 50%.

**Example 2 (On next page.)**

**Example 2****OWNERSHIP IN COMPANY**

<u>Stockholder</u>	<u>A</u>	<u>B</u>	<u>C</u>	<u>COMMON Ownership</u>
1.	50%	20%	10%	10%
2.	25%	20%	15%	15%
				25%

If stockholder 1 owns 50% of Company A, 20% of B and 10% of C, his or her identical ownership in all three companies is 10%. Stockholder 2 owns 25% of Company A, 20% of B and 15% of C resulting in an identical ownership of 15%. In the aggregate, stockholders 1 and 2 have an identical ownership of 25%.

**Example 3**

<u>Stockholder</u>	<u>Co A</u>	<u>Co B</u>	<u>Co C</u>	<u>Identical</u>
1.	100%	15%	15%	15%
2.	0	40	50	0
3.	0	40	20	0
	100%	95%	85%	15%

There is no controlled group among Companies A, B and C since the identical ownership is less than 50%.

<u>Stockholder</u>	<u>Co B</u>	<u>Co C</u>	<u>Identical</u>
1.	15%	15%	15%
2.	40	50	40
3.	40	20	20
	95%	85%	75%

There is a controlled group among Companies B and C since the three stockholders together own more than 80% of B and C and their identical ownership is greater than 50%.

**IV COMBINED GROUP**

Three or more corporations, each of which is a member of a parent/subsidiary or brother/sister group of corporations and one of which is:

- A. a common parent corporation included in a parent/subsidiary group and also
- B. is included in a brother/sister group of corporations.

**Example 4**

An individual stockholder owns 80% of Corporation X and 85% of Corporation Y forming a brother-sister controlled group. Y owns 100% of Corporation Z forming a parent-subsidiary controlled group. Since Y is

the parent in a parent-subsidary group and is also part of a brother-sister group, a combined controlled group exists between X, Y and Z.

## V DETERMINATION OF OWNERSHIP

### A. Parent-Subsidiary Controlled Group

1. Stock owned directly by a corporation
2. Stock for which the corporation has an option to purchase
3. Stock owned by an estate or trust where the beneficiary of such estate or trust has an actuarial interest of 5% or more in such estate or trust. The percentage of such stock considered to be owned by the beneficiary is equal to the beneficiary's interest in the estate or trust.

**Note:** Such ownership does not apply with respect to stock owned by an employees' trust described at Code §401(a) which is exempt from tax under Code §501(a).

### B. Brother-Sister Controlled Group

1. Stock owned directly by an individual
2. Stock owned directly or indirectly by a partnership of which the individual is a 5% or more partner. The percentage of such stock considered to be owned by the individual is equal to the greater of the individual's capital interest or profits interest in the partnership.
3. Stock for which the individual has an option to purchase
4. Stock owned by an estate or trust where the individual as beneficiary of such estate or trust has an actuarial interest of 5% or more in such estate or trust. The percentage of such stock considered to be owned by the individual is equal to the beneficiary's interest in the estate or trust.
5. Stock owned directly or indirectly by a corporation in which the individual owns 5% or more of such corporation. The percentage of such stock considered to be owned by the individual is equal to his or her proportionate interest in the value of all stock in such corporation.
6. Stock owned directly or indirectly by the individual's spouse. Special rules apply to situations where both spouses own and operate separate corporations. The special rules avoid a controlled group where one spouse, for example, owns a dental practice and the other owns an accounting firm.
7. Stock owned directly or indirectly by an individual's children who have not attained age 21. The children under age 21 would also be deemed to own stock owned directly or indirectly by his or her parent.
8. Stock owned directly or indirectly by an individual's parents, grandparents, grandchildren and children who have attained age 21 provided that the individual owns directly or indirectly (as provided at sub-paragraphs f and g) more than 50% of the stock of the same corporation. The principals of this paragraph are illustrated in the following example:

### Example 5

The family ownership situation:

- Frank, the father, owns directly 40 shares of Corporation Z stock.
- Frank's son Mike, age 20, owns directly 30 shares of Corporation Z stock.
- Frank's son Allan, age 30, owns directly 20 shares of Corporation Z stock.

What is the direct and indirect ownership of Frank, Mike and Allan?

- a. Frank is considered to own a total of 90 shares:
  - i. 40 shares directly.
  - ii. 30 indirectly from Mike (giving Frank an interest greater than 50%) (see 7 above), and
  - iii. 20 shares from Allan. (see 8 above).
- b. Mike is considered to own a total of 70 shares:
  - i. 30 shares directly and
  - ii. 40 shares in-directly from Frank. (see 7 above).
- c. Allan is considered to own a total of 20 shares:

No attribution from Frank or from Mike. (see 7 & 8 above)

### C. Controlled Groups That Include Nonstock Organizations or Governmental Entities:

A nonstock organization, such as a tax-exempt organization, can be part of a controlled group even though no one has an ownership interest in that organization.

The IRS looks to Treas. Reg. §1.512(b)-1(1)(4)(i)(b) to interpret the proper application of these control principles to nonstock entities. A controlling interest exists if at least 80% of the directors or trustees of a nonstock organization are either:

1. representatives of a controlling entity (which may be another tax-exempt entity or a nonexempt for-profit entity); or
2. are directly or indirectly controlled by a controlling entity.

A trustee or director is a representative of the controlling entity if he is a trustee, director, agent or employee of the controlling organization.

IRS Notice 89-23, defines an employer to include controlled group members of a tax-exempt organization, applying these principles. A controlled group might consist entirely of tax-exempt organizations or partly of tax-exempt organizations and partly of nonexempt for-profit organizations. Notice 89-23 prescribes safe harbor nondiscrimination tests for §403(b) plans.

In IRS Notice 96-64, the IRS notes that, until further guidance is issued, tax-exempt organizations will be held to a good faith compliance standard in applying the controlled group rules. Any further guidance will be effective only on a prospective basis.

