AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES

NORMAL TAXES AND SURTAXES (CONTINUED)

DEFERRED COMPENSATION, ETC.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

Sec.
1.401–0 Scope and definitions.
1.401–1 Qualified pension, profit-sharing, and stock bonus plans.
1.401–2 Impossibility of diversion under the trust instrument.
1.401–3 Requirements as to coverage.
1.401–4 Discrimination as to contributions or benefits (before 1994).
1.401–5 Period for which requirements of section 401(a) (3), (4), (5), and (6) are applicable with respect to plans put into effect before September 2, 1974.
1.401–6 Termination of a qualified plan.
1.401–7 Forfeitures under a qualified pension plan.
1.401–8 Custodial accounts prior to January 1, 1974.
1.401–9 Face-amount certificates—nontransferable annuity contracts.
1.401–10 Definitions relating to plans covering self-employed individuals.
1.401–11 General rules relating to plans covering self-employed individuals.
1.401–12 Requirements for qualification of trusts and plans benefiting owner-employees.
1.401–13 Excess contributions on behalf of owner-employees.
1.401–14 Inclusion of medical benefits for retired employees in qualified pension or annuity plans.
1.401(a)–1 Post-ERISA qualified plans and qualified trusts; in general.
1.401(a)–2 Impossibility of diversion under qualified plan or trust.
1.401(a)–4 Optional forms of benefit (before 1994).
1.401(a)–11 Qualified joint and survivor annuities.
1.401(a)–12 Mergers and consolidations of plans and transfers of plan assets.
1.401(a)–13 Assignment or alienation of benefits.
1.401(a)–14 Commencement of benefits under qualified trusts.
1.401(a)–15 Requirement that plan benefits are not decreased on account of certain Social Security increases.
1.401(a)–16 Limitations on benefits and contributions under qualified plans.
1.401(a)–19 Nonforfeitability in case of certain withdrawals.
1.401(a)–20 Requirements of qualified joint and survivor annuity and qualified preretirement survivor annuity.
1.401(a)–30 Limit on elective deferrals.
1.401(a)–50 Puerto Rican trusts; election to be treated as a domestic trust.
1.401(a)(4)–0 Table of contents.
1.401(a)(4)–1 Nondiscrimination requirements of section 401(a)(4).
1.401(a)(4)–2 Nondiscrimination in amount of employer contributions under a defined contribution plan.
1.401(a)(4)–3 Nondiscrimination in amount of employer-provided benefits under a defined benefit plan.
1.401(a)(4)–4 Nondiscriminatory availability of benefits, rights, and features.
1.401(a)(4)–5 Plan amendments and plan terminations.
1.401(a)(4)–6 Contributory defined benefit plans.
1.401(a)(4)–7 Imputation of permitted disparity.
1.401(a)(4)–8 Cross-testing.
1.401(a)(4)–9 Plan aggregation and restructuring.
1.401(a)(4)–10 Testing of former employees.
1.401(a)(4)–11 Additional rules.
1.401(a)(4)–12 Definitions.
1.401(a)(4)–13 Effective dates and fresh-start rules.
1.401(a)(5)–1 Special rules relating to nondiscrimination requirements.
1.401(a)(17)–1 Limitation on annual compensation.
1.401(a)(26)–0 Table of contents.
1.401(a)(26)–1 Minimum participation requirements.
1.401(a)(26)–2 Minimum participation rule.
1.401(a)(26)–3 Rules applicable to a defined benefit plan's prior benefit structure.
1.401(a)(26)–4 Testing former employees.
1.401(a)(26)–5 Employees who benefit under a plan.
1.401(a)(26)–6 Excludable employees.
1.401(a)(26)–7 Testing methods.
1.401(a)(26)–8 Definitions.
1.401(a)(26)–9 Effective dates and transition rules.
1.401(a)(31)–1 Requirement to offer direct rollover of eligible rollover distributions; questions and answers.
1.401(b)–1 Certain retroactive changes in plan.
1.401(e)–1 Definitions relating to plans covering self-employed individuals.
1.401(e)–2 General rules relating to plans covering self-employed individuals.
1.401(e)–3 Requirements for qualification of trusts and plans benefiting owner-employees.

1.401(e)–4 Contributions for premiums on annuity, etc., contracts and transitional rule for certain excess contributions.
1.401(e)–5 Limitation of contribution and benefit bases to first $100,000 of annual compensation in case of plans covering self-employed individuals.
1.401(e)–6 Special rules for shareholder-employers.
1.401(f)–1 Certain custodial accounts and annuity contracts.
1.401(k)–0 Certain cash or deferred arrangements, table of contents.
1.401(k)–1 Certain cash or deferred arrangements.
1.401(l)–0 Table of contents.
1.401(l)–1 Permitted disparity in employer-provided contributions or benefits.
1.401(l)–2 Permitted disparity for defined contribution plans.
1.401(l)–3 Permitted disparity for defined benefit plans.
1.401(l)–4 Special rules for railroad plans.
1.401(l)–5 Overall permitted disparity limits.
1.401(l)–6 Effective dates and transition rules.
1.401(m)–0 Employee and matching contributions, table of contents.
1.401(m)–1 Employee and matching contributions.
1.401(m)–2 Multiple use of alternative limitation.
1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).
1.402(a)(5)–1T Rollovers of partial distributions from qualified trusts and annuities. (Temporary)
1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).
1.402(c)–1 Taxability of beneficiary of certain foreign situs trusts.
1.402(c)–2 Eligible rollover distributions; questions and answers.
1.402(d)–1 Effect of section 402(d).
1.402(e)–1 Certain plan terminations.
1.402(f)–1 Required explanation of eligible rollover distributions; questions and answers.
1.402(g)–0 Limitation on exclusion for elective deferrals, table of contents.
1.402(g)–1 Limitation on exclusion for elective deferrals.
1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.
1.403(a)–2 Capital gains treatment for certain distributions.
1.403(b)–1 Taxability of beneficiary under annuity purchased by a section 501(c)(3) organization or public school.
1.403(b)–2 Eligible rollover distributions; questions and answers.
1.403(c)–1 Taxability of beneficiary under a nonqualified annuity.
1.403(d)–1 Taxability of employee when rights under contracts purchased by exempt organizations change from forfeitable to nonforfeitable.
1.404(a)–1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.
1.404(a)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for employees. (Temporary)
1.404(a)–2 Information to be furnished by employer claiming deductions; taxable years ending before December 31, 1971.
1.404(a)–2A Information to be furnished by employer; taxable years ending on or after December 31, 1971, and before December 31, 1975.
1.404(a)–3 Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 401(a); application of section 404(a)(1).
1.404(a)–4 Pension and annuity plans; limitations under section 404(a)(1)(A).
1.404(a)–5 Pension and annuity plans; limitations under section 404(a)(1)(B).
1.404(a)–6 Pension and annuity plans; limitations under section 404(a)(1)(C).
1.404(a)–7 Pension and annuity plans; contributions in excess of limitations under section 404(a)(1); application of section 404(a)(1)(D).
1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).
1.404(a)(8)–1T Deductions for plan contributions on behalf of self-employed individuals. (Temporary)
1.404(a)–9 Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).
1.404(a)–10 Profit-sharing plan of an affiliated group; application of section 404(a)(3)(B).
1.404(a)–11 Trusts created or organized outside the United States; application of section 404(a)(4).
1.404(a)–12 Contributions of an employer under a plan that does not meet the requirements of section 401(a); application of section 404(a)(5).
1.404(a)–13 Contributions of an employer where deductions are allowable under section 404(a) (1) or (2) and also under section 404(a)(3); application of section 404(a)(7).
1.404(a)–14 Special rules in connection with the Employee Retirement Income Security Act of 1974.
1.404(b)–1 Method of contribution, etc., having the effect of a plan; effect of section 404(b).
1.404(b)–1T Method or arrangement of contributions, etc., deferring the receipt of

compensation or providing for deferred benefits. (Temporary)
1.404(c)–1 Certain negotiated plans; effect of section 404(c).
1.404(d)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for independent contractors. (Temporary)
1.404(e)–1 Contributions on behalf of a self-employed individual to or under a pension, annuity, or profit-sharing plan meeting the requirements of section 401; application of section 404(a) (8), (9), and (10) and section 404 (e) and (f).
1.404(e)–1A Contributions on behalf of a self-employed individual to or under a qualified pension, annuity, or profit-sharing plan.
1.404(g)–1 Deduction of employer liability payments.
1.404(k)–1T Questions and answers relating to the deductibility of certain dividend distributions. (Temporary)
1.405–1 Qualified bond purchase plans.
1.405–2 Deduction of contributions to qualified bond purchase plans.
1.405–3 Taxation of retirement bonds.
1.406–1 Treatment of certain employees of foreign subsidiaries as employees of the domestic corporation.
1.407–1 Treatment of certain employees of domestic subsidiaries engaged in business outside the United States as employees of the domestic parent corporation.
1.408–1 General rules.
1.408–2 Individual retirement accounts.
1.408–3 Individual retirement annuities.
1.408–4 Treatment of distributions from individual retirement arrangements.
1.408–5 Annual reports by trustees or issuers.
1.408–6 Disclosure statements for individual retirement arrangements.
1.408–7 Reports on distributions from individual retirement plans.
1.408A–0 Roth IRAs; table of contents.
1.408A–1 Roth IRAs in general.
1.408A–2 Establishing Roth IRAs.
1.408A–3 Contributions to Roth IRAs.
1.408A–4 Converting amounts to Roth IRAs.
1.408A–5 Recharacterized contributions.
1.408A–6 Distributions.
1.408A–7 Reporting.
1.408A–8 Definitions.
1.408A–9 Effective date.
1.409–1 Retirement bonds.
1.410(a)–1 Minimum participation standards; general rules.
1.410(a)–2 Effective dates.
1.410(a)–3 Minimum age and service conditions.
1.410(a)–3T Minimum age and service conditions (temporary).
1.410(a)–4 Maximum age conditions and time of participation.
1.410(a)–5 Year of service; break in service.
1.410(a)–6 Amendment of break in service rules; transition period.
1.410(a)–7 Elapsed time.
1.410(a)–8 Five consecutive 1-year breaks in service, transitional rules under the Retirement Equity Act of 1984.
1.410(a)–8T Year of service; break in service (temporary).
1.410(a)–9 Maternity and paternity absence.
1.410(a)–9T Elapsed time (temporary).
1.410(b)–0 Table of contents.
1.410(b)–1 Minimum coverage requirements (before 1994).
1.410(b)–2 Minimum coverage requirements (after 1993).
1.410(b)–3 Employees and former employees who benefit under a plan.
1.410(b)–4 Nondiscriminatory classification test.
1.410(b)–5 Average benefit percentage test.
1.410(b)–6 Excludable employees.
1.410(b)–7 Definition of plan and rules governing plan disaggregation and aggregation.
1.410(b)–8 Additional rules.
1.410(b)–9 Definitions.
1.410(b)–10 Effective dates and transition rules.
1.410(d)–1 Election by church to have participation, vesting, funding, etc. provisions apply.
1.411(a)–1 Minimum vesting standards; general rules.
1.411(a)–2 Effective dates.
1.411(a)–3 Vesting in employer-derived benefits.
1.411(a)–3T Vesting in employer-derived benefits (temporary).
1.411(a)–4 Forfeitures, suspensions, etc.
1.411(a)–4T Forfeitures, suspensions, etc. (temporary).
1.411(a)–5 Service included in determination of nonforfeitable percentage.
1.411(a)–6 Year of service; hours of service; breaks in service.
1.411(a)–7 Definitions and special rules.
1.411(a)–8 Changes in vesting schedule.
1.411(a)–8T Changes in vesting schedule (temporary).
1.411(a)–9 Amendment of break in service rules; transitional period.
1.411(a)–11 Restriction and valuation of distributions.
1.411(b)–1 Accrued benefit requirements.
1.411(c)–1 Allocation of accrued benefits between employer and employee contributions.
1.411(d)–1 Coordination of vesting and discrimination requirements. [Reserved]
1.411(d)–2 Termination or partial termination; discontinuance of contributions.
1.411(d)–3 Other special rules.
1.411(d)–4 Section 411(d)(6) protected benefits.
1.411(d)–5 Class year plans; plan years beginning after October 22, 1986.
1.411(d)–6 Section 204(h) notice.

1.412(b)–2 Amortization of experience gains in connection with certain group deferred annuity contracts.
1.412(b)–5 Election of the alternative amortization method of funding.
1.412(c)(1)–1 Determinations to be made under funding method—terms defined.
1.412(c)(1)–2 Shortfall method.
1.412(c)(1)–3 Applying the minimum funding requirements to restored plans.
1.412(c)(1)–3T Applying the minimum funding requirements to restored plans (temporary).
1.412(c)(2)–1 Valuation of plan assets; reasonable actuarial valuation methods.
1.412(c)(3)–1 Reasonable funding methods.
1.412(c)(3)–2 Effective dates and transitional rules relating to reasonable funding methods.
1.412(i)–1 Certain insurance contract plans.
1.413–1 Special rules for collectively bargained plans.
1.413–2 Special rules for plans maintained by more than one employer.
1.414(b)–1 Controlled group of corporations.
1.414(c)–1 Commonly controlled trades or businesses.
1.414(c)–2 Two or more trades or businesses under common control.
1.414(c)–3 Exclusion of certain interests or stock in determining control.
1.414(c)–4 Rules for determining ownership.
1.414(c)–5 Effective date.
1.414(e)–1 Definition of church plan.
1.414(f)–1 Definition of multiemployer plan.
1.414(g)–1 Definition of plan administrator.
1.414(l)–1 Mergers and consolidations of plans or transfers of plan assets.
1.414(q)–1 Highly compensated employee.
1.414(q)–1T Highly compensated employee (temporary).
1.414(r)–0 Table of contents.
1.414(r)–1 Requirements applicable to qualified separate lines of business.
1.414(r)–2 Line of business.
1.414(r)–3 Separate line of business.
1.414(r)–4 Qualified separate line of business—fifty-employee and notice requirements.
1.414(r)–5 Qualified separate line of business—administrative scrutiny requirement—safe harbors.
1.414(r)–6 Qualified separate line of business—administrative scrutiny requirement—individual determinations.
1.414(r)–7 Determination of the employees of an employer's qualified separate lines of business.
1.414(r)–8 Separate application of section 410(b).
1.414(r)–9 Separate application of section 401(a)(26).
1.414(r)–10 Separate application of section 129(d)(8). [Reserved]
1.414(r)–11 Definitions and special rules.
1.414(s)–1 Definition of compensation.
1.415–1 General rules with respect to limitations on benefits and contributions under qualified plans.
1.415–2 Definitions and special rules.
1.415–3 Limitations for defined benefit plans.
1.415–4 Transitional rule for defined benefit plans.
1.415–5 Cost of living adjustments for defined benefit plans.
1.415–6 Limitation for defined contribution plans.
1.415–7 Limitation in case of defined benefit and defined contribution plan for same employee.
1.415–8 Combining and aggregating plans.
1.415–9 Disqualification of plans and trusts.
1.415–10 Special aggregation rules.
1.416–1 Questions and answers on top-heavy plans.
1.417(e)–1 Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417.
1.417(e)–1T Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417. (Temporary)
1.419–1T Treatment of welfare benefit funds. (Temporary)
1.419A–1T Qualified asset account limitation of additions to account. (Temporary)
1.419A–2T Qualified asset account limitation for collectively bargained funds. (Temporary)
1.420–1 Significant reduction in retiree health coverage during the cost maintenance period.

CERTAIN STOCK OPTIONS

1.421–1 Effective dates and meaning and use of certain terms.
1.421–2 Restricted stock option.
1.421–3 Exercise of restricted stock option.
1.421–4 Modification, extension, or renewal.
1.421–5 Operation of section 421.
1.421–6 Options to which section 421 does not apply.
1.421–7 Meaning and use of certain terms.
1.421–8 General rules.
1.422–4 Qualified stock options (prior law).
1.422–5 Stockholder approval of incentive stock option plans.
1.423–1 Applicability of section 421(a).
1.423–2 Employee stock purchase plan defined.
1.425–1 Definitions and special rules applicable to statutory options.

AUTHORITY: 26 U.S.C. 7805.

§ 1.401–12 also issued under 26 U.S.C. 401(d)(1).

§ 1.401(a)(5)–1 also issued under 26 U.S.C. 401(a)(5).

§ 1.401(a)(17)–1 also issued under 26 U.S.C. 401(a)(17).

§§ 1.401(a)(26)–1 through (a)(26)–9 also issued under 26 U.S.C. 401(a)(26).

§ 1.401(b)–1 also issued under 26 U.S.C. 401(b).

§ 1.401(l)–0 through 1.401(l)–6 also issued under 26 U.S.C. 401(l).
§ 1.408A–1 also issued under 26 U.S.C. 408A.
§ 1.408A–2 also issued under 26 U.S.C. 408A.
§ 1.408A–3 also issued under 26 U.S.C. 408A.
§ 1.408A–4 also issued under 26 U.S.C. 408A.
§ 1.408A–5 also issued under 26 U.S.C. 408A.
§ 1.408A–6 also issued under 26 U.S.C. 408A.
§ 1.408A–7 also issued under 26 U.S.C. 408A.
§ 1.408A–8 also issued under 26 U.S.C. 408A.
§ 1.408A–9 also issued under 26 U.S.C. 408A.
§§ 1.410(b)–2 through 1.410(b)–10 also issued under 26 U.S.C. 410(b)(6).
§ 1.411(a)–7 also issued under 26 U.S.C. 411(a)(7)(B)(i).
§ 1.411(d)–4 also issued under 26 U.S.C. 411(d)(6).
§ 1.411(d)–6 is issued under Reorganization Plan No. 4 of 1978, 29 U.S.C. 1001nt.
§§ 1.414(c)–1 through 1.414(c)–5 also issued under 26 U.S.C. 414(c).
§ 1.414(q)–1T is also issued under 26 U.S.C. 414(q).
§§ 1.414(r)–0 through 1.414(r)–7 also issued under 26 U.S.C. 414(r).
§ 1.414(r)–8 also issued under 26 U.S.C. 410(b) and 414(r).
§ 1.414(r)–9 also issued under 26 U.S.C. 401(a)(26) and 414(r).
§ 1.414(r)–10 also issued under 26 U.S.C. 129 and 414(r).
§ 1.414(r)–1 also issued under 26 U.S.C. 414(r).
§ 1.414(s)–1 also issued under 26 U.S.C. 414(s).
§ 1.417(e)–1 also issued under 26 U.S.C. 417(e)(3)(A)(ii)(II).
§ 1.417(e)–1T also issued under 26 U.S.C. 417(e)(3)(A)(ii)(II).
§ 1.420–1 also issued under 26 U.S.C. 420(c)(3)(E).

DEFERRED COMPENSATION, ETC.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

§ 1.401–0 Scope and definitions.

(a) *In general.* Sections 1.401 through 1.401–14 (inclusive) reflect the provisions of section 401 prior to amendment by the Employee Retirement Income Security Act of 1974. The sections following § 1.401–14 and preceding § 1.402(a)–1 (hereafter referred to in this section as the ''Post-ERISA Regulations'') reflect the provisions of section 401 after amendment by such Act.

(b) *Definitions.* For purposes of the Post-ERISA regulations—

(1) *Qualified plan.* The term ''qualified plan'' means a plan which satisfies the requirements of section 401(a).

(2) *Qualified trust.* The term ''qualified trust'' means a trust which satisfies the requirements of section 401(a).

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42320, Aug. 23, 1977]

§ 1.401–1 Qualified pension, profit-sharing, and stock bonus plans.

(a) *Introduction.* (1) Sections 401 through 405 relate to pension, profit-sharing, stock bonus, and annuity plans, compensation paid under a deferred-payment plan, and bond purchase plans. Section 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

(2) A qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer—

(i) In the case of a pension plan, to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to profits (see paragraph (b)(1)(i) of this section);

(ii) In the case of a profit-sharing plan, to enable employees or their beneficiaries to participate in the profits of the employer's trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a)(3)(B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan (see paragraph (b)(1)(ii) of this section); and

(iii) In the case of a stock bonus plan, to provide employees or their beneficiaries benefits similar to those of profit-sharing plans, except that such benefits are distributable in stock of the employer, and that the contributions by the employer are not necessarily dependent upon profits. If the employer's contributions are dependent upon profits, the plan may enable employees or their beneficiaries to participate not only in the profits of the employer, but also in the profits of an affiliated employer who is entitled to deduct his contributions to the plan

under section 404(a)(3)(B) (see paragraph (b)(1)(iii) of this section).

(3) In order for a trust forming part of a pension, profit-sharing, or stock bonus plan to constitute a qualified trust under section 401(a), the following tests must be met:

(i) It must be created or organized in the United States, as defined in section 7701(a)(9), and it must be maintained at all times as a domestic trust in the United States;

(ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries (see paragraph (b)(2) through (5) of this section);

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan, and, in the case of a plan which covers (as defined in paragraph (a)(2) of § 1.401–10) any self-employed individual, the time and method of such distribution must satisfy the requirements of section 401(a)(9) with respect to each employee covered by the plan (see paragraph (e) of § 1.401–11);

(iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries (see § 1.401–2);

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees (see § 1.401–3 and, in addition, see § 1.401–12 for special rules as to plans covering owner-employees);

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees (see § 1.401–4);

(vii) It must be part of a plan which provides the nonforfeitable rights described in section 401(a)(7) (see § 1.401–6);

(viii) If the trust forms part of a pension plan, the plan must provide that forfeitures must not be applied to increase the benefits any employee would receive under such plan (see § 1.401–7);

(ix) It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in section 401(a)(10) and (d).

(4) For taxable years beginning after December 31, 1962, self-employed individuals may be included in qualified plans. See §§ 1.401–10 through 1.401–13.

(b) *General rules.* (1)(i) A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants (see § 1.401–7, relating to the treatment of forfeitures under a qualified pension plan). A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or

benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14).

(ii) A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant. A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under section 401(a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. For the rules with respect to discrimination, see §§ 1.401–3 and 1.401–4. A profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

(iii) A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan.

(iv) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(2) The term ''plan'' implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the case of a profit-sharing plan, other than a profit-sharing plan which covers employees and owner-employees (see section 401(d)(2)(B)), it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees. In the event a plan is abandoned, the employer should promptly notify the district director, stating the circumstances which led to the discontinuance of the plan.

(3) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify as a plan for the exclusive benefit of employees even though other employees who are not shareholders are also included under the plan. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan

is not for the exclusive benefit of employees in general if, by any device whatever, it discriminates either in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 401(a) (3), (4), and (5). Similarly, a stock bonus or profit-sharing plan is not a plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not only with the form of a plan but also with its effects in operation. For example, section 401(a)(5) specifies certain provisions which of themselves are not discriminatory. However, this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(4) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the Armed Forces of the United States. A plan covering only former employees may qualify under section 401(a) if it complies with the provisions of section 401(a)(3)(B), with respect to coverage, and section 401(a)(4), with respect to contributions and benefits, as applied to all of the former employees. The term ''beneficiaries'' of an employee within the meaning of section 401 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plan after the death of the employee.

(5)(i) No specific limitations are provided in section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, such a trust will be subject to tax under section 511 with respect to any ''unrelated business taxable income'' (as defined in section 512) realized by it from its investments.

(ii) Where the trust funds are invested in stock or securities of, or loaned to, the employer or other person described in section 503(b), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. The trustee shall report any of such investments on the return which under section 6033 it is required to file and shall with respect to any such investment furnish the information required by such return. See § 1.6033–1.

(c) *Portions of years.* A qualified status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 401(a)(6) and § 1.401–3.

(d) *Plan of several employers.* A trust forming part of a plan of several employers for their employees will be qualified if all the requirements are otherwise satisfied.

(e) *Determination of exemptions and returns.* (1) An employees' trust may request a determination letter as to its qualification under section 401 and exemption under section 501. For the procedure for obtaining such a determination letter see paragraph (l) of § 601.201 of this chapter (Statement of Procedural Rules).

(2) A trust which qualifies under section 401(a) and which is exempt under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. See §§ 1.6033–1 and 1.6033–2(a)(3). In case such a trust realizes any unrelated business taxable income, as defined in section 512, such trust is also required to file a return with respect to such income. See paragraph (e) of § 1.6012–2 and paragraph

(a)(5) of § 1.6012–3 for requirements with respect to such returns. For information required to be furnished periodically by an employer with respect to the qualification of a plan, see §§ 1.404(a)–2, 1.404(a)–2A, and 1.6033–2(a)(2)(ii)*(i)*.

[T.D. 6500, 25 FR 11670, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10118, Sept. 17, 1963; T.D. 6722, 29 FR 5071, Apr. 14, 1964; T.D. 7168, 37 FR 5024, Mar. 9, 1972; T.D. 7428, 41 FR 34619, Aug. 16, 1976]

§ 1.401–2 Impossibility of diversion under the trust instrument.

(a) *In general.* (1) Under section 401(a)(2) a trust is not qualified unless under the trust instrument it is impossible (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries. This section does not apply to funds of the trust which are allocated to provide medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14. For the rules prohibiting diversion of such funds and the requirement of reversion to the employer after satisfaction of all liabilities under the medical benefits account, see paragraph (c) (4) and (5) of § 1.401–14. For rules permitting reversion to the employer of amounts held in a section 415 suspense acount, see § 1.401(a)–2(b).

(2) As used in section 401(a)(2), the phrase ''if under the trust instrument it is impossible'' means that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. Although it is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries.

(3) As used in section 401(a)(2), the phrase ''purposes other than for the exclusive benefit of his employees or their beneficiaries'' includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) *Meaning of* ''*liabilities*''. (1) The intent and purpose in section 401(a)(2) of the phrase ''prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust'' is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust. A balance due to an ''erroneous actuarial computation'' is the surplus arising because actual requirements differ from the expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan and were made by a person competent to make such determinations in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation.

(2) The term ''liabilities'' as used in section 401(a)(2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute ''liabilities'' within the meaning of that term. It must be impossible for the employer (or other non employee) to recover any amounts other than such amounts as remain in the trust because of ''erroneous actuarial computations'' after the satisfaction of all fixed and contingent obligations. Furthermore, the trust instrument must contain a definite affirmative provision to this effect, irrespective of whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and regardless of whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

[T.D. 6500, 25 FR 11672, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5072, Apr. 14, 1964; T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401–3 Requirements as to coverage.

(a)(1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be qualified unless it is part of a plan which satisfies the coverage requirements of section 401(a)(3). However, if the plan covers any individual who is an owner- employee, as defined in section 401(c)(3), the requirements of section 401(a)(3) and this section are not applicable to such plan, but the plan must satisfy the requirements of section 401(d) (see § 1.401–12).

(2) The percentage requirements in section 401(a)(3)(A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(3) The application of section 401(a)(3)(A) may be illustrated by the following example:

Example. A corporation adopts a plan at a time when it has 1,000 employees. The plan provides that all full-time employees who have been employed for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires participating employees to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been employed for a period of two years. Fifty of the employees were seasonal employees whose customary employment did not exceed five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment did not exceed 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. The requirements of section 401(a)(3)(A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to whom the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	81+%
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 401(a)(3)(A), it may still qualify under section 401(a)(3)(B) provided always that (as required by section 401(a) (3) and (4)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Since, for the purpose of section 401, a profit-sharing plan is a plan

which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, employees who receive the amounts allocated to their accounts before the expiration of such a period of time or the occurrence of such a contingency shall not be considered covered by a profit-sharing plan in determining whether the plan meets the coverage requirements of section 401(a)(3) (A) and (B). Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit- sharing plan for them, the employees who receive the shares immediately shall not, for the purpose of section 401, be considered covered by a profit-sharing plan.