The proposed regulations issued in November, 2004 and effective as of January 1, 2007 provide that control group determination for tax-exempt organizations is based on more than 80% common directorship on the Board of Directors for each organization.

## VI MULTIPLE EMPLOYERS/ONE PLAN

### A. Multi-Employer Plans - Union Plan Spread Over Many Employers

A multi-employer plan is a single plan maintained pursuant to a collective bargaining agreement between a union and one or more employers (see Code §413). Under these plans, more than one employer usually contributes to the same plan. Each employer takes its own deduction for the contribution it contributes on behalf of its own employees.

### B. Multiple Employer Plans - Two or More Unrelated Employers

Two or more employers may jointly maintain a qualified plan even if they are not related by common ownership.

Unrelated employers may not use a prototype plan and would have to adopt an individually designed plan. Generally, deductions for contributions will only be permitted to the extent made for the benefit of the employees of the employer making the contribution.

**Note:** Rev. Proc. 2002-21 created rules for Professional Employer Organizations (PEOs) which requires them to either change their multiple employer plan to an individually designed plan or have each employer adopt their own prototype plan. Though this Rev. Proc. ended the practice of placing unrelated employers in the same plan unless the plan is approved by the IRS as an individually designed plan, Rev. Proc 2003-86 provides a transition period for existing PEOs through the EGTRRA Remedial Amendment Period.

### C. Related Employers

A controlled group or affiliated service group, may adopt a prototype plan. This is usually done through Board Resolutions and the signing of an additional signature page on the adoption agreement by each participating employer. The plan is treated as one plan for testing and filing purposes, but each employer generally takes its own deduction for the contribution to its employees. For Profit-Sharing Plans only, an affiliated employer, under the same plan and trust may make a contribution for the employees of a non-profitable member of the plan.

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## PART TWO - SECTION 415

### I ANNUAL ADDITIONS - CODE §415(c)

In developing pension legislation Congress believed it important to limit the benefits that could be earned under a qualified plan for any individual. In a defined contribution plan the limit is determined as an annual addition to each participant account. Limitations were also enacted for the amount that a company can deduct from its taxable income for contributions to its retirement plans.

#### A. Limitation

Effective in 2002 the annual additions limit will be the lesser of 100% of compensation or \$40,000 as adjusted for Cost of Living Adjustments. The history of the limit since 2002 is, \$40,000 for 2003, \$41,000 for 2004, \$42,000 for 2005, \$44,000 for 2006, \$45,000 for 2007 and \$46,000 for 2008. Thus, the amount that may be allocated to a Participant for the year may not exceed this limitation. *This is a per employer limit.* So if an employee works for two unrelated employers during one year, the employee would have a separate 415 limit with each employer. If, however, the employers are related, as in a controlled group, then the employee would have only one 415 limit. Compensation includes deferrals under a qualified plan and §125 cafeteria plan.

#### B. Annual Additions Include [Regulation §1.415-6(b)(1)]:

The annual additions are calculated by adding up contributions in four basic categories:

##### 1. Employee pre-tax and Roth elective deferrals including:

- a. Excess elective deferrals not distributed to the participant by April 15 following the calendar year for which the excess deferral was made.

**Note:** Excess elective deferrals timely returned to a participant (i.e. by the next April 15th) are not considered annual additions.

- b. Excess contributions recharacterized as after-tax contributions or distributed to a participant.

##### 2. Employee after-tax contributions, voluntary or required, including excess aggregate contributions representing employer related matching or discretionary amounts distributed to a participant.

3. Employer discretionary and matching contributions including excess aggregate contributions distributed to a participant. Matching contributions that are forfeited by failure to pass the ACP test are considered as annual additions with respect to participants receiving the forfeiture allocation and with respect to the participant to whom the forfeiture is charged.
  4. Forfeitures of employer related contributions including matching contributions allocated to participant accounts.
- C. Disposition of Excess Annual Additions - Regulation §1.415-6(b)(6)

The Regulations have traditionally allowed a plan to deal with an excess annual addition by following the steps below:

1. Returning after-tax contributions plus investment earnings thereon to participants.
2. Returning employee pre-tax or Roth elective deferrals plus earnings (if provided for in the plan document) to participants.
3. Holding employer contributions and/or forfeitures in a suspense account and allocating them to the affected participant in the next limitation year or as chosen in the plan document.
4. Reallocating the excess annual addition in the same limitation year in which the excess was created to participants not affected by the §415 limit.

D. Distribution of Elective Deferrals and Employee Contributions – Rev Proc 92-93

1. Elective deferrals treated as excess annual additions plus the investment earnings thereon (if distributed) are included in income (Roth is exempt since already taxed) in the year distributed.
2. Investment earnings on excess employee after-tax contributions are included in income in the year distributed.

3. Neither the Regulations nor the Revenue Procedure specifies the timing of a distribution to correct an excess annual addition. It would appear, however, that the distribution must be made prior to the end of the next limitation year in order for the plan to maintain its qualified status.

4. The amount returned to the participant is not considered when performing the ADP or ACP tests or when determining the maximum elective deferral for the calendar year.

5. The amount distributed is not subject to:
- a. The notice and spousal consent or the joint and survivor annuity rules,

- b. The 10% penalty on early distributions, and
  - c. The restrictions on in-service withdrawals.
6. The amount includable in income is subject to income tax withholding under Code §3405 but is not an eligible rollover distribution under Code §402(c)(4). Thus, income tax withholding is voluntary.
  7. The distribution is not considered for purposes of any minimum distribution required under Code §401(a)(9).