(d) Section 401(a)(5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 401(a)(3)(B) even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided the effect of covering only such employees does not discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees, and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirements of section 401(a)(3)(B). Conversely, if a contributory plan is offered to all of the employees but the contributions required of the employee participants are so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(e)(1) Section 401(a)(5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of section 401(a)(3)(B) merely because all employees whose entire annual remuneration constitutes ''wages'' under section 3121(a)(1) (for purposes of the Federal Insurance Contributions Act, chapter 21 of the Code) are excluded from the plan. A reference to section 3121(a)(1) for years after 1954 shall be deemed a reference to section 1426(a)(1) of the Internal Revenue Code of 1939 for years before 1955. This provision, in conjunction with section 401(a)(3)(B), is intended to permit the qualification of plans which supplement the old-age, survivors, and disability insurance benefits under the Social Security Act (42 U.S.C. ch. 7). Thus, a classification which excludes all employees whose entire remuneration constitutes ''wages'' under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from wages under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in making his determination with respect to discrimination in classification under section 401(a)(3)(B), the Commissioner will consider whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). If, therefore, a classification of employees under a plan results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below any such salary amount or rate, it may be found to be discriminatory within the meaning of section 401(a)(3)(B). If, however, the relative or proportionate differences in benefits which result from such classification are approximately offset by the old-age, survivors, and disability insurance benefits which are provided by the Social Security Act

and which are not attributable to employee contributions under the Federal Insurance Contributions Act, the plan will be considered to be properly integrated with the Social Security Act and will, therefore, not be considered discriminatory.

(2)(i) For purposes of determining whether a plan is properly integrated with the Social Security Act, the amount of old-age, survivors, and disability insurance benefits which may be considered as attributable to employer contributions under the Federal Insurance Contributions Act is computed on the basis of the following:

(A) The rate at which the maximum monthly old-age insurance benefit is provided under the Social Security Act is considered to be the average of *(1)* the rate at which the maximum benefit currently payable under the Act (i.e., in 1971) is provided to an employee retiring at age 65, and *(2)* the rate at which the maximum benefit ultimately payable under the Act (i.e., in 2010) is provided to an employee retiring at age 65. The resulting figure is 43 percent of the average monthly wage on which such benefit is computed.

(B) The total old-age, survivors, and disability insurance benefits with respect to an employee is considered to be 162 percent of the employee's old-age insurance benefits. The resulting figure is 70 percent of the average monthly wage on which it is computed.

(C) In view of the fact that social security benefits are funded through equal contributions by the employer and employee, 50 percent of such benefits is considered attributable to employer contributions. The resulting figure is 35 percent of the average monthly wage on which the benefit is computed.

Under these assumptions, the maximum old-age, survivors, and disability insurance benefits which may be attributed to employer contributions under the Federal Insurance Contributions Act is an amount equal to 35 percent of the earnings on which they are computed. These computations take into account all amendments to the Society Security Act through the Social Security Amendments of 1971 (85 Stat. 6). It is recognized, however, that subsequent amendments to this Act may increase the percentages described in (A) or (B) of this subdivision (i), or both. If this occurs, the method used in this subparagraph for determining the integration formula may result in a figure under (C) of this subdivision (i) which is greater than 35 percent and a plan could be amended to adopt such greater figure in its benefit formula. In order to minimize future plan amendments of this nature, an employer may anticipate future changes in the Social Security Act by immediately utilizing such a higher figure, but not in excess of 37½ percent, in developing its benefit formula.

(ii) Under the rules provided in this subparagraph, a classification of employees under a noncontributory pension or annuity plan which limits coverage to employees whose compensation exceeds the applicable integration level under the plan will not be considered discriminatory within the meaning of section 401(a)(3)(B), where:

(A) The integration level applicable to an employee is his covered compensation, or is *(1)* in the case of an active employee, a stated dollar amount uniformly applicable to all active employees which is not greater than the covered compensation of any active employee, and *(2)* in the case of a retired employee an amount which is not greater than his covered compensation. (For rules relating to determination of an employee's covered compensation, see subdivision (iv) of this subparagraph.)

(B) The rate at which normal annual retirement benefits are provided for any employee with respect to his average annual compensation in excess of the plan's integration level applicable to him does not exceed 37½ percent.

(C) Average annual compensation is defined to mean the average annual compensation over the highest 5 consecutive years.

(D) There are no benefits payable in case of death before retirement.

(E) The normal form of retirement benefits is a straight life annuity, and if there are optional forms, the benefit payments under each optional form are actuarially equivalent to benefit payments under the normal form.

(F) In the case of any employee who reaches normal retirement age before

completion of 15 years of service with the employer, the rate at which normal annual retirement benefits are provided for him with respect to his average annual compensation in excess of the plan's integration level applicable to him does not exceed 2½ percent for each year of service.

(G) Normal retirement age is not lower than age 65.

(H) Benefits payable in case of retirement or any other severance of employment before normal retirement age cannot exceed the actuarial equivalent of the maximum normal retirement benefits, which might be provided in accordance with (A) through (G) of this subdivision (ii), multiplied by a fraction, the numerator of which is the actual number of years of service of the employee at retirement or severance, and the denominator of which is the total number of years of service he would have had if he had remained in service until normal retirement age. A special disabled life mortality table shall not be used in determining the actuarial equivalent in the case of severance due to disability.

(iii) (A) If a plan was properly integrated with old-age and survivors insurance benefits on July 5, 1968 (hereinafter referred to as an ''existing plan''), then, notwithstanding the fact that such plan does not satisfy the requirements of subdivision (ii) of this subparagraph, it will continue to be considered properly integrated with such benefits until January 1, 1972. Such plan will be considered properly integrated after December 31, 1971, so long as the benefits provided under the plan for each employee equal the sum of—

(1) The benefits to which he would be entitled under a plan which, on July 5, 1968, would have been considered properly integrated with old-age and survivors insurance benefits, and under which benefits are provided at the same (or a lesser) rate with respect to the same portion of compensation with respect to which benefits are provided under the existing plan, multiplied by the percentage of his total service with the employer performed before a specified date not later than January 1, 1972; and

(2) The benefits to which he would be entitled under a plan satisfying the requirements of subdivision (ii) of this subparagraph, multiplied by the percentage of his total service with the employer performed on and after such specified date.

(B) A plan which, on July 5, 1968, was properly integrated with old-age and survivors insurance benefits will not be considered not to be properly integrated with such benefits thereafter merely because such plan provides a minimum benefit for each employee (other than an employee who owns, directly or indirectly, stock possessing more than 10 percent of the total combined voting power or value of all classes of stock of the employer corporation) equal to the benefit to which he would be entitled under the plan as in effect on July 5, 1968, if he continued to earn annually until retirement the same amount of compensation as he earned in 1967.

(C) If a plan was properly integrated with old-age and survivors insurance benefits on May 17, 1971, notwithstanding the fact that such plan does not satisfy the requirements of subdivision (ii) of this subparagraph, it will continue to be considered properly integrated with such benefits until January 1, 1972.

(iv) For purposes of this subparagraph, an employee's covered compensation is the amount of compensation with respect to which old-age insurance benefits would be provided for him under the Social Security Act (as in effect at any uniformly applicable date occurring before the employee's separation from the service) if for each year until he attains age 65 his annual compensation is at least equal to the maximum amount of earnings subject to tax in each such year under the Federal Insurance Contributions Act. A plan may provide that an employee's covered compensation is the amount determined under the preceding sentence rounded to the nearest whole multiple of a stated dollar amount which does not exceed $600.

(v) In the case of an integrated plan providing benefits different from those described in subdivision (ii) or (iii) (whichever is applicable) of this subparagraph, or providing benefits related to years of service, or providing

benefits purchasable by stated employer contributions, or under the terms of which the employees contribute, or providing a combination of any of the foregoing variations, the plan will be considered to be properly integrated only if, as determined by the Commissioner, the benefits provided thereunder by employer contributions cannot exceed in value the benefits described in subdivision (ii) or (iii) (whichever is applicable) of this subparagraph. Similar principles will govern in determining whether a plan is properly integrated if participation therein is limited to employees earning in excess of amounts other than those specified in subdivision (iv) of this subparagraph, or if it bases benefits or contributions on compensation in excess of such amounts, or if it provides for an offset of benefits otherwise payable under the plan on account of old-age, survivors, and disability insurance benefits. Similar principles will govern in determining whether a profit-sharing or stock bonus plan is properly integrated with the Social Security Act.

(3) A plan supplementing the Social Security Act and excluding all employees whose entire annual remuneration constitutes ''wages'' under section 3121(a)(1) will not, however, be deemed discriminatory merely because, for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month.

(4) Similar considerations, to the extent applicable in any case, will govern classifications under a plan supplementing the benefits provided by other Federal or State laws. See section 401(a)(5).

(5) If a plan provides contributions or benefits for a self-employed individual, the rules relating to the integration of such a plan with the contributions or benefits under the Social Security Act are set forth in paragraph (c) of § 1.401–11 and paragraph (h) of § 1.401–12.

(6) This paragraph (e) does not apply to plan years beginning on or after January 1, 1989.

(f) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 401(a)(3), in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 401(a).

(g) It is provided in section 401(a)(6) that a plan will satisfy the requirements of section 401(a)(3), if on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 401(a)(3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 401(a)(3).

[T.D. 6500, 25 FR 11672, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10119, Sept. 17, 1963; T.D. 6982, 33 FR 16499, Nov. 13, 1968; T.D. 7134, 36 FR 13592, July 22, 1971; 36 FR 13990, July 29, 1971; T.D. 8359, 56 FR 47614, Sept. 19, 1991]

§ 1.401–4 Discrimination as to contributions or benefits (before 1994).

(a)(1)(i) In order to qualify under section 401(a), a trust must not only meet the coverage requirements of section 401(a)(3), but, as provided in section 401(a)(4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan.

(ii) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, any amount allocated to an employee which is withdrawn before the expiration of such a period of time or the occurrence of such a contingency shall

not be considered in determining whether the contributions under the plan discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. Thus, in case a plan permits employees to receive immediately the whole or any part of the amounts allocated to their accounts, or to have the whole or any part of such amounts paid to a profit-sharing plan for them, any amounts which are received immediately shall not, for the purpose of section 401, be considered contributed to a profit-sharing plan.

(iii) Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see § 1.401–7.

(2)(i) Section 401(a)(5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 401 a) (3) or (4). See § 1.401–3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act (chapter 21 of the Code) differ from the contributions or benefits based on any excess of such annual compensation over such part. With regard to the application of the rules of section 401(a)(5) in the case of a plan which benefits a self-employed individual, see paragraph (c) of § 1.401–11.

(ii) The exceptions specified in section 401(a)(5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits.

(iii) Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of an allocation formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes all employees whose entire remuneration constitutes wages under section 3121(a)(1) (relating to the Federal Insurance Contributions Act), or a plan under which the contributions or benefits based on that part of an employee's remuneration which is excluded from ''wages'' under such act differs from the contributions or benefits based on that part of the employee's remuneration which is not so excluded, or a plan under which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 401(a).

(c)(1) Although a qualified plan may provide for termination at will by the employer or discontinuance of contributions thereunder, this will not of itself prevent a trust from being a qualified trust. However, a qualified pension plan must expressly incorporate provisions which comply with the restrictions contained in subparagraph (2) of this paragraph at the time the plan is established, unless (i) it is reasonably certain at the inception of the plan that such restrictions would not affect the amount of contributions which may be used for the benefit of any employee, or (ii) the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of any early termination of the plan. Although these provisions are the only provisions required to be incorporated in the plan to prevent the discrimination that may arise because of an early termination of the plan, the plan may in operation result in the discrimination prohibited by section

401(a)(4), unless other provisions are later incorporated in the plan. Any pension plan containing a provision described in this paragraph shall not fail to satisfy section 411(a), (d)(2) and (d)(3) merely by reason of such a plan provision. Paragraph (c)(7) of this section sets forth special early termination rules applicable to certain qualified defined benefit plans for plan years affected by the Employee Retirement Income Security Act of 1974 (''ERISA''). Paragraph (c)(7) of this section does not contain all the rules required by the enactment of ERISA.

(2)(i) If employer contributions under a qualified pension plan may be used for the benefit of an employee who is among the 25 highest paid employees of the employer at the time the plan is established and whose anticipated annual pension under the plan exceeds $1,500, such plan must provide that upon the occurrence of the conditions described in subdivision (ii) of this subparagraph, the employer contributions which are used for the benefit of any such employee are restricted in accordance with subdivision (iii) of this subparagraph.

(ii) The restrictions described in subdivision (iii) of this subparagraph become applicable if—

(A) The plan is terminated within 10 years after its establishment,

(B) The benefits of an employee described in subdivision (i) of this subparagraph become payable within 10 years after the establishment of the plan, or

(C) The benefits of an employee described in subdivision (i) of this subparagraph become payable after the plan has been in effect for 10 years, and the full current costs of the plan for the first 10 years have not been funded. In the case of an employee described in (B) of this subdivision, the restrictions will remain applicable until the plan has been in effect for 10 years, but if at that time the full current costs have been funded the restrictions will no longer apply to the benefits payable to such an employee. In the case of an employee described in (B) or (C) of this subdivision, if at the end of the first 10 years the full current costs are not met, the restrictions will continue to apply until the full current costs are funded for the first time.

(iii) The restrictions required under subdivision (i) of this subparagraph must provide that the employer contributions which may be used for the benefit of an employee described in such subdivision shall not exceed the greater of $20,000, or 20 percent of the first $50,000 of the annual compensation of such employee multiplied by the number of years between the date of the establishment of the plan and—

(A) The date of the termination of the plan,

(B) In the case of an employee described in subdivision (ii)(B) of this subparagraph, the date the benefit of the employee becomes payable, if before the date of the termination of the plan, or

(C) In the case of an employee described in subdivision (ii)(C) of this subparagraph, the date of the failure to meet the full current costs of the plan. However, if the full current costs of the plan have not been met on the date described in (A) or (B) of this subdivision, whichever is applicable, then the date of the failure to meet such full current costs shall be substituted for the date referred to in (A) or (B) of this subdivision. For purposes of determining the contributions which may be used for the benefit of an employee when (b) of this subdivision applies, the number of years taken into account may be recomputed for each year if the full current costs of the plan are met for such year.

(iv) For purposes of this subparagraph, the employer contributions which, at a given time, may be used for the benefits of an employee include any unallocated funds which would be used for his benefits if the plan were then terminated or the employee were then to withdraw from the plan, as well as all contributions allocated up to that time exclusively for his benefits.

(v) The provisions of this subparagraph apply to a former or retired employee of the employer, as well as to an employee still in the employer's service.

(vi) The following terms are defined for purposes of this subparagraph—

(A) The term ''benefits'' includes any periodic income, any withdrawal values

payable to a living employee, and the cost of any death benefits which may be payable after retirement on behalf of an employee, but does not include the cost of any death benefits with respect to an employee before retirement nor the amount of any death benefits actually payable after the death of an employee whether such death occurs before or after retirement.

(B) The term *full current costs* means the normal cost, as defined in § 1.404(a)–6, for all years since the effective date of the plan, plus interest on any unfunded liability during such period.

(C) The term *annual compensation* of an employee means either such employee's average regular annual compensation, or such average compensation over the last five years, or such employee's last annual compensation if such compensation is reasonably similar to his average regular annual compensation for the five preceding years.

(3) The amount of the employer contributions which can be used for the benefit of a restricted employee may be limited either by limiting the annual amount of the employer contributions for the designated employee during the period affected by the limitation, or by limiting the amount of funds under the plan which can be used for the benefit of such employee, regardless of the amount of employer contributions.

(4) The restrictions contained in subparagraph (2) of this paragraph may be exceeded for the purpose of making current retirement income benefit payments to retired employees who would otherwise be subject to such restrictions, if—

(i) The employer contributions which may be used for any such employee in accordance with the restrictions contained in subparagraph (2) of this paragraph are applied either (A) to provide level amounts of annuity in the basic form of benefit provided for under the plan for such employee at retirement (or, if he has already retired, beginning immediately), or (B) to provide level amounts of annuity in an optional form of benefit provided under the plan if the level amount of annuity under such optional form of benefit is not greater than the level amount of annuity under the basic form of benefit provided under the plan;

(ii) The annuity thus provided is supplemented, to the extent necessary to provide the full retirement income benefits in the basic form called for under the plan, by current payments to such employee as such benefits come due; and

(iii) Such supplemental payments are made at any time only if the full current costs of the plan have then been met, or the aggregate of such supplemental payments for all such employees does not exceed the aggregate employer contributions already made under the plan in the year then current.

If disability income benefits are provided under the plan, the plan may contain like provisions with respect to the current payment of such benefits.

(5) If a plan has been changed so as to increase substantially the extent of possible discrimination as to contributions and as to benefits actually payable in event of the subsequent termination of the plan or the subsequent discontinuance of contributions thereunder, then the provisions of this paragraph shall be applied to the plan as so changed as if it were a new plan established on the date of such change. However, the provision in subparagraph (2)(iii) of this paragraph that the unrestricted amount of employer contributions on behalf of any employee is at least $20,000 is applicable to the aggregate amount contributed by the employer on behalf of such employee from the date of establishment of the original plan, and, for purposes of determining if the employee's anticipated annual pension exceeds $1,500, both the employer contributions on the employee's behalf prior to the date of the change in the plan and those expected to be made on his behalf subsequent to the date of the change (based on the employee's rate of compensation on the date of the change) are to be taken into account.

(6) This paragraph shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of an early termination of a qualified pension plan during any such taxable year, the employer contributions which may be used for the benefit of any employee must conform to the

requirements of this paragraph. However, any pension plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed in this paragraph.

(7)(i) A qualified defined benefit plan subject to section 412 (without regard to section 412(h)(2)) shall not be required to contain the restriction described in paragraph (c)(2)(ii)(*c*) of this section applicable to an employee in a plan whose full current costs for the first 10 years have not been funded.

(ii) A qualified defined benefit plan covered by section 4021(a) of ERISA (''qualified Title IV plan'') shall satisfy the restrictions in paragraph (c)(2) of this section only if the plan satisfies this paragraph (c)(7). A plan satisfies this paragraph (c)(7) by providing that employer contributions which may be used for the benefit of an employee described in paragraph (c)(2) of this section who is a substantial owner, as defined in section 4022(b)(5) of ERISA, shall not exceed the greater of the dollar amount described in paragraph (c)(2)(iii) of this section or a dollar amount which equals the present value of the benefit guaranteed for such employee under section 4022 of ERISA, or if the plan has not terminated, the present value of the benefit that would be guaranteed if the plan terminated on the date the benefit commences, determined in accordance with regulations of the Pension Benefit Guaranty Corporation (''PBGC'').

(iii) A plan satisfies this paragraph (c)(7) by providing that employer contributions which may be used for the benefit of all employees described in paragraph (c)(2) of this section (other than an employee who is a substantial owner as defined in section 4022(b)(5) of ERISA) shall not exceed the greater of the dollar amount described in paragraph (c)(2)(iii) of this section or a dollar amount which equals the present value of the maximum benefit described in section 4022(b)(3)(B) of ERISA (determined on the date the plan terminates or on the date benefits commence, whichever is earlier and determined in accordance with regulations of PBGC) without regard to any other limitations in section 4022 of ERISA.

(iv) A plan provision satisfying this paragraph (c)(7) may be adopted by amendment or by incorporation at the time of establishment. Any allocation of assets attributable to employer contributions to an employee which exceeds the dollar limitation in this paragraph (c)(7) may be reallocated to prevent prohibited discrimination.

(v) The early termination rules in the preceding subparagraphs (1) through (6) apply to a qualified Title IV plan except where such rules are determined by the Commissioner to be inconsistent with the rules of this paragraph (c)(7), §1.411(d)–2, and section 4044(b)(4) of ERISA. The early termination rules of this paragraph (c)(7) contain some of the rules under section 401(a)(4) and (a)(7), as in effect on September 2, 1974, and section 411(d) (2) and (3). Section 1.411(d)–2 also contains certain discrimination and vesting rules which are applicable to plan terminations.

(vi) Paragraph (c)(7) of this section applies to plan terminations occurring on or after March 12, 1984. For distributions not on account of plan terminations, paragraph (c)(7) applies to distributions in plan years beginning after December 31, 1983. However, a plan may elect to apply that paragraph to distributions not on account of plan termination on or after January 10, 1984.

(d)(1) Except as provided in paragraph (d)(2) of this section, the provisions of this section do not apply to plan years beginning on or after January 1, 1994. For rules applicable to plan years beginning on or after January 1, 1994, see §§1.401(a)(4)–1 through 1.401(a)(4)–13.

(2) In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), the provisions of this section do not apply to plan years beginning on or after January 1, 1996.

For rules applicable to plan years beginning on or after January 1, 1996, see §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

(Secs. 411 (d)(2) and (3) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 88 Stat. 912; 26 U.S.C. 411(d)(2) and (3) and 7805))

[T.D. 6500, 25 FR 11674, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10119, Sept. 17, 1963; T.D. 7934, 49 FR 1183, Jan. 10, 1984; 49 FR 2104, Jan. 18, 1984; T.D. 8360, 56 FR 47536, Sept. 19, 1991; T.D. 8485, 58 FR 46778, Sept. 3, 1993]

§ 1.401–5 Period for which requirements of section 401(a) (3), (4), (5), and (6) are applicable with respect to plans put into effect before September 2, 1974.

A pension, profit-sharing, stock bonus, or annuity plan shall be considered as satisfying the requirements of section 401(a) (3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all the provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus, if an employer in 1954 adopts such a plan as of January 1, 1954, and makes a return on the basis of the calendar year, he will have until March 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a) (3), (4), (5), and (6) for the calendar year 1954 provided that by March 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1954, the effective date of the plan. If an employer is on a fiscal year basis, for example, April 1 to March 31, and in 1954 adopts such a plan effective as of April 1, 1954, he will have until June 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a) (3), (4), (5), and (6) for the fiscal year beginning April 1, 1954, provided that by June 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to April 1, 1954, the effective date of the plan. It should be noted that under section 401(b) the period in which a plan may be amended to qualify under section 401(a) ends before the date on which taxpayers other than corporations are required to file income tax returns. See section 6072. This section shall not apply to any pension, profit-sharing, stock bonus, or annuity plan put into effect after September 1, 1974, and shall not apply with respect to any disqualifying provision to which § 1.401(b)–1 applies.

[T.D. 6500, 25 FR 11674, Nov. 26, 1960; as amended by T.D. 7436, 41 FR 42653, Sept. 28, 1976]

§ 1.401–6 Termination of a qualified plan.

(a) *General rules.* (1) In order for a pension, profit-sharing, or stock bonus trust to satisfy the requirements of section 401, the plan of which such trust forms a part must expressly provide that, upon the termination of the plan or upon the complete discontinuance of contributions under the plan, the rights of each employee to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of § 1.402(b)–1.

(2)(i) A qualified plan must also provide for the allocation of any previously unallocated funds to the employees covered by the plan upon the termination of the plan or the complete discontinuance of contributions under the plan. Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination of the plan or the discontinuance of contributions thereunder.

(ii) Any provision for the allocation of unallocated funds is acceptable if it specifies the method to be used and does not conflict with the provisions of section 401(a)(4) and the regulations thereunder. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees

covered by the plan. For example, an allocation may be satisfactory if priority is given to benefits for employees over the age of 50 at the time of the termination of the plan, or those who then have at least 10 years of service, if there is no possibility of discrimination in favor of employees who are officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(iii) Subdivisions (i) and (ii) of this subparagraph do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) *Termination defined.* (1) Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. For example, a plan is terminated when, in connection with the winding up of the employer's trade or business, the employer begins to discharge his employees. However, a plan is not terminated, for example, merely because an employer consolidates or replaces that plan with a comparable plan. Similarly, a plan is not terminated merely because the employer sells or otherwise disposes of his trade or business if the acquiring employer continues the plan as a separate and distinct plan of its own, or consolidates or replaces that plan with a comparable plan. See paragraph (d)(4) of § 1.381(c)(11)–1 for the definition of comparable plan. In addition, the Commissioner may determine that other plans are comparable for purposes of this section.

(2) For purposes of this section, the term *termination* includes both a partial termination and a complete termination of a plan. Whether or not a partial termination of a qualified plan occurs when a group of employees who have been covered by the plan are subsequently excluded from such coverage either by reason of an amendment to the plan, or by reason of being discharged by the employer, will be determined on the basis of all the facts and circumstances. Similarly, whether or not a partial termination occurs when benefits or employer contributions are reduced, or the eligibility or vesting requirements under the plan are made less liberal, will be determined on the basis of all the facts and circumstances. However, if a partial termination of a qualified plan occurs, the provisions of section 401(a)(7) and this section apply only to the part of the plan that is terminated.

(c) *Complete discontinuance defined.* (1) For purposes of this section, a complete discontinuance of contributions under the plan is contrasted with a suspension of contributions under the plan, which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees.

(2) In the case of a pension plan, a suspension of contributions will not constitute a discontinuance if—

(i) The benefits to be paid or made available under the plan are not affected at any time by the suspension, and

(ii) The unfunded past service cost at any time (which includes the unfunded prior normal cost and unfunded interest on any unfunded cost) does not exceed the unfunded past service cost as of the date of establishment of the plan, plus any additional past service or supplemental costs added by amendment.

(3) In any case in which a suspension of a profit-sharing plan is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan.

(d) *Contributions or benefits which remain forfeitable.* The provisions of this

section do not apply to amounts which are reallocated to prevent the discrimination prohibited by section 401(a)(4) (see paragraph (c) of § 1.401–4).

(e) *Effective date.* This section shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of the termination or complete discontinuance (as defined in this section) of any qualified plan during any such taxable year, the rights accorded to each employee covered under the plan must conform to the requirements of this section. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section.

[T.D. 6675, 28 FR 10120, Sept. 17, 1963]

§ 1.401–7 Forfeitures under a qualified pension plan.

(a) *General rules.* In the case of a trust forming a part of a qualified pension plan, the plan must expressly provide that forfeitures arising from severance of employment, death, or for any other reason, must not be applied to increase the benefits any employee would otherwise receive under the plan at any time prior to the termination of the plan or the complete discontinuance of employer contributions thereunder. The amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan. However, a qualified pension plan may anticipate the effect of forfeitures in determining the costs under the plan. Furthermore, a qualified plan will not be disqualified merely because a determination of the amount of forfeitures under the plan is made only once during each taxable year of the employer.

(b) *Examples.* The rules of paragraph (a) of this section may be illustrated by the following examples:

Example (1). The B Company Pension Trust forms a part of a pension plan which is funded by individual level annual premium annuity contracts. The plan requires ten years of service prior to obtaining a vested right to benefits under the plan. One of the company's employees resigns his position after two years of service. The insurance company paid to the trustees the cash surrender value of the contract—$750. The B Company must reduce its next contribution to the pension trust by this amount.

Example (2). The C Corporation's trusteed pension plan has been in existence for 20 years. It is funded by individual contracts issued by an insurance company, and the premiums thereunder are paid annually. Under such plan, the annual premium accrued for the year 1966 is due and is paid on January 2, 1966, and on July 1 of the same year the plan is terminated due to the liquidation of the employer. Some forfeitures were incurred and collected by the trustee with respect to those participants whose employment terminated between January 2 and July 1. The plan provides that the amount of such forfeitures is to be applied to provide additional annuity benefits for the remaining employees covered by the plan. The pension plan of the C Corporation satisfies the provisions of section 401(a)(8). Although forfeitures are used to increase benefits in this case, this use of forfeitures is permissible since no further contributions will be made under the plan.

(c) *Effective date.* This section applies to taxable years of a qualified plan commencing after September 30, 1963. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section.

[T.D. 6675, 28 FR 10121, Sept. 17, 1963]

§ 1.401–8 Custodial accounts prior to January 1, 1974.

(a) *Treatment of a custodial account as a qualified trust.* For taxable years of a plan beginning after December 31, 1962, a custodial account may be used, in lieu of a trust, under any pension, profit-sharing, or stock bonus plan, described in section 401 if the requirements of paragraph (b) of this section are met. A custodial account may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account as part of a plan does not preclude the use of a trust or another custodial account as part of the same plan. A plan under which a custodial account is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied. For regulations relating to the period after December 31, 1973, see § 1.401(f)–11.

(b) *Rules applicable to custodial accounts.* (1) A custodial account shall be

treated for taxable years beginning after December 31, 1962, as a qualified trust under section 401 if such account meets the following requirements described in subdivisions (i) through (iii) of this subparagraph:

(i) The custodial account must satisfy all the requirements of section 401 that are applicable to qualified trusts. See subparagraph (2) of this paragraph.

(ii) The custodian of the custodial account must be a bank.