E. Tax Reporting for Distributions - Rev Proc 92-98

1. Distributions are reported on Form 1099-R.
2. A separate Form 1099-R is used to report the distribution of elective deferrals and/or employee contributions. A separate 1099-R would be used to report excess deferrals, excess contributions and excess aggregate contributions.
3. Return of *elective deferrals* is taxable in the year distributed and reported on 1099-R as:
  - Box 1 and 2a = Total Amount of the Distribution
  - Box 5 = Blank
  - Box 7 = Code E
4. Return of *employee contributions or designated Roth account contributions*, plus gains is reported on the 1099-R as follows:
  - Box 1 = Gross Distribution
  - Box 2a = Gains distributed on employee contributions or designated Roth contributions
  - Box 5 = Employee contributions or designated Roth contributions
  - Box 7 = Code E

**II FINAL 415 REGULATIONS DEFINITION OF POST-SEVERANCE COMPENSATION**

The post-severance payment rules contained in the Final Code Section 415 regulations generally apply to limitation years beginning on or after July 1, 2007. Thus, for a plan with a calendar-year limitation year, the effective date is January 1, 2008; an off-calendar-year plan with a limitation year of July 1, 2007 to June 30, 2008, is already required to follow these rules.

Employers were able to use the post-severance definition contained in the proposed regulations until the final rules were issued. The final 415 regulations contained significant changes to the proposed post-severance compensation rules, so both rules are presented below.

A. Post-Severance Compensation Definition

1. Paid by the later of 2½ months or the end of the limitation year after severance. For retirement plan purposes, post-severance payments must be made by the later of 2½ months after severance from employment or by the end of the limitation year that includes the date of severance from employment.
2. Compensation that would have been received is required to be included. Just as with the proposed regulations, the final regulations require post-severance payments of amounts that would have been received if employment had continued to be included in the plan definition of compensation if paid within the appropriate time frames. Unlike in prior guidance where the inclusion of post-severance was optional, under the final regulations it is now required.
3. Employer Optional Amounts:

Post-severance payments of accrued bona fide sick, vacation, and other leave that are paid within the above time frame are *not included* in compensation for plan purposes unless the plan specifically includes such payments. Thus, an employer may, by plan design, exclude this type of post-severance compensation from the definition of compensation under the plan document. In addition, unfunded nonqualified plan payments that would have been received had employment continued may be included as post-severance compensation. The addition of the nonqualified plan provision was a surprise for many practitioners; since these plans only benefit a select group of management and highly compensated employees.

B. Post-Severance Compensation Other Issues

1. Coordination with USERRA

Post-severance payments to an individual who is performing qualified military service [as defined in Section 414(u)] is counted as Section 415 compensation. This applies to the extent such payments do not exceed the amounts the individual would have received had the individual continued to perform services for the employer rather than entering qualified military service (known as differential pay). Such payments are not limited to those made by the end of the 2½-month period or the end of the limitation year period.

2. Permanent Disability

Post-severance payments are also included in the definition of Section 415 compensation for an individual who terminates employment due to total disability. Such payments are also not limited to those made by the end of the 2½-month period or the end of the limitation year period.

**Note:** In addition, a governmental plan may provide that the calendar year that includes the date of severance from employment be substituted for the limitation year that includes the date of severance from employment for this purpose.

3. Plan Amendment Timing

Since the final regulations are effective for limitation years beginning on or after July 1, 2007, calendar year plans must be amended by the end of the 2008 limitation year. Since the timing will probably coincide with the IRS's formal approval of the new preapproved defined contribution document, it appears that an execution of both a restatement onto the EGTRRA document and a snap-on Section 415 amendment will be required. We will keep you posted on this. Unfortunately, we are not allowed to include the Section 415 amendments in the EGTRRA restatements; because the language was not on the 2004 Cumulative List.

SPECIAL

# BACK-TO-BASICS - MODULE 5

## PART THREE - DEDUCTION LIMITS

### I DEFINED CONTRIBUTION PLANS

#### A. 25% Deduction Limit (IRC §404)

Prior to 2002, there were different limits for Profit-Sharing plans. EGTRRA brought parity in the deduction limits for Defined Contribution plans. The deductible limit for Defined Contribution plans is 25% of eligible participant's compensation gross compensation. Thus, there is no need to have a Profit-Sharing plan and a Money Purchase plan in order to achieve the 25%. However, some employer's have maintained the Money Purchase plan as it represents a fixed required contribution that the employees have come to expect. Compensation is subject to the Code §401(a)(17) limit (i.e., \$200,000, as indexed. The history since 2002 is \$200,000 for 2003, \$205,000 for 2004, \$210,000 for 2005, \$220,000 for 2006, \$225,000 for 2007 and \$230,000 for 2008).

**Note:** Compensation for a terminated employee who is not entitled to share in the employer's contribution is not considered for deduction purposes unless the participant was eligible to make elective deferrals.

#### B. Elective Deferrals

1. *Elective deferrals are not included in the 25% employer deduction limit.* Elective deferrals are restricted by either a plan limit, §415 limitations, or by the need for withholding.
2. Elective deferrals are considered employer contributions even though they are not considered part of the employer's 25% deduction.

#### EXAMPLE

##### 2008 Maximum Deductible Contribution

<u>Employee</u>	<u>Actual Compensation</u>	<u>Elective Deferral</u>	<u>Compensation for Deduction</u>
1	\$250,000	\$15,500	\$230,000
2	100,000	8,000	100,000
3	50,000	5,000	50,000
4	30,000	1,500	30,000
5	20,000	500	20,000
		\$30,500	\$430,000
			<u>X.25</u>
			Maximum Contribution
			\$107,500

**Note:** \$107,500 is the maximum deductible employer contribution (discretionary and match). This amount excludes the \$30,500 in employee elective deferrals that are deductible separately.

- C. Amounts paid into the Trust that are in excess of the compensation limit can be carried over and deducted in the next year, as long as the employer's deduction does not exceed the compensation limit in the next year.
- D. Any amounts that are not deductible are subject to a 10% excise tax paid by the employer.
- E. The contribution is either discretionary or required, depending on the plan's terms. An employer does not need to have profits to make a contribution to a profit-sharing plan, although the contribution may be tied to profits. Neither the Profit Sharing nor the Stock Bonus plan is subject to the minimum funding requirements. If there are no profits, contributions will be deducted in later years when there are profits.