(iii) The custodial agreement provides that the investment of the funds in the account is to be made—

(A) Solely in stock of one or more regulated investment companies which is registered in the name of the custodian or its nominee and with respect to which an employee who is covered by the plan is the beneficial owner, or

(B) Solely in annuity, endowment, or life insurance contracts, issued by an insurance company and held by the custodian until distributed pursuant to the terms of the plan. For purposes of the preceding sentence, a face-amount certificate described in section 401(g) and §1.401–9 is treated as an annuity issued by an insurance company.

See subparagraphs (3) and (4) of this paragraph.

(2) As a result of the requirement described in subparagraph (1)(i) of this paragraph (relating to the requirements applicable to qualified trusts), the custodial account must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan, for any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries as provided for in the plan (see paragraph (a) of §1.401–2).

(3) The requirement described in subparagraph (1)(iii) of this paragraph, relating to the investment of the funds of the plan, applies, for example, to the employer contributions under the plan, any employee contributions under the plan, and any earnings on such contributions. Such requirement also applies to capital gains realized upon the sale of stock described in (A) of such subdivision, to any capital gain dividends received in connection with such stock, and to any refunds described in section 852(b)(3)(D)(ii) (relating to undistributed capital gains of a regulated investment company) which is received in connection with such stock. However, since such requirement relates only to the investment of the funds of the plan, the custodian may deposit funds with a bank, in either a checking or savings account, while accumulating sufficient funds to make additional investments or while awaiting an appropriate time to make additional investments.

(4) The requirement in subparagraph (1)(iii)(A) of this paragraph that an employee covered by the plan be the beneficial owner of the stock does not mean that the employee who is the beneficial owner must have a nonforfeitable interest in the stock. Thus, a plan may provide for forfeitures of an employee's interest in such stock in the same manner as plans which use a trust. In the event of a forfeiture of an employee's beneficial ownership in the stock of a regulated investment company, the beneficial ownership of such stock must pass to another employee covered by the plan.

(c) *Effects of qualification*. (1) Any custodial account which satisfies the requirements of section 401(f) shall be treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Accordingly, such a custodial account shall be treated as a separate legal person which is exempt from the income tax by section 501(a). On the other hand, such a custodial account is required to file the returns described in sections 6033 and 6047 and to supply any other information which a qualified trust is required to furnish.

(2) In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(d) *Effect of loss of qualification*. If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such

custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available within the meaning of section 402(a)(1) to the employees for whom they are held.

(e) *Definitions.* For purposes of this section—

(1) The term *bank* means a bank as defined in section 401(d)(1).

(2) The term *regulated investment company* means any domestic corporation which issues only redeemable stock and is a regulated investment company within the meaning of section 851(a) (but without regard to whether such corporation meets the limitations of section 851(b)).

(Secs. 401(f)(2), 7805, Internal Revenue Code of 1954 (88 Stat. 939 and 68A Stat. 917; 26 U.S.C. 401(f)(2), 7805))

[T.D. 6675, 28 FR 10121, Sept. 17, 1963, as amended by T.D. 7565, 43 FR 41204, Sept. 15, 1978. Redesignated and amended by T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401–9 Face-amount certificates—nontransferable annuity contracts.

(a) *Face-amount certificates treated as annuity contracts.* Section 401(g) provides that a face-amount certificate (as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. sec. 80a–2)) which is not transferable within the meaning of paragraph (b)(3) of this section shall be treated as an annuity contract for purposes of sections 401 through 404 for any taxable year of a plan subject to such sections beginning after December 31, 1962. Accordingly, there may be established for any such taxable year a qualified plan under which such face-amount certificates are purchased for the participating employees without the creation of a trust or custodial account. However, for such a plan to qualify, the plan must satisfy all the requirements applicable to a qualified annuity plan (see section 403(a) and the regulations thereunder).

(b) *Nontransferability of face-amount certificates and annuity contracts.* (1)(i) Section 401(g) provides that, in order for any face-amount certificate, or any other contract issued after December 31, 1962, to be subject to any provision under sections 401 through 404 which is applicable to annuity contracts, as compared to other forms of investment, such certificate or contract must be nontransferable at any time when it is held by any person other than the trustee of a trust described in section 401(a) and exempt under section 501(a). Thus, for example, in order for a group or individual retirement income contract to be treated as an annuity contract, if such contract is not held by the trustee of an exempt employees' trust, it must satisfy the requirements of this section. Furthermore, a face-amount certificate or an annuity contract will be subject to the tax treatment under section 403(b) only if it satisfies the requirements of section 401(g) and this section. Any certificate or contract in order to satisfy the provisions of this section must expressly contain the provisions that are necessary to make such certificate or contract not transferable within the meaning of this paragraph.

(ii) In the case of any group contract purchased by an employer under a plan to which sections 401 through 404 apply, the restriction on transferability required by section 401(g) and this section applies to the interest of the employee participants under such group contract but not to the interest of the employer under such contract.

(2) If a trust described in section 401(a) which is exempt from tax under section 501(a) distributes any annuity, endowment, retirement income, or life insurance contract, then the rules relating to the taxability of the distributee of any such contract are set forth in paragraph (a)(2) of § 1.402(a)–1.

(3) A face-amount certificate or an annuity contract is transferable if the owner can transfer any portion of his interest in the certificate or contract to any person other than the issuer thereof. Accordingly, such a certificate or contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the certificate or contract to any person other than the issuer thereof. On the other hand, for purposes of section 401(g), a face-amount certificate or annuity contract is not considered to be transferable merely because such certificate or contract, or the plan of

which it is a part, contains a provision permitting the employee to designate a beneficiary to receive the proceeds of the certificate or contract in the event of his death, or contains a provision permitting the employee to elect to receive a joint and survivor annuity, or contains other similar provisions.

(4) A material modification in the terms of an annuity contract constitutes the issuance of a new contract regardless of the manner in which it is made.

(c) *Examples*. The rules of this section may be illustrated by the following examples:

Example (1). The P Employees' Annuity Plan is a nontrusteed plan which is funded by individual annuity contracts issued by the Y Insurance Company. Each annuity contract issued by such company after December 31, 1962, provides, on its face, that it is ''NOT TRANSFERABLE''. The terms of each such contract further provide that, ''This contract may not be sold, assigned, discounted, or pledged as collateral for a loan or as security for the performance of an obligation or for any other purpose, to any person other than this company.'' The annuity contracts of the P Employees' Annuity Plan satisfy the requirements of section 401(g) and this section.

Example (2). The R Company Pension Trust forms a part of a pension plan which is funded by individual level premium annuity contracts. Such contracts are purchased by the trustee of the R Company Pension Trust from the Y Insurance Company. The trustee of the R Company Pension Trust is the legal owner of each such contract at all times prior to the distribution of such contract to a qualifying annuitant. The trustee purchases such a contract on January 3, 1963, in the name of an employee who qualifies on that date for coverage under the plan. At the time such contract is purchased, and while the contract is held by the trustee of the R Company Pension Trust, the contract does not contain any restrictions with respect to its transferability. The annuity contract purchased by the trustee of the R Company Pension Trust satisfies the requirements of section 401(g) and this section while it is held by the trustee.

Example (3). A is the trustee of the X Corporation's Employees' Pension Trust. The trust forms a part of a pension plan which is funded by individual level premium annuity contracts. The trustee is the legal owner of such contracts, but the employees covered under the plan obtain beneficial interests in such contracts after ten years of service with the X Corporation. On January 15, 1980, A distributes to D an annuity contract issued to A in D's name on June 25, 1959, and distributes to E an annuity contract issued to A in E's name on September 30, 1963. The contract issued to D need not be nontransferable, but the contract issued to E must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

Example (4). The corpus of the Y Corporation's Employees' Pension Plan consists of individual insurance contracts in the names of the covered employees and an auxiliary fund which is used to convert such policies to annuity contracts at the time a beneficiary of such trust retires. F retires on June 15, 1963, and the trustee converts the individual insurance contract on F's life to a life annuity which is distributed to him. The life annuity issued on F's life must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

[T.D. 6675, 28 FR 10122, Sept. 17, 1963]

§ 1.401–10 Definitions relating to plans covering self-employed individuals.

(a) *In general*. (1) Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan for taxable years beginning after December 31, 1962. This section contains definitions relating to plans covering self-employed individuals. The provisions of §§ 1.401–1 through 1.401–9, relating to requirements which are applicable to all qualified plans, are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401–11 through 1.401–13. Section 1.401–11 contains general rules which are applicable to any plan covering a self-employed individual who is an employee within the meaning of paragraph (b) of this section. Section 1.401–12 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of paragraph (d) of this section. Section 1.401–13 contains rules relating to excess contributions by, or for, an owner-employee. The provisions of this section and of §§ 1.401–11 through 1.401–13 are applicable to taxable years beginning after December 31, 1962.

(2) A self-employed individual is covered under a qualified plan during the period beginning with the date a contribution is first made by, or for, him

under the qualified plan and ending when there are no longer funds under the plan which can be used to provide him or his beneficiaries with benefits.

(b) *Treatment of a self-employed individual as an employee.* (1) For purposes of section 401, a self-employed individual who receives earned income from an employer during a taxable year of such employer beginning after December 31, 1962, shall be considered an employee of such employer for such taxable year. Moreover, such an individual will be considered an employee for a taxable year if he would otherwise be treated as an employee but for the fact that the employer did not have net profits for that taxable year. Accordingly, the employer may cover such an individual under a qualified plan during years of the plan beginning with or within a taxable year of the employer beginning after December 31, 1962.

(2) If a self-employed individual is engaged in more than one trade or business, each such trade or business shall be considered a separate employer for purposes of applying the provisions of sections 401 through 404 to such individual. Thus, if a qualified plan is established for one trade or business but not the others, the individual will be considered an employee only if he received earned income with respect to such trade or business and only the amount of such earned income derived from that trade or business shall be taken into account for purposes of the qualified plan.

(3)(i) The term *employee*, for purposes of section 401, does not include a self-employed individual when the term ''common-law'' employee is used or when the context otherwise requires that the term ''employee'' does not include a self-employed individual. The term ''common- law'' employee also includes an individual who is treated as an employee for purposes of section 401 by reason of the provisions of section 7701(a)(20), relating to the treatment of certain full-time life insurance salesmen as employees. Furthermore, an individual who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a). Thus, for example, a minister who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a).

(ii) An individual may be treated as an employee within the meaning of section 401(c)(1) of one employer even though such individual is also a common-law employee of another employer. For example, an attorney who is a common-law employee of a corporation and who, in the evenings maintains an office in which he practices law as a self-employed individual is an employee within the meaning of section 401(c)(1) with respect to the law practice. This example would not be altered by the fact that the corporation maintained a qualified plan under which the attorney is benefited as a common-law employee.

(4) For the purpose of determining whether an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility under a qualified plan established by an employer, such an employer may take into account past services rendered by such an employee both as a self-employed individual and as a common-law employee if past services rendered by other employees, including common-law employees, are similarly taken into account. However, an employer cannot take into account only past services rendered by employees within the meaning of section 401(c)(1) if past services rendered to such employer by individuals who are, or were, common-law employees are not taken into account. Past service as described in this subparagraph may be taken into account for the purpose of determining whether an individual who is, or was, an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility even if such service was rendered prior to January 1, 1963. On the other hand, past service cannot be taken into account for purposes of determining the contributions which may be made on such an individual's behalf under a qualified plan.

(c) *Definition of earned income*—(1) *General rule.* For purposes of section 401

and the regulations thereunder, ''earned income'' means, in general, net earnings from self-employment (as defined in section 1402(a)) to the extent such net earnings constitute compensation for personal services actually rendered within the meaning of section 911(b).

(2) *Net earnings from self-employment.* (i) The computation of the net earnings from self-employment shall be made in accordance with the provisions of section 1402(a) and the regulations thereunder, with the modifications and exceptions described in subdivisions (ii) through (iv) of this subparagraph. Thus, an individual may have net earnings from self-employment, as defined in section 1402(a), even though such individual does not have self-employment income, as defined in section 1402(b), and, therefore, is not subject to the tax on self-employment income imposed by section 1401.

(ii) Items which are not included in gross income for purposes of chapter 1 of the Code and the deductions properly attributable to such items must be excluded from the computation of net earnings from self-employment even though the provisions of section 1402(a) specifically require the inclusion of such items. For example, if an individual is a resident of Puerto Rico, so much of his net earnings from self-employment as are excluded from gross income under section 933 must not be taken into account in computing his net earnings from self-employment which are earned income for purposes of section 401.

(iii) In computing net earnings from self-employment for the purpose of determining earned income, a self-employed individual may disregard only deductions for contributions made on his own behalf under a qualified plan. However, such computation must take into account the deduction allowed by section 404 or 405 for contributions under a qualified plan on behalf of the common-law employees of the trade or business.

(iv) For purposes of determining whether an individual has net earnings from self-employment and, thus, whether he is an employee within the meaning of section 401(c)(1), the exceptions in section 1402(c) (4) and (5) shall not apply. Thus, certain ministers, certain members of religious orders, doctors of medicine, and Christian Science practitioners are treated for purposes of section 401 as being engaged in a trade or business from which net earnings from self-employment are derived. In addition, the exceptions in section 1402(c)(2) shall not apply in the case of any individual who is treated as an employee under section 3121(d)(3) (A), (C), or (D). Therefore, such individuals are treated, for purposes of section 401, as being engaged in a trade or business from which net earnings from self-employment may be derived.

(3) *Compensation for personal services actually rendered.* (i) For purposes of section 401, the term ''earned income'' includes only that portion of an individual's net earnings from self-employment which constitutes earned income as defined in section 911(b) and the regulations thereunder. Thus, such term includes only professional fees and other amounts received as compensation for personal services actually rendered by the individual. There is excluded from ''earned income'' the amount of any item of income, and any deduction properly attributable to such item, if such amount is not received as compensation for personal services actually rendered. Therefore, an individual who renders no personal services has no ''earned income'' even though such an individual may have net earnings from self-employment from a trade or business.

(ii) If a self-employed individual is engaged in a trade or business in which capital is a material income-producing factor, then, under section 911(b), his earned income is only that portion of the net profits from the trade or business which constitutes a reasonable allowance as compensation for personal services actually rendered. However, such individual's earned income cannot exceed 30 percent of the net profits of such trade or business. The net profits of the trade or business is not necessarily the same as the net earnings from self-employment derived from such trade or business.

(4) *Minimum earned income when both personal services and capital are material income-producing factors.* (i) If a self-employed individual renders personal

services on a full-time, or substantially full-time, basis to only one trade or business, and if with respect to such trade or business capital is a material income-producing factor, then the amount of such individual's earned income from the trade or business is considered to be not less than so much of his share in the net profits of such trade or business as does not exceed $2,500.

(ii) If a self-employed individual renders substantial personal services to more than one trade or business, and if with respect to all such trades or businesses such self-employed individual actually renders personal services on a full-time, or substantially full-time, basis, then the earned income of the self-employed individual from trades or businesses for which he renders substantial personal services and in which both personal services and capital are material income-producing factors is considered to be not less than—

(A) So much of such individual's share of the net profits from all trades or businesses in which he renders substantial personal services as does not exceed $2,500, reduced by.

(B) Such individual's share of the net profits of any trade or business in which only personal services is a material income-producing factor.

However, in no event shall the share of the net profits of any trade or business in which capital is a material income-producing factor be reduced below the amount which would, without regard to the provisions of this subdivision, be treated as the earned income derived from such trade or business under section 911(b). In making the computation required by this subdivision, any trade or business with respect to which the individual renders substantial personal services shall be taken into account irrespective of whether a qualified plan has been established by such trade or business.

(iii) If the provisions of subdivision (ii) of this subparagraph apply in determining the earned income of a self-employed individual, and such individual is engaged in two or more trades or businesses in which capital and personal services are material income-producing factors, then the total amount treated as the earned income shall be allocated to each such trade or business for which he performs substantial personal services in the same proportion as his share of net profits from each such trade or business bears to his share of the total net profits from all such trades or businesses. Thus, in such case, the amount of earned income attributable to any such trade or business is computed by multiplying the total earned income as determined under subdivision (ii) of this subparagraph by the individual's net profits from such trade or business and dividing that product by the individual's total net profits from all such trades or businesses.

(iv) For purposes of this subparagraph, the determination of whether an individual renders personal services on a full-time, or substantially full-time, basis is to be made with regard to the aggregate of the trades and businesses with respect to which the employee renders substantial personal services as a common-law employee or as a self-employed individual. However, for all other purposes in applying the rules of this subparagraph, a trade or business with respect to which an individual is a common-law employee shall be disregarded.

(d) *Definition of owner-employee.* For purposes of section 401 and the regulations thereunder, the term ''owner-employee'' means a proprietor of a proprietorship, or, in the case of a partnership, a partner who owns either more than 10 percent of the capital interest, or more than 10 percent of the profits interest, of the partnership. Thus, an individual who owns only 2 percent of the profits interest but 11 percent of the capital interest of a partnership is an owner-employee. A partner's interest in the profits and the capital of the partnership shall be determined by the partnership agreement. In the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined in the same manner as their distributive shares of partnership taxable income. However, a guaranteed payment (as described in section 707(c)) is not considered a distributive share of partnership income for such purpose. See section 704(b), relating to the determination of the distributive share by the income or

loss ratio, and the regulations thereunder. In the absence of a provision in the partnership agreement, a partner's capital interest in a partnership shall be determined on the basis of his interest in the assets of the partnership which would be distributable to such partner upon his withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(e) *Definition of employer.* (1) For purposes of section 401, a sole proprietor is considered to be his own employer, and the partnership is considered to be the employer of each of the partners. Thus, an individual partner is not an employer who may establish a qualified plan with respect to his services to the partnership.

(2) Regardless of the provision of local law, a partnership is deemed, for purposes of section 401, to be continuing until such time as it is terminated within the meaning of section 708, relating to the continuation of a partnership.

[T.D. 6675, 28 FR 10123, Sept. 17, 1963]

§ 1.401–11 General rules relating to plans covering self-employed individuals.

(a) *Introduction.* This section provides certain rules which supplement, and modify, the rules of §§ 1.401–1 through 1.401–9 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). The provisions of this section apply to taxable years beginning after December 31, 1962. Except as otherwise provided, paragraphs (b) through (m) of this section apply to taxable years beginning after December 31, 1962. Paragraph (n) of this section applies to plan years determined in accordance with paragraph (n)(1) of this section.

(b) *General rules.* (1) If the amount of employer contributions for common-law employees covered under a qualified plan is related to the earned income (as defined in section 401(c)(2)) of a self-employed individual, or group of self-employed individuals, such a plan is a profit-sharing plan (as described in paragraph (b)(1)(ii) of § 1.401–1) since earned income is dependent upon the profits of the trade or business with respect to which the plan is established. Thus, for example, a plan, which provides that the employer will contribute 10 percent of the earned income of a self-employed individual but no more than $2,500, and that the employer contribution on behalf of common-law employees shall be the same percentage of their salaries as the contribution on behalf of the self-employed individual bears to his earned income, is a profit-sharing plan, since the amount of the employer's contribution for common-law employees covered under the plan is related to the earned income of a self-employed individual and thereby to the profits of the trade or business. On the other hand, for example, a plan which defines the compensation of any self-employed individual as his earned income and which provides that the employer will contribute 10 percent of the compensation of each employee covered under the plan is a pension plan since the contribution on behalf of common-law employees is fixed without regard to whether the self-employed individual has earned income or the amount thereof.

(2) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits self-employed individuals to be treated as employees and therefore included in qualified plans, but it is clear that such law requires such self-employed individuals to provide benefits for their employees on a nondiscriminatory basis. Self-employed individuals will not be considered as providing contributions or benefits for an employee to the extent that the wages or salary of the employee covered under the plan are reduced at or about the time the plan is adopted.

(3) In addition to permitting self-employed individuals to participate in qualified plans, the Self-Employed Individuals Tax Retirement Act of 1962 extends to such individuals some of the tax benefits allowed common-law employee-participants in such plans. However, the tax benefits allowed a self-employed individual are restricted by the limits which are placed on the deductions allowed for contributions on such an individual's behalf. In view of these restrictions on the tax benefits

extended to any self-employed individual, a self-employed individual participating in a qualified plan may not participate in any forfeitures. Therefore, in the case of a qualified plan which covers any self-employed individual, a separate account must be established for each self-employed individual to which no forfeitures can be allocated.

(c) *Requirements as to coverage.* (1) In general, section 401(a)(3) and the regulations thereunder prescribe the coverage requirements which a qualified plan must satisfy. However, if such a plan covers self-employed individuals who are not owner-employees, it must, in addition to satisfying such requirements, satisfy the requirements of this paragraph. If any owner-employee is covered under a qualified plan, the provisions of this paragraph do not apply, but the provisions of section 401(d), including section 401(d)(3), do apply (see § 1.401–12).

(2)(i) Section 401(a)(3)(B) provides that a plan may satisfy the coverage requirements for qualification if it covers such employees as qualify under a classification which is found not to discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. Section 401(a)(5) sets forth certain classifications that will not in themselves be considered discriminatory. Under such section, a classification which excludes all employees whose entire remuneration constitutes ''wages'' under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from ''wages'' under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in determining if a classification is discriminatory under section 401(a)(3)(B), consideration will be given to whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). A plan which covers self-employed individuals, none of whom is an owner-employee, may also be integrated with the contributions or benefits under the Social Security Act. In such a case, the portion of the earned income (as defined in section 401(c)(2)) of such an individual which does not exceed the maximum amount which may be treated as self-employment income under section 1402(b)(1), and which is derived from the trade or business with respect to which the plan is established, shall be treated as ''wages'' under section 3121(a)(1) subject to the tax imposed by section 3111 (relating to the tax on employers) for purposes of applying the rules of paragraph (e)(2) of § 1.401–3, relating to the determination of whether a plan is properly integrated. However, if the plan covers an owner-employee, the rules relating to the integration of the plan with the contributions or benefits under the Social Security Act contained in paragraph (b) of § 1.401–12 apply.

(ii) Certain of the classifications enumerated in section 401(a)(5) do not apply to plans which provide contributions or benefits for any self-employed individual. Since self-employed individuals are not salaried or clerical employees, the provision in section 401(a)(5) permitting a plan, in certain cases to cover only this type of employee is inapplicable to plans which cover any self-employed individual.

(iii) The classifications enumerated in section 401(a)(5) are not exclusive, and it is not necessary that a qualified plan cover all employees or all full-time employees. Plans may qualify even though coverage is limited in accordance with a particular classification incorporated in the plan, provided the effect of covering only such employees as satisfy such eligibility requirement does not result in the prohibited discrimination.

(d) *Discrimination as to contributions or benefits*—(1) *In general.* In order for a plan to be qualified, there must be no

discrimination in contributions or benefits in favor of employees who are officers, shareholders, supervisors, or highly compensated, as against other employees whether within or without the plan. A self-employed individual, by reason of the contingent nature of his compensation, is considered to be a highly-compensated employee, and thus is a member of the group in whose favor discrimination is prohibited. In determining whether the prohibited discrimination exists, the total employer contribution on behalf of a self-employed individual shall be taken into account regardless of the fact that only a portion of such contribution is allowed as a deduction. For additional rules relating to discrimination as to contributions or benefits with regard to plans covering any owner-employee, see § 1.401–12.

(2) *Base for computing contributions or benefits.* (i) A plan which is otherwise qualified is not considered discriminatory merely because the contributions or benefits provided under the plan bear a uniform relationship to the total compensation, basic compensation, or regular rate of compensation of the employees, including self-employed individuals, covered under the plan.

(ii) In the case of a self-employed individual who is covered under a qualified plan, the total compensation of such individual is the earned income (as defined in section 401(c)(2)) which such individual derives from the employer's trade or business, or trades or businesses, with respect to which the qualified plan is established. Thus, for example, in the case of a partner, his total compensation includes both his distributive share of partnership income, whether or not distributed, and guaranteed payments described in section 707(c) made to him by the partnership establishing the plan, to the extent that such income constitutes earned income as defined in section 401(c)(2).

(iii)(A) The basic or regular rate of compensation of any self-employed individual is that portion of his earned income which bears the same ratio to his total earned income derived from the trade or business, or trades or businesses, with respect to which the qualified plan is established as the aggregate basic or regular compensation of all common-law employees covered under the plan bears to the aggregate total compensation of such employees derived from such trade or business, or trades or businesses.

(B) If an employer establishes two or more plans which satisfy the requirements of section 401(a) separately, and only one such plan covers a self-employed individual, the determination of the basic or regular rate of compensation of such self-employed individual is made with regard to the compensation of common-law employees covered under the plan which provides contributions or benefits for such self-employed individual. On the other hand, if two or more plans must be considered together in order to satisfy the requirements of section 401(a), the computation of the basic or regular rate of compensation of a self-employed individual must be made with regard to the compensation of the common-law employees covered by so many of such plans as are required to be taken together in order to satisfy the qualification requirements of section 401(a).

(3) *Discriminatory contributions.* If a discriminatory contribution is made by, or for, a self-employed individual who is an employee within the meaning of section 401(c)(1) because of an erroneous assumption as to the earned income of such individual, the plan will not be considered discriminatory if adequate adjustment is made to remove such discrimination. In the case of any self-employed individual who is an owner-employee, the amount of any excess contribution to be returned and the manner in which it is to be repaid are determined by the provisions of section 401(d)(8) and (e). However, if any self-employed individual, including any owner-employee, has not made the full contribution permitted to be made on his behalf as an employee, then, if the plan expressly provides, so much of any excess contribution by such self-employed individual's employer as may, under the provisions of the plan, be treated as a contribution made by such individual as an employee can be so treated.

(e) *Distribution of entire interest.* (1) If a trust forms part of a plan which covers a self-employed individual, such

trust shall constitute a qualified trust under section 401 only if the plan of which such trust is a part expressly provides that the entire interest of each employee, including any common-law employee, will be distributed in accordance with the provisions of subparagraph (2) or (3) of this paragraph.

(2) Unless the provisions of subparagraph (3) of this paragraph apply, the entire interest of each employee (including contributions he has made on his own behalf, contributions made on his behalf by his employer, and interest thereon) must be actually distributed to such employee—

(i) In the case of an employee, other than an individual who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year of such employee in which he attains the age of 70½, or not later than the last day of the taxable year in which such employee retires, whichever is later, and

(ii) In the case of an employee who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year in which he attains the age of 70½.

(3) In lieu of distributing an employee's entire interest in a qualified plan as provided in subparagraph (2) of this paragraph, such interest may be distributed commencing no later than the last taxable year described in such subparagraph (2). In such case, the plan must expressly provide that the entire interest of such an employee shall be distributed to him and his beneficiaries, in a manner which satisfies the requirements of subparagraph (5) of this paragraph, over any of the following periods (or any combination thereof)—

(i) The life of the employee, or

(ii) The lives of the employee and his spouse, or

(iii) A period certain not longer than the life expectancy of the employee, or

(iv) A period certain not longer than the joint life and last survivor expectancy of the employee and his spouse.

(4) For purposes of subparagraphs (3) and (5) of this paragraph, the determination of the life expectancy of the employee or the joint life and last survivor expectancy of the employee and his spouse is to be made either (i) only once, at the time the employee receives the first distribution of his entire interest under the plan, or (ii) periodically, in a consistent manner. Such life expectancy or joint life and last survivor expectancy cannot exceed the period computed by the use of the expected return multiples in §1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the life expectancy tables of such company.

(5) If an employee's entire interest is to be distributed over a period described in subparagraph (3) of this paragraph, then the amount to be distributed each year must be at least an amount equal to the quotient obtained by dividing the entire interest of the employee under the plan at the time the distribution is made (expressed in either dollars or units) by the life expectancy of the employee, or joint life and last survivor expectancy of the employee and his spouse (whichever is applicable), determined in accordance with the provisions of subparagraph (4) of this paragraph. However, no distribution need be made in any year, or a lesser amount may be distributed, if the aggregate amounts distributed by the end of that year are at least equal to the aggregate of the minimum amounts required by this subparagraph to have been distributed by the end of such year.

(6) If an employee's entire interest is distributed in the form of an annuity contract, then the requirements of section 401(a)(9) are satisfied if the distribution of such contract takes place before the end of the latest taxable year described in subparagraph (2) of this paragraph, and if the employee's interest will be paid over a period described in subparagraph (3) of this paragraph and at a rate which satisfies the requirements of subparagraph (5) of this paragraph.