## **II DEFINED BENEFIT PLANS DEDUCTION LIMITS**

The deductible amount for a defined benefit plan on an annual basis is the minimum funding standard requirement under §412(a) as determined by the plan's actuary.

## **III COMBINED DEFINED CONTRIBUTION AND DEFINED BENEFIT PLANS DEDUCTION LIMITS PRIOR TO 2006**

Where an employer maintains both a defined contribution and a defined benefit plan, a combined deductible limit is imposed. Prior to 2006, the limit is the greater of:

- A. 25% of compensation paid to all participants in both plans, or
- B. The amount necessary to satisfy the Code §412 minimum funding requirements for the defined benefit plan. If this limit is applied, no contribution may be deducted for the defined contribution plan. Accordingly, plans should be written to prohibit contributions to the DC plan under these circumstances.
- C. Now that elective deferrals are independent of the 25% of compensation DC limit, if the greater amount is the minimum funding requirement, the elective deferrals may still be made to the DC plan.

**Note:** The limit does not apply if no employee benefits under both plans.

## **IV COMBINED DEFINED CONTRIBUTION AND DEFINED BENEFIT PLANS DEDUCTION LIMITS AFTER 2005**

After 2005, the Pension Protection Act changed the deduction rules for an employer who has both a defined benefit plan and a defined contribution plan. The new rules follow.

- A. PPA Change Effective 2006 and 2007

The Pension Protect Act (PPA) modification of the 25% combined Defined Benefit/Defined Contribution (DB/DC) limit allows for a potential increased deduction by employers. Employers who sponsor both DB and DC plans covering the same participants now may make an employer contribution of up to 6% of their participants' compensation to the DC plan in addition to the contribution necessary to fund their DB plan. This will allow the total contribution to exceed the previous 25% combined plan deduction limit.

1. DC Deduction of 6% When DB Minimum Funding Requirement Exceeds 25% of Compensation

For 2006 and 2007, the employer may make a contribution of up to 6% of compensation to a DC plan without the amount being counted towards the 25% limit.

For 2006 and 2007, there is no distinction necessary as to whether a plan is subject to the PBGC or not.

**Note:** Since 2002, elective deferrals have been independent of the 25% of compensation DC limit, if the greater amount is the minimum funding requirement, the elective deferrals may still be made to the DC plan.

2. **Example:** A Doctor age 59 employing two younger NHCEs has a defined benefit plan and a deferral-only 401(k) plan (since deferrals are not included in the deduction limit). Due to the size of the doctor's plan, it is exempt from PBGC coverage.

According to PPA, the allowable deduction limit may exceed the 25% limit that applies to combined DB and DC plans if no more than 6% of compensation is contributed to the DC plan. Therefore, the employer decides to add an enhanced safe harbor matching contribution formula of \$/\$ on the first 6% deferred. (**Note:** The DB numbers are hypothetical and not based on actuarial calculations.)

	<u>Compensation</u>	<u>Age</u>	<u>DB Amount</u>	<u>Actual Deferral</u>	<u>Actual Match</u>
Doctor	225,000	59	68,000	20,500	13,500
NHCE 1	45,000	35	7,000	2,700	2,700
NHCE 2	30,000	27	3,000	1,800	1,800
Totals	300,000		78,000	25,000	18,000

Prior to PPA, the Doctor would have been limited to a tax deduction of \$78,000 for the DB. (The greater of 25% or the DB minimum funding requirement.) After PPA, the deduction for employer contributions increases to \$96,000 with the allowance of a 6% defined contribution plan deduction. Of the additional \$18,000 contribution made to the DC plan, the Doctor's portion is \$13,500.

3. Top Heavy Resolution:

The plans in the above example are both top-heavy. However, because the safe harbor plan only permits deferrals and safe harbor matching contributions, it is exempt from top-heavy requirements. Although the DB plan would not similarly be exempt, in this fact set, the amount of the enhanced match satisfies the DB top-heavy benefit accrual requirement when contributed as an allocation to the DC plan. Note that if participants did not defer at least 5%, then they would have to receive a top-heavy minimum under the DB plan.

B. PPA Change Effective 2008

1. Plans not covered by the PBGC

It is important to note that DB plans that are not covered by the PBGC will continue to be subject to the 25% combined deduction limit but may still make a 6% of compensation deductible contribution to the DC plan without it applying towards the 25% limit in situations where the DB minimum funding requirement exceeds the 25%. Employee elective deferrals continue to be excluded from the deductible contribution calculation (while remaining fully deductible by the employer).

2. Plans Covered by the PBGC

For employers with *DB plans covered by the PBGC*, these plans are no longer subject to the 25% combined DB/DC deduction limit rules. Therefore, DB plans covered by the PBGC may take a deduction for the minimum funding amount even when it exceeds 25% of compensation AND the employer may also take a deduction of up to 25% of compensation for the DC plan.

**Note:** With limited exceptions, most defined benefit plans are covered by Title IV of ERISA and the PBGC. The exceptions are plans of "professional service employers" with 25 or fewer active participants and plans covering only substantial owners and no common law employees.

**THE FOLLOWING IS FOR REFERENCE PURPOSES REGARDING IRS NOTICE 2007-28**

Notice 2007-28 reiterates that the combined defined benefit plan and defined contribution plan deduction limit is the greater of the 25% DC deduction limit or the DB minimum-funding requirement; and that as of 2006, if the DB limit exceeds the 25% DC limit, an employer may still deduct a DC contribution of up to 6% of compensation. Further, in determining the maximum deductible contribution under combined limit multiemployer plans are excluded from the calculation.

The notice also confirms that 401(k) plans are included in the deduction calculation to the extent that matching and/or non-elective employer contributions are made. However, if a 401(k) plan's contributions are limited to elective deferrals only, such a plan is excluded from the deduction calculations.