(7) The requirements of section 401(a)(9) do not preclude contributions from being made on behalf of an owner-employee under a qualified plan subsequent to the taxable year in which the distribution of his entire interest is required to commence. Thus, if all other requirements for qualification are satisfied, a qualified plan may provide contributions for an owner-employee

who has already attained age 70½. However, a distribution of benefits attributable to contributions made on behalf of an owner-employee in a taxable year beginning after the taxable year in which he attains the age of 70½ must satisfy the requirements of subparagraph (3) of this paragraph. Thus, if an owner-employee has already attained the age of 70½ at the time the first contribution is made on his behalf, the distribution of his entire interest must commence in the year in which such contribution is first made on his behalf.

(8) This paragraph shall not apply and an otherwise qualified trust will not be disqualified if the method of distribution under the plan is one which was designated by a common-law employee prior to October 10, 1962, and such method of distribution is not in accordance with the provisions of section 401(a)(9). Such exception applies regardless of whether the actual distribution of the entire interest of an employee making such a designation, or any portion of such interest, has commenced prior to October 10, 1962.

[T.D. 6675, 28 FR 10124, Sept. 17, 1963, as amended by T.D. 6982, 33 FR 16500, Nov. 13, 1968]

§ 1.401–12 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) *Introduction.* This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). However, to the extent that the provisions of § 1.401–11 are not modified by the provisions of this section, such provisions are also applicable to a plan which covers an owner-employee. The provisions of this section apply to taxable years beginning after December 31, 1962. Except as otherwise provided, paragraphs (b) through (m) of this section apply to taxable years beginning after December 31, 1962. Paragraph (n) of this section applies to plan years determined in accordance with paragraph (n)(1) of the section.

(b) *General rules.* (1) The qualified plan and trust of an unincorporated trade or business does not have to satisfy the additional requirements for qualification merely because an owner-employee derives earned income (as defined in section 401(c)(2)) from the trade or business with respect to which the plan is established. Such additional requirements need be satisfied only if an owner-employee is actually covered under the plan of the employer. An owner-employee may only be covered under a plan of an employer if such owner-employee has so consented. However, the consent of the owner-employee may be either expressed or implied. Thus, for example, if contributions are, in fact, made on behalf of an owner-employee, such owner-employee is considered to have impliedly consented to being covered under the plan.

(2) A qualified plan covering an owner-employee must be a definite written program and arrangement setting forth all provisions essential for qualification at the time such plan is established. Therefore, for example, even though the owner-employee is the only employee covered under the plan at the time the plan is established, the plan must incorporate all the provisions relating to the eligibility and benefits of future employees.

(c) *Bank trustee.* (1)(i) If a trust created after October 9, 1962, is to form a part of a qualified pension or profit-sharing plan covering an owner-employee, or if a trust created before October 10, 1962, but not exempt from tax on October 9, 1962, is to form part of such a plan, the trustee of such trust must be a bank as defined in paragraph (c)(2) of this section, unless an exception contained in paragraph (c)(4) of this section applies, or paragraph (n) of this section applies.

(ii) The provisions of this paragraph do not apply to an employees' trust created prior to October 10, 1962, if such trust was exempt from tax on October 9, 1962, even though the plan of which such trust forms a part is amended after December 31, 1962, to cover any owner-employee. Although the trustee of a trust described in the preceding sentence need not be a bank, all other requirements for the qualification of such a trust must be satisfied at the

time an owner-employee is first covered under such plan.

(2) The term *bank* as used in this paragraph means—

(i) A bank as defined in section 581;

(ii) A corporation which, under the laws of the State of its incorporation or under the laws of the District of Columbia, is subject to both the supervision of, and examination by, the authority in such jurisdiction in charge of the administration of the banking laws;

(iii) In the case of a trust created or organized outside of the United States, that is, outside the States and the District of Columbia, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to both supervision and examination by governmental authority;

(iv) Beginning on January 1, 1974, an insured credit union (within the meaning of section 101 (6) of the Federal Credit Union Act, 12 U.S.C. 1752 (6)).

(3) Although a bank is required to be the trustee of a qualified trust, another person, including the employer, may be granted the power in the trust instrument to control the investment of the trust funds either by directing investments, including reinvestments, disposals, and exchanges, or by disapproving proposed investments, including reinvestments, disposals, or exchanges.

(4)(i) This paragraph does not apply to a trust created or organized outside the States and the District of Columbia before October 10, 1962, if, on October 9, 1962, such trust is described in section 402(c) as an organization treated as if it was a trust exempt from tax under section 501(a).

(ii) In addition, the requirement that the trustee must be a bank does not apply to a qualified trust forming a part of a pension or profit-sharing plan if—

(A) The investments of all the funds in such trust are in annuity, endowment, or life insurance contracts, issued by a company which is a life insurance company as defined in section 801(a) during the taxable year immediately preceding the year that such contracts are originally purchased;

(B) All the proceeds which are, or may become, payable under the contract are payable directly to the employee or his beneficiary;

(C) The plan contains a provision to the effect that the employer is to substitute a bank as a trustee or custodian of the contracts if the employer is notified by the district director that such substitution is required because the trustee is not keeping such records, or making such returns, or rendering such statements, as are required by forms or regulations.

However, a qualified trust may only purchase insurance protection to the extent permitted under a qualified plan (see paragraph (b)(1) (i) and (ii) of § 1.401–1).

(5) An employer may designate several trusts (or custodial accounts) or a trust or trusts and an annuity plan or plans as constituting parts of a single plan which is intended to satisfy the requirements for qualification. However, each trust (or custodial account) so designated which is part of a plan covering an owner-employee must satisfy the requirements of this paragraph. Thus, for example, if all other requirements for qualification are satisfied by the plan, a qualified profit-sharing plan may provide that a portion of the contributions under the plan will be paid to a custodial account, the custodian of which is a bank, for investment in stock of a regulated investment company, and the remainder of such contributions will be paid to a trust, the trustee of which is not a bank, for investment in annuity contracts.

(d) *Profit-sharing plan.* (1) A profit-sharing plan, as defined in paragraph (b)(1)(ii) of § 1.401–1, which covers any owner-employee must contain a definite formula for determining the contributions to be made by the employer on behalf of employees, other than owner-employees. A formula to be definite must specify the portion of profits to be contributed to the trust and must also define profits for plan purposes. A definite formula may contain a variable factor, if the value of such factor may not vary at the discretion of the employer. For example, the percentage of profits to be contributed each year may differ depending on the amount of profits. On the other hand, a formula

which, for example, specifies that profits for plan purposes are not to exceed the cash on hand at the time the employer contribution is made is not a definite formula. The requirement that the plan formula be definite is satisfied if such formula limits the amount to be contributed on behalf of all employees covered under the plan to the amount which permits self-employed individuals to obtain the maximum deduction under section 404(a). However, even though the plan formula is definite, the plan must satisfy all the other requirements for qualification, including the requirement that the contributions under the plan not discriminate in favor of any self-employed individual, and the requirement that the plan be for the exclusive benefit of the employees in general.

(2) A definite contribution formula constitutes an integral part of a qualified profit-sharing plan and may not be amended except for a valid business reason.

(3) The requirement that a profit-sharing plan contain a definite formula for determining the amount of contributions to be made on behalf of employees does not apply to contributions which are made on behalf of owner-employees. However, such contributions are subject to the requirement that they be nondiscriminatory with respect to other employees and must not exceed the limitations on allowable and deductible contributions which may be made by owner-employees.

(e) *Requirements as to coverage*—(1) *Coverage of all employees*. The coverage requirements contained in section 401(a)(3) do not apply to a plan which covers any owner-employee. However, such a plan must satisfy the coverage requirements of section 401(d), including section 401(d)(3). Accordingly, a plan which covers an owner-employee must benefit each employee of the trade or business (other than any owner-employee who does not consent to be covered under the plan) whose customary period of employment has been for more than 20 hours a week for more than five months during each of three consecutive periods of twelve calendar months. Therefore, a plan may not provide, for example, that an employee, other than an owner-employee, is ineligible to participate because he does not consent to be a participant or because he does not consent to make reasonable contributions under the plan.

(2) *Period of service*. (i) In determining whether an employee renders service to the same employer, and, therefore, must be covered under the plan of such employer, a partnership is considered to be one employer during the entire period prior to the time it is terminated within the meaning of section 708 (see paragraph (e)(2) of § 1.401–10).

(ii) In the case of a common-law employee who becomes an employee within the meaning of section 401(c)(1) with respect to the same trade or business, his period of employment is the aggregate of his service as a common-law employee and an employee within the meaning of section 401(c)(1).

(iii) In determining whether any employee, including any owner-employee, has three years of service, past service of any such employee may be taken into account as provided in paragraph (b) of § 1.401–10. Thus, if an employer takes into account past service for any owner-employee, he must take into account the past service of all his other employees to the same extent. However, a plan may provide for coverage after a period of service which is shorter than three years, but in no case may the plan require a waiting period for employees which is longer than that required for the owner-employees.

(f) *Discrimination in contributions or benefits*. (1) Variations in contributions or benefits may be provided under the plan so long as the plan does not discriminate, either as to contributions or benefits, in favor of officers, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees, as against other employees (see § 1.401–4). For the purpose of determining whether the provisions of a plan which provide contributions or benefits for an owner-employee result in the prohibited discrimination, an owner-employee, like other self-employed individuals, is considered a highly compensated employee (see paragraph (d) of § 1.401–11). Whether or not a plan is discriminatory is determined by the

actual operation of the plan as well as by its formal provisions.

(2) The provisions of section 401(a)(5), relating to certain plan provisions which will not in and of themselves be considered discriminatory, are not applicable to any plan which covers any owner-employee. Such a plan must, instead, satisfy the requirements of section 401(a)(10) and section 401(d)(6). Accordingly, a plan is not discriminatory within the meaning of section 401(a)(4) merely because the contributions or benefits provided for the employees covered under the plan bear a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of such employees. The total compensation or the basic or regular rate of compensation of an owner-employee is computed in accordance with the provisions of paragraph (d)(2) of § 1.401–11.

(3) Even though the contributions under the plan do not bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered thereunder and the plan would otherwise be considered discriminatory within the meaning of section 401(a)(4), the plan shall not be considered discriminatory if such variation is due to employer contributions on behalf of any owner-employee which are required, under the plan, to be applied to pay premiums or other consideration on one or more level premium contracts described in section 401(e)(3)(A). In a taxable year to which the foregoing exception applies and, therefore, one in which the contributions under the plan would otherwise be discriminatory, the employer contributions to pay such premiums or other consideration must be the only employer contributions made for the owner-employee, and the contributions for such taxable year under such plan must not be in excess of the amount permitted to be paid toward the purchase of such a contract under the provisions of section 401(e)(3). Furthermore, the exception described in this subparagraph only applies to contributions made under a plan which otherwise satisfies the requirements of section 401(a)(4) and the regulations thereunder. Thus, if a plan provides for the purchase, in accordance with section 401(e)(3), of a level premium contract for an owner-employee, then such plan must provide either that the benefits for all employees are nondiscriminatory or, in the case of a money-purchase type of plan, that the contributions for all employees are based on compensation determined in a non-discriminatory manner. For example, since the contributions on behalf of the owner-employee are based on his earned income during the period preceding the purchase of the contract, the contributions for other employees must be based on their compensation during the same period if this will result in larger contributions on their behalf.

(4) In the case of a plan which covers any owner-employee, the contributions or benefits provided under the plan cannot vary with respect to years of service except as provided in subparagraph (5) of this paragraph.

(5) The provisions of section 401(d)(3) do not preclude the coverage of employees with less than three years of service if such coverage is provided on a nondiscriminatory basis. However, a plan will not be disqualified merely because the contributions or benefits for employees who have less than three years of service are not as favorable as the contributions or benefits for employees having more than three years of service.

(g) *Nonforfeitable rights.* (1)(i) Except as provided in subparagraph (2) of this paragraph, if an owner-employee is covered under the plan of his employer, each employee's rights to the contributions, or to the benefits derived from the contributions, of such employer must be nonforfeitable at the time such contributions are paid to, or under, the plan. The employees who must obtain such nonforfeitable rights include the self-employed individuals who are covered under the plan. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of § 1.402(b)–1.

(ii) Under section 401(d)(2), it is necessary that each employee obtain nonforfeitable rights to the employer contributions under the plan on his behalf from the time such contributions are paid. Thus, each employee must have a nonforfeitable interest to the portion

of the funds under the plan which is allocable to the employer contributions made under the plan on his behalf.

(2) The provisions of subparagraph (1) of this paragraph do not apply to the extent that employer contributions on behalf of any employee must remain forfeitable in order to satisfy the requirements of paragraph (c) of § 1.401–4. However, employer contributions on behalf of employees whose rights are required to remain forfeitable to satisfy such requirements must be nonforfeitable except for such contingency.

(h) *Integration with social security.* (1) If a qualified plan covers any owner-employee, then the rules relating to the integration of such plan with the contributions or benefits under the Social Security Act are provided in this paragraph. Accordingly, the provisions of paragraph (e) of § 1.401–3 and paragraph (c) of § 1.401–11 do not apply to such a plan. In the case of a plan which provides contributions or benefits for any owner-employee, integration of the plan with the Social Security Act for any taxable year of the employer can take place only if not more than one-third of the employer contributions under the plan which are deductible under section 404 for that year are made on behalf of the owner-employees. If such requirement is satisfied, then the plan may be integrated with the contributions or benefits under the Social Security Act in accordance with the rules of subparagraph (3) of this paragraph.

(2)(i) For purposes of subparagraph (1) of this paragraph, in determining the total amount of employer contributions which are deductible under section 404, the provisions of section 404(a), including the provisions of section 404(a)(9) (relating to plans benefiting self-employed individuals), and section 404(e) (relating to the special limitations for self-employed individuals) are taken into account, but the provisions of section 404(a)(10) (relating to the special limitation on the amount allowed as a deduction for self-employed individuals) are not taken into account.

(ii) The amount of deductible employer contributions which are made on behalf of all owner-employees for the year is compared with the amount of deductible employer contributions for the year made on behalf of all employees covered under the plan (including self-employed individuals who are not owner-employees and owner-employees) for the purpose of determining whether the deductible contributions by the employer on behalf of owner-employees are not more than one-third of the total deductible contributions.