The notice explains how to handle the situation where the plan year and the employer's taxable year are not the same. The employer has been provided with three alternatives to determine the allowable deduction when this occurs:

- the deductible limit may be determined for the plan year beginning in the taxable year, or
- the deductible limit may be determined for the plan year ending in the taxable year, or
- a weighted average of the above alternatives may be used.

The deduction limits and applicable law in effect for the applicable taxable year will apply in each instance.

The notice contains two examples of this concept.

When calculating the deductible limit under the 2006 changes, the deductible limit is determined as of the valuation date for the plan year, and it is adjusted for earnings to the earlier of the end of plan year or the end of taxable year of the employer. (This example is found in Treas. Reg. §1.404(a)-14(f)(3).)

For plans with 100 or fewer participants, the unfunded current liability will not include liability attributable to benefit increases for HCEs resulting from a plan amendment adopted or that became effective within the last two years. If a new plan is adopted, it will not be treated as a plan amendment if the employer did not maintain a DB plan that covered an HCE during the last two years who is now covered by the new plan. For example, if an HCE was not covered by a DB plan in 2005 or 2004, a new plan established during 2006 would not be penalized by this rule.

Additional changes to allowable deductions for DB funding include the replacement of the current liability limitation under 404(a)(1)(D) with a limitation based on 150% of current liability. Strangely enough, until this Notice was issued, few if any practitioners thought that any employer contribution to the DC plan, even amounts under 6% would cause the loss of the ability to use the 150% limit instead of the current limit. In fact, the situation seems to be even worse. If the employer has a \$1,000,000 eligible payroll and a minimum funding requirement of \$250,000, but a full funding limitation of \$350,000 (without regard to the new 150% rule) it appears under the Notice that the employer could only deduct the \$250,000 minimum and any DC contribution up to 6% of compensation (\$60,000). It seemingly makes no sense to have a rule that just because the employer maintains a DC plan, even one to which it contributes negligible amounts, that the employer can't deduct more than the greater of minimum funding requirement or 25% of compensation, if it could afford in a given year to increase the plan's funding ratio. This interpretation seems to go against what Congress was trying to achieve in PPA. Hopefully, the IRS will reconsider its position or Congress will correct this as part of any technical corrections legislation it takes up.

In addition 404(a)(1)(F) option to use the permissible 30-year rate range instead of the permissible corporate rate range has been eliminated.

The notice defers addressing the PPA deduction changes that are effective as of the 2008 plan year to guidance that will be issued at a later date.

## **V SIMPLIFIED EMPLOYEE PENSION PLANS (SEPS)**

- A. The deductible limit for SEPs is 25% of each eligible employee's compensation.
- B. The deduction for the SEP contribution reduces the amount of deduction otherwise available for contributions to another defined contribution plan.

## **VI YEAR IN WHICH THE CONTRIBUTION IS DEDUCTIBLE**

- A. An employer contribution to a defined contribution plan must be made by the due date of the employer's tax return, plus extensions in order to be deductible for that year. Thus, for example, if a corporate employer's fiscal year is the calendar year, the deadline for making a deductible contribution to the 2007 calendar year plan would be March 15, 2008 (plus extensions if the employer has filed for an extension). The deadline may be extended six months until September 15, 2008. The due date for an individual whose tax year is the calendar year is April 15 (may be extended to October 15).

**Note:** A contribution is considered timely if it is mailed (with postage mark) by the due date of the filing of the tax return. It may actually be received after the due date. U.S. Postal Service or Private Delivery Companies is acceptable.

- B. In some cases, a contribution can be made to the plan after the tax filing due date plus extensions, but it will have to be deducted in the following year. For example, a booster contribution (QNEC) made to a 401(k) plan to help pass the ADP/ACP tests can be made up to 12 months following the close of the plan year. However, the contribution would have to be deducted in the next year if it is made after the tax filing due date for that year.
- C. An employer's plan year does not match its fiscal year. The rule of thumb to remember is that an employer may only deduct contributions based on compensation that is actually paid during the employer's taxable year.

If the employer's fiscal year is different from the Plan Year, Internal Revenue Code §404 states that the contribution is deductible in the tax year that ends with or within the taxable year of the trust. However, the employer may only deduct contributions based on compensation that is actually paid during the employer's tax year.

**Example:** An employer has a fiscal year ending June 30; however its 401(k) plan uses the calendar year as its plan year. The employer received an extension to March 15, 2008 to file its tax return for the fiscal year ending June 30, 2007. On that tax return, the employer claimed a deduction for the entire amount of elective deferrals and matching contributions contributed to the plan during the 2007 calendar year. Although all of the contributions had been made by December 31, 2007 in accordance with plan terms, the IRS disallowed the deduction for any contributions based on compensation earned after June 30, 2007, the last day of the employer's tax year [see Revenue Ruling 90-105].

Mapping out the dates in this example:

1. July 1, 2006 to June 30, 2007 = Employer's 2006 Fiscal Year
2. Jan. 1, 2007 to Dec. 31, 2007 = 401(k) Calendar/Plan Year 2007
3. Employer Deduction for Matching Contributions May Be Taken Only for Matching Contributions Based on Compensation Paid from July 1, 2006 to June 30, 2007.

Thus, the IRS disallowed the deduction for the matching contributions on compensation paid between July 1, 2007 and Dec. 31, 2007.

## VII MINIMUM FUNDING REQUIREMENTS

- A. Both the money purchase plan and the target benefit plan are subject to the Code §412 minimum funding requirements. Simply stated, this means that the annual contribution is required and offers the employer no flexibility in terms of a minimum or maximum. The contribution formula stated in the plan must be followed. With the target benefit plan, the rate of contribution for each participant will vary with age.

- B. Unlike the Profit-Sharing or stock bonus plans, the contribution for these plans can be made up to 8½ months following the close of the plan year. However, only those contributions made by the due date of the tax return plus extensions will be deductible for that plan year. If made after the due date of the tax return plus extensions, the contribution will have to be deducted in the next year.

**Example:** Employer X has a calendar-year money purchase plan. Employer X makes the required contribution for plan year 2007 in August 2008. Employer X's fiscal year is also the calendar year and the corporate tax return for 2007 was filed on March 15, 2008, with no extensions. The 2007 plan contribution, although timely for minimum funding requirements, will have to be deducted on the employer's 2008 tax return.

- C. If the employer can show that making the contribution to the plan would cause temporary substantial business hardship, the employer may make application to the IRS for a waiver of the contribution for that year. Application for such a waiver must be submitted to the IRS no later than 2½ months after the close of the plan year.

SPECIAL

# BACK-TO-BASICS - MODULE 5

## PART FOUR - ANTIALIENATION 401(a)(13) & BANKRUPTCY LAW

### I ANTIALIENATION - GENERAL RULE

One of the special benefits accorded to a qualified retirement plan, such as a 401(k) plan, is the protection from creditors and from court assignments. The Employee Retirement Income Security Act (ERISA) Title I, Section 206(d) protects a participant's assets from creditors. Creditors may not garnish, levy or attach the participant's assets in a qualified retirement plan. A plan that covers more than just an owner-employee and his or her spouse or just partners is provided this ERISA "Title I protection."

If the plan covers one or more "common-law-employees," it has a requirement to distribute Summary Plan Descriptions (SPDs) to the plan participants. Plans with such an SPD requirement are covered under Title I of ERISA and have protection from creditors. This protection also applies to a plan that at any time in the past was subject to the SPD requirement. If the plan no longer has "common-law-employees," the protection remains because it once had "common-law-employees" and was subject to the SPD requirements.

A participant may not assign, pledge or otherwise anticipate his or her benefit under the plan. In addition, the Trustee/Custodian may not recognize an attempt by the participant or by another party to assign, pledge or otherwise access the participant's benefit.

#### A. Participant's Interest in the Plan Excluded from Bankruptcy Estate

The participant's assets in a qualified retirement plan are protected from creditors even in the event of a bankruptcy. If the plan is covered by Title I of ERISA and the plan includes a nonalienation provision that is enforceable under ERISA, the plan is excludable from a bankruptcy estate.

#### B. Exceptions to the ERISA Protection

Of course, there are always exceptions to the rule. A participant's assets are not protected from a federal tax levy or from a Qualified Domestic Relations Order (QDRO). Another exception is the provision to allow the participant's account to be used as collateral for a participant loan from the plan. In addition, once a participant receives a distribution of his or her assets from a qualified plan and places them in another account or investment, creditors may then seek assignment of those assets.

##### 1. IRS Tax Levy Exception

If an IRS tax levy is received on a participant of the plan, the plan must honor the IRS tax levy. However, based on guidance from the IRS, the plan may refuse to honor the processing of a distribution to satisfy the levy if the participant is not yet eligible to receive distributions from the plan. If the participant is eligible to make a distribution, the IRS levy may be processed either with or without the participant's consent after the plan's administrative policies for IRS levies have been completed.

Rarely, in “flagrant and aggravated” cases, IRS policy does provide for enforcement of the levy before the participant is eligible for distribution. The IRS will make it clear if they intend to treat the levy in this manner.

As to taxation of a distribution paid to the IRS via tax levy, the individual will owe income tax on the taxable portion of the distribution. If the individual is under age 59 ½, the 10% premature distribution does not apply. When it comes to state tax levies, the states do not have the same ERISA exception as the federal government, thus, state tax levies cannot be applied against a participant’s qualified retirement plan balance.

## 2. QDRO Exception

As noted above, the Qualified Domestic Relations Order (QDRO) is also an exception. A QDRO is a court order issued subsequent to a divorce or separate maintenance agreement that directs a portion of a participant’s plan assets to be paid to an “alternate payee.” The alternate payee may be the spouse, ex-spouse or dependent children of the participant. A Domestic Relations Order (DRO) must be written according to very specific rules to be considered “qualified.” If it does not meet the qualification requirements, it will have to be returned to the court for revision. Once a DRO has been qualified, the plan administrator must follow its instructions and segregate the affected plan assets or pay the designated sum to the alternate payee(s), as identified in the QDRO. The QDRO rules are quite extensive and a DRO usually requires review by an attorney to ascertain that it meets the requirements to be a QDRO. One of the things a QDRO may not do is require a payment option that is not otherwise available under the plan.

## 3. Court Ordered Payment

A court may issue an order providing for the offset of the participant’s account pursuant to a judgment of conviction of a crime against the plan, a civil judgment or order in connection with a violation of ERISA’s fiduciary rules or a settlement between the participant and the IRS or PBGC in connection with a violation of ERISA’s fiduciary rules.

## 4. Criminal Sentence or “Bad Boy” Clauses Not Permitted

Generally, the terms of a criminal sentence may not order the plan to pay out a participant’s benefits to a third party as restitution, even for a crime committed against the employer.

**Example** - An employee embezzled \$20,000 from the employer. The employer is not permitted to recover the \$20,000 by taking the participant’s 401(k) plan assets because of ERISA protection of retirement benefits. There is a limited exception in cases where the crime was committed against the plan. Had the employee stolen

\$20,000 from plan's assets instead of from the employer, then a Federal court or the U. S. Department of Labor could order the plan administrator to offset the plan's loss against the participant's account. In this case, the participant is presumed to have already received a distribution from the plan for the amount embezzled from the plan.

5. Using A One Time Distribution To Pay A Creditor

If the participant desires, a distribution may be used to pay a creditor provided the participant is eligible to take a distribution, for example, due to termination of employment or the attainment of age 59½. If the participant requests this voluntarily and not under duress, the payment may be assigned to a creditor. Once the participant makes the specific request for this distribution to the third party, the plan administrator will obtain from the third party an acknowledgement that the payment may be made to them.

6. Paying a Creditor From Installment Distributions

A participant who is in installment payout status may assign an amount from the series of installment or annuity distributions. However, ERISA permits no more than 10% of each payment to be paid to a creditor. The assignment must be able to be revoked by the participant.

7. Participant Loan

One half of a participant's vested account balance may be pledged to secure a plan loan to the participant.

**II BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 (BAPCPA)**

A. Under BAPCPA assets held in all qualified retirement plans (such as a 401(k), profit sharing, thrift, money purchase, ESOPs, and defined benefit plans), 403(b) plans, and 457(b) plans of state and local governments will be entirely protected since they are expressly excluded from the bankruptcy estate.

1. Participant loan repayments must be repaid. The law settled a long-standing conflict between ERISA and the Bankruptcy Courts by requiring that plan participant must continue payments on their qualified plan loans rather than suspending them.

2. BAPCPA states that the balance of participants in a plan with its own determination letter is automatically exempt from the bankruptcy estate. Otherwise, the plan must show that:

- a. The IRS or a court has not made a prior determination that the plan is not qualified;
- or

- b. The plan is in substantial compliance with Code Section 401(a); or
- c. If the Plan is not in substantial compliance, the debtor is not responsible for the failure.

B. IRA Bankruptcy Rules

1. One Million Dollars in IRA Excluded

APCPA excludes traditional IRAs and Roth IRAs from the bankruptcy estate, but only up to a \$1 million limit, without regard to rollover amounts.

Although *Rousey v. Jacoway* had settled the issue whether IRAs could be excluded from the bankruptcy estate on the same basis as qualified plans, it did not address the federal bankruptcy law provision regarding the dollar amount that could be excluded. Thus, *Rousey* left intact the rule that an IRA may be excluded from the bankruptcy estate only up to an amount that was reasonably needed for the individual and spouse to live on in retirement. BAPCPA now provides the answer to this remaining question.

2. Amounts Rolled into IRA from a Qualified Plan Have An Unlimited Bankruptcy Exclusion

Under BAPCPA, funds that are rolled over to an IRA from one of the above “qualified” retirement plans are excluded from the bankruptcy estate *entirely*.

**MHC Comment:** Because of this favored status, there may once again be good reasons for a participant to keep rollovers from retirement plans separate from their traditional IRAs and Roth IRAs and to not commingle such assets.

**Note:** Considering the maximum contribution amount for IRA’s has always been between \$1,500 and the \$5,000 current limit, the \$1,000,000 limit set by BAPCPA for IRA assets will provide sufficient protection for these accounts for the foreseeable future.

C. Antialienation Rules Still Apply to Individuals Who Have Not Filed for Bankruptcy

Retirement plan bankruptcy protection rules have changed, but the rules in non-bankruptcy situations have not changed for sole proprietor plans and IRAs.

Thus, if creditors are seeking an IRA or a qualified plan not subject to Title 1 of ERISA (such as sole proprietor plans that cover no “common-law-employees”) that has not filed for bankruptcy, they are only protected to the extent provided by the applicable state law.

D. State Law Versus Federal Law

State insolvency laws will still have a role to play in bankruptcy. Most states require that debtors can only claim the state's exemptions plus those provided under other Federal laws, such as ERISA. Some states permit debtors to choose between exemptions provided under their laws and the Federal law. Therefore, in a situation where state law provides full or greater protection in excess of \$1 million for a traditional IRA, the individual may still choose to apply the state bankruptcy provision. Obviously, this is a decision that should only be made with the advice of legal counsel.

SPECIAL ADVERTISING SECTION

# BACK-TO-BASICS - MODULE 5

## PART FIVE – PLAN INVESTMENTS; EARNINGS & THE TRUST FUND

### I ALLOCATION OF INVESTMENT EARNINGS

Participant recordkeeping and information management systems have changed dramatically in recent years. The principal reasons for the advancement of systems are related to the increasing use of mutual funds as plan investment vehicles and the remarkable advances in data processing and information management software. Today, many plans update participant account balances on a daily basis and provide immediate access to account and investment information via the Internet or a toll free telephone number with an automated voice response service.

#### A. Balance Forward Systems

Traditionally, participant records have been maintained on what is known as a *balance forward* system. Under this type of arrangement, cash transactions are administered in a daily accounting environment. While the fair market value of plan assets is normally available daily, the asset accounting system can be updated at less frequent intervals. Generally, the participant recordkeeping system is not linked to the asset valuation system.

Normally, investments are valued at the plan level on the date on which an asset list is to be prepared. Participant records are maintained on another system that can be updated at any time based on the most recent information available from the asset accounting system. In some cases, participant records are only updated on the anniversary date of the plan. On the other hand, plan asset lists may be prepared as frequently as monthly.

1. There are some advantages to a *balance forward* system:

- a. The recordkeeper can make valuation adjustments to plan assets to reflect accrued income and contributions received after the valuation date.
- b. The trustee has time to determine a value for plan assets, which may not be traded daily.
- c. Account balances and assets do not have to settle daily.
- d. The recordkeeper has flexibility in scheduling workflow.

2. There are also disadvantages:

- a. Participant statements are always prepared after the date on which plan assets are valued. An extended time period results in outdated information.

- b. Any administrative activity requiring the value of a participant's account balance must be based on the last valuation of account balances. This causes problems with respect to participant loans and distributions.

B. How Balance Forward Systems Work

Investment earnings must be allocated on the basis of participant account balances.

Since account balances may change during the plan year as a result of contributions or distributions, the plan must define the account balance for purposes of allocation.

**Example:** The account balance may be defined as the balance at the beginning of the plan year plus ½ of the contributions received during the year minus any distributions made during the year.

Assume for purposes of the following example that the employer has a profit-sharing plan and that no contributions were made to the plan for the 2006 plan year. Investment earnings for the trust fund at the last valuation date for the 2006 plan year were \$3,500.

	Account balance as of last valuation date	Distribution after last valuation date	Account balance for allocation purposes	Allocation of investment earnings
Employee A:	\$37,500	0	\$37,500	\$2,430.55
Employee B:	12,000	4,000	8,000	518.52
Employee C:	8,500	0	8,500	550.93
			\$54,000	\$3,500.00

To determine the amount of earnings allocated to each account, first divide the investment earnings for the Plan Year by total account balances for allocation purposes. The resulting factor is the percentage increase in account balances for the year. (Note that Employee B's distribution must first be subtracted from his or her account balance). The computation for Employee A is as follows:

$$\frac{\$ 3,500}{\$54,000} = .064815 \times \$37,500 = \$2,430.55$$

Allocations for other employees are computed in the same manner.

C. Daily Valuation Systems

In a daily valuation environment, the cash and asset accounting system is combined with or linked to the participant recordkeeping system. Under this arrangement, contributions and investment earnings are allocated to participant accounts when they are credited to the asset accounting system. Asset values are determined daily and are reflected in the price of shares or units credited to participant accounts. This procedure allows the system to determine the value of participant accounts daily. This information can then be accessed daily for administrative and statement purposes. Mutual funds are the preferred investment vehicle in a daily valuation environment since they are valued

daily and the plan can effectively limit the number of securities held without giving up the need for diversification. A plan with many individual holdings would not generally be a good candidate for a daily system.

1. Advantages of a *daily valuation system*:
  - a. Provides immediate access to participant account information.
  - b. Facilitates administrative activities such as determining maximum loan amount and determining account balance for distributions.
  - c. Makes it possible for participants to move from one investment option to another on a daily basis.
  - d. Allows for the preparation of participant statements at any time.
  - e. Facilitates adding services such as account inquiries by means of a toll free number or by electronic means.
  - f. Makes it possible to offer paperless transactions, such as, loans, distributions changes in investments, deferral changes and more.
2. There are disadvantages as well:
  - a. For all practical purposes, plan investments may be limited to mutual funds. Thus, daily valuation plans usually do not offer investments in real estate, life insurance or privately held stock.
  - b. Participant accounts and plans assets must balance daily. There is no opportunity for "as of" adjustments. Corrections and adjustments must be made on a "real time" basis.
  - c. The system must update participant information daily in order to process contributions and allocate funds to the investment options selected by participants.
  - d. The benefits of a daily valuation system may not out weigh the higher costs for a small employer, and this type of system is of less value to an employer who does not offer participant directed investments.

D. Conversion to a Daily Valuation System

Converting to a daily system involves close cooperation between the plan sponsor and the recordkeeper. Here are some of the things to consider:

1. Assets

Will your current plan assets lend themselves to a daily system or will you be required to invest in mutual funds? Are there any special requirements for participant loans?

2. Documentation

Check your document to be sure the valuation and allocation language will work properly with a daily system. Amend the document if there are language problems.

3. Blackout Period

In order to convert, the recordkeeper must update account balances to match the current value of plan assets. When in balance, account balances and plan assets will be adjusted simultaneously. To facilitate the reconciliation, the recordkeeper generally requires that the sponsor make no contributions, that no distributions be made and that no investment changes be processed. The blackout period generally lasts for a period of about 30 business days. This may vary depending upon the service provider and complexity of the plan. The Sarbanes-Oxley Act of 2002 created blackout notice requirements. Sarbanes-Oxley defines a blackout period as more than 3 business days during which any of the following transactions may not be done:

- a. Distribution
- b. Apply for a loan
- c. Transfer investments.

4. Communications

The sponsor should provide participants with an announcement describing the change and the benefits associated therewith. Participants should also be advised that they would not be able to change investments, borrow or request a withdrawal during the blackout period.

E. Looking Ahead

Assuming that the current trend to allow participants to select mutual fund investments continues, the percentage of plans operating in a daily environment will continue to increase. Other factors that will encourage the adoption of daily systems will include:

- 1. Lower costs.
- 2. The growing need to access information daily.
- 3. Investment transfers.
- 4. Account inquiries via toll free numbers and by electronic means.

5. Paperless transactions.

Will plan sponsors continue to have the option to utilize a balance forward system? Yes, but a growing number of financial institutions and recordkeepers are no longer accepting new balance forward clients. As costs continue to decrease, most plan sponsors will want to be in a daily environment.

## II THE TRUST FUND

- A. The fund represents the plan's assets and includes all contributions and investment earnings thereon held by the Trustee/Custodian.
- B. The assets of the fund must be held and administered by the Trustee/Custodian under the terms of the plan.
- C. If "deemed" IRAs are incorporated into the plan design, a separate trust may need to be established to hold the deemed IRA assets. IRA restrictions, such as no loans and no insurance must be followed.
- D. Exclusive Benefit Rule: Trustee/Custodian must hold Plan assets for the exclusive benefit of plan participants and their beneficiaries.
- E. The Trust is generally part of the plan document or it may exist outside the plan document.

## III PLAN INVESTMENTS

- A. Investment Alternatives of the Trustee
  - 1. The Trustee may invest the fund in stocks, bonds, money market instruments, mutual funds, savings accounts and certificates, treasury obligations, insurance contracts and other securities that are readily marketable.
  - 2. The Trustee may also invest the fund in a group or collective fund established by the Trustee for the purpose of pooling the assets of qualified plans for investment purposes.
  - 3. The Trustee may not loan plan assets to the employer or to an officer of the employer.
  - 4. The Trustee may permit the employees to select the allocation of the plan investments in their own account.
- B. Investment Alternatives of the Custodian
  - 1. The Custodian may invest the fund at the direction of the employer in savings accounts, savings certificates and in other savings instruments offered by the Custodian.
  - 2. The Custodial arrangement may be designed for use by the commercial departments of institutions who desire to offer only savings products to retirement plan customers.

C. Special Investment Options

Many plans contain language allowing the employer to offer participant loans, the purchase of individual insurance policies and allow the employer or plan participants to direct investments.

SPECIAL INVESTMENT