(3) If a plan covering an owner-employee satisfies the requirement of subparagraph (1) of this paragraph, and if the employer wishes to integrate such plan with the contributions or benefits under the Social Security Act, then—

(i) The employer contributions under the plan on behalf of any owner-employee shall be reduced by an amount determined by multiplying the earned income of such owner-employee which is derived from the trade or business with respect to which the plan is established and which does not exceed the maximum amount which may be treated as self-employment income under section 1402(b)(1), by the rate of tax imposed under section 1401(a); and

(ii) The employer contributions under the plan on behalf of any employee other than an owner-employee may be reduced by an amount not in excess of the amount determined by multiplying the employee's wages under section 3121(a)(1) by the rate of tax imposed under section 3111(a). For purposes of this subdivision, the earned income of a self-employed individual which is derived from the trade or business with respect to which the plan is established and which is treated as self-employment income under section 1402(b)(1), shall be treated as ''wages'' under section 3121(a)(1).

(4) A money purchase pension plan or a profit-sharing plan may provide that such plan will be integrated with the Social Security Act only for such taxable years of the employer in which the requirements for integration are satisfied. However, a qualified plan cannot provide that employer contributions are only to be made for taxable years in which the integration requirements are satisfied.

(i) *Limit on contributions on behalf of an owner-employee.* (1) Section 401(d)(5) requires that a plan which covers any

owner-employee must contain provisions which restrict the employer contributions that may be made on behalf of any owner-employee for each taxable year to an amount no greater than that which is deductible under section 404. In computing the amount deductible under section 404 for purposes of section 401(d)(5) and this paragraph, the limitations contained in section 404(a)(9) and (e), relating to special limitations for self-employed individuals, are taken into account, but such amount is determined without regard to section 404(a)(10), relating to the special limitation on the amount allowed as a deduction for self-employed individuals. Accordingly, a qualified plan which covers any owner-employee cannot permit employer contributions to be made on behalf of such owner-employee in excess of 10 percent of the earned income which is derived by such owner-employee from the trade or business with respect to which the plan is established, or permit the employer to contribute more than $2,500 on behalf of any such owner-employee for any taxable year.

(2)(i) In determining whether the plan permits contributions to be made in excess of the limitations of subparagraph (1) of this paragraph, employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance are not to be taken into account. To determine the amount of employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance, see paragraph (f) of §1.404(e)–1 and paragraph (b) of §1.72–16. However, contributions for such insurance can be made only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder.

(ii) A further exception to the limit on the amount of contributions which an employer may make under the plan on behalf of an owner-employee is made in the case of contributions which are required, under the plan, to be applied to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts described in section 401(e)(3) (see section 401(e)(3) and the regulations thereunder).

(j) *Excess contributions.* The provisions of section 401(e) define the term ''excess contribution'' and indicate the consequences of making such a contribution (see §1.401–13). However, section 401(d)(8) provides that a qualified plan which provides contributions or benefits for any owner-employee must contain certain provisions which complement the rules contained in section 401(e). Under section 401(d)(8), a qualified plan must provide that—

(1) The net amount of any excess contribution (determined in accordance with the provisions of §1.401–13) must be returned to the owner-employee on whose behalf it is made, together with the net income earned on such excess contribution;

(2) For each taxable year for which the trust is considered to be a nonqualified trust with respect to an owner-employee under section 401(e)(2) because the net amount of an excess contribution and the earnings thereon have not been returned to such owner-employee, the income of the trust for that taxable year attributable to the interest of such owner-employee is to be paid to him.

(3) If an excess contribution is determined to be willfully made (within the meaning of section 401(e)(2)(E)), the entire interest of the owner-employee on whose behalf such contribution was made is required to be distributed to such owner-employee. Furthermore, the plan must require the distribution of an owner-employee's entire interest under the plan if a willful excess contribution is determined to have been made under any other plan in which the owner-employee is covered as an owner-employee.

(k) *Contributions of property under a qualified plan.* (1) The contribution of property, other than money, prior to January 1, 1975, by the person who is the employer (within the meaning of section 401(c)(4)) to a qualified trust forming a part of a plan which covers employees some or all of whom are owner-employees who control (within the meaning of section 401(d)(9)(B) and the regulations thereunder) the trade or business with respect to which the plan is established is a prohibited transaction between such trust and the employer-grantor of such trust (see

section 503(g) prior to its repeal by sec. 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)).

(2) A contribution of property, other than money, prior to January 1, 1975, to a qualified trust by an owner-employee who controls, or a member of a group of owner-employees who together control, the trade or business with respect to which the plan is established, or a contribution of property, other than money, to a qualified trust by a member of such an owner-employee's family (as defined in section 267(c)(4)), is a prohibited transaction. (See section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)).

(3) See section 4975 and the regulations thereunder with respect to rules relating to the contribution of property, other than money, made after December 31, 1974.

(l) *Controlled trades or businesses*— (1) *Plans covering an owner-employee who controls another trade or business.* (i) A plan must not cover any owner-employee, or group of two or more owner-employees, if such owner-employee, or group of owner-employees, control (within the meaning of subparagraph (3) of this paragraph) any other trade or business, unless the employees of such other trade or business controlled by such owner-employee, or such group of owner-employees, are included in a plan which satisfies the requirements of section 401(a), including the qualification requirements of section 401(d). The employees who must be covered under the plan of the trade or business which is controlled include the self-employed individuals who are not owner-employees and the owner-employees who consent to be covered by such plan. Accordingly, the employer must determine whether any owner-employee, or group of owner-employees, who may participate in the plan which is established by such employer controls any other trade or business, and whether the requirements of this subparagraph are satisfied with respect to the plan established in such other trade or business. The plan of an employer may exclude an owner-employee who controls another trade or business from coverage under the plan even though such owner-employee consents to be covered, if a plan which satisfies the requirements of subdivision (ii) of this subparagraph has not been established in the trade or business which such owner-employee controls.

(ii) The qualified plan which the owner-employee, or owner-employees, are required to provide for the employees of the trade or business which they control must provide contributions and benefits which are not less favorable than the contributions and benefits provided for the owner-employee, or owner-employees, under the plan of any trade or business which they do not control. Thus, for example, if the contributions or benefits for the owner-employee under the plan of the trade or business which he does not control are computed on the basis of his total (as compared to basic or regular rate) of compensation, then the contributions or benefits for employees covered under the plan of the trade or business which the owner controls must be computed on the basis of their total compensation. However, the requirements of this subdivision cannot be satisfied if the benefits and contributions provided under the plan for the employees of the trade or business which is controlled are not comparable to those provided under the plan covering the owner-employee, or group of owner-employees, in the trade or business which they do not control. Thus, for example, if the owner-employee is covered by a pension plan in the trade or business which he does not control, he may not satisfy the requirements of this subdivision by establishing a profit-sharing plan in the trade or business which he does control.

(iii) If an individual is covered as an owner-employee under the plans of two or more trades or businesses which he does not control and such individual controls a trade or business, then the contributions or benefits of the employees under the plan of the trade or business which he does control must be as favorable as those provided for him under the most favorable plan of the trade or business which he does not control.

(2) *Owner-employees who control more than one trade or business.* If the plan

provides contributions or benefits for an owner-employee who controls, or group of owner-employees who together control, the trade or business with respect to which the plan is established, and such owner-employee, or group of owner-employees, also control as owner-employees one or more other trades or businesses, plans must be established with respect to such controlled trades or businesses so that when taken together they form a single plan which satisfies the requirements of section 401 (a) and (d) with respect to the employees of all the controlled trades or businesses.

(3) *Control defined.* (i) For purposes of this paragraph, an owner-employee, or a group of two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such group of two or more owner-employees together—

(A) Own the entire interest in an unincorporated trade or business, or

(B) In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

In determining whether an owner-employee, or group of owner-employees, control a trade or business within the meaning of the preceding sentence, it is immaterial whether or not such individuals could be covered under a plan established with respect to the trade or business. For example, if an individual who is an owner-employee has a 60-percent capital interest in another trade or business, such individual controls such trade or business and the provisions of this paragraph apply even though the individual derives no earned income, as defined in section 401(c)(2), from the controlled trade or business. For purposes of determining the ownership interest of an owner-employee, or group of owner-employees, an owner-employee, or group of owner-employees, is treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership controlled by such owner-employee, or group of owner-employees.

(ii) The provisions of subparagraphs (1) and (2) of this paragraph apply only if the owner-employee who controls, or the group of owner-employees who control, a trade or business, or trades or businesses, within the meaning of subdivision (i) of this subparagraph is the same owner-employee, or group of owner-employees, covered under the plan intended to satisfy the requirements for qualification. Thus, for example, if A is a 50-percent partner in both the AB and AC partnership, and if the AB partnership wishes to establish a plan covering A and B, the provisions of subparagraphs (1) and (2) of this paragraph do not apply, since A does not control either partnership, and since B has no interest in the AC partnership.

(m) *Distribution of benefits.* (1)(i) Section 401(d)(4)(B) requires that a qualified plan which provides contributions or benefits for any owner-employee must not provide for the payment of benefits to such owner-employee at any time before he has attained age 59½. An exception to the foregoing rule permits a qualified plan to provide for the distribution of benefits to an owner-employee prior to the time he attains age 59½ if he is disabled. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of §1.72–17 for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. In general, both sections 72(m)(7) and 213(g)(3) provide that an individual is considered disabled if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In addition, section 401(d)(4)(B) does not preclude the distribution of benefits to the estate or other beneficiary of a deceased owner-employee prior to the time the owner-employee would have attained age 59½ if he had lived.

(ii) A qualified plan must provide that if, despite the restrictions in the plan to the contrary, an amount is prematurely distributed, or made available, to a participant in such plan who is, or has been, an owner-employee, then no contribution shall be made under the plan by, or for, such individual during any of the 5 taxable years of the plan beginning after the distribution is made.

(2)(i) The provisions of subparagraph (1) of this paragraph preclude an owner-employee who is a participant in a qualified pension or profit-sharing plan of his employer from withdrawing any part of the funds accumulated on his behalf except as provided in such subparagraph (1). However, the distribution of an owner-employee's interest, or any portion of such interest, after he attains age 59½ is determined by the provisions of the plan. Thus, for example, if a qualified pension plan provides that the normal retirement age under the plan is age 65, an owner-employee would not be entitled to a distribution of an amount under the plan merely because he attained age 59½.

(ii) The provisions of subparagraph (1) of this paragraph do not preclude the establishment of a profit-sharing plan which provides for the distribution of all, or part, of participants' accounts after a fixed number of years. However, such a plan must not permit a distribution of any amount to any owner-employee prior to the time the owner-employee has attained age 59½ or becomes disabled within the meaning of section 72(m)(7) or section 213(g)(3), whichever is applicable. On the other hand, if a distribution would have been made under the plan to an owner-employee but for the fact that he had not attained age 59½, then the amount of such distribution (including any increment earned on such amount) must be distributed to such owner-employee at such time as he attains age 59½.

(3) A qualified pension, annuity, or profit-sharing plan which covers an owner-employee must provide that the distribution of an owner-employee's entire interest under the plan must begin prior to the end of the taxable year in which he attains the age of 70½, and such distribution must satisfy the requirements of section 401(a)(9) and paragraph (e) of §1.401–11. Furthermore, section 401(d)(7) provides that, if an owner-employee dies prior to the time his entire interest has been distributed to him, such owner-employee's entire remaining interest under the plan must, in general, either be distributed to his beneficiary, or beneficiaries, within 5 years, or be used within that period to purchase an immediate annuity for his beneficiary, or beneficiaries. However, a distribution within 5 years of the death of the owner-employee is not required if the distribution of his interest has commenced and such distribution is for a term certain over a period not extending beyond the joint life and survivor expectancy of the owner-employee and his spouse. Thus, for example, an annuity for the joint life and survivor expectancy of an owner-employee and his spouse which guarantees payments for 10 years is a distribution which is payable over a period which does not exceed the joint life and survivor expectancy of the owner-employee and his spouse if such expectancy is at least 10 years at the time the distribution first commences.

[T.D. 6675, 28 FR 10126, Sept. 17, 1963, as amended by T.D. 6982, 33 FR 16500, Nov. 13, 1968; T.D. 6985, 33 FR 19815, Dec. 27, 1968; T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7611, 44 FR 23520, Apr. 20, 1979; T.D. 8635, 60 FR 65549, Dec. 20, 1995]

§ 1.401–13 Excess contributions on behalf of owner-employees.

(a) *Introduction.* (1) The provisions of this section prescribe the rules relating to the treatment of excess contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in paragraph (d) of §1.401–10). Paragraph (b) of this section defines the term ''excess contribution''. Paragraph (c) of this section describes an exception to the definition of an excess contribution in the case of contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts. Paragraph (d) of this section describes the effect of making an excess contribution which is not determined to have been willfully made, and paragraph (e) of this section describes the effect of making an excess contribution which is determined to have been willfully made.

(2) Under section 401(c)(1), certain self-employed individuals are treated as employees for purposes of section 401. In addition, under section 401(c)(4), a proprietor is treated as his own employer, and the partnership is treated

as the employer of the partners. Under section 404, certain contributions on behalf of a self-employed individual are treated as deductible and taken into consideration in determining the amount allowed as a deduction under section 404(a). Such contributions are treated under section 401 and the regulations thereunder as employer contributions on behalf of the self-employed individual. However, in some cases, additional contributions may be made on behalf of a self-employed individual. Such contributions are not taken into consideration in determining the amount deductible under section 404 and are not taken into consideration in computing the amount allowed as a deduction under section 404(a). For purposes of section 401 and the regulations thereunder, such contributions are treated as employee contributions by the self-employed individual. If a self-employed individual is an owner-employee within the meaning of section 401(c)(3) and paragraph (d) of § 1.401–10, then this section prescribes the rules applicable if contributions are made in excess of those permitted to be made under section 401.

(b) *Excess contributions defined.* (1)(i) Except as provided in paragraph (c) relating to contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts, an excess contribution is any amount described in subparagraphs (2) through (4) of this paragraph.

(ii) For purposes of determining if the amount of any contribution made under the plan on behalf of an owner-employee is an excess contribution, the amount of any contribution made under the plan which is allocable to the purchase of life, accident, health, or other insurance is not taken into account. The amount of any contribution which is allocable to the cost of insurance protection is determined in accordance with the provisions of paragraph (f) of § 1.404 (e)–1 and paragraph (b) of § 1.72–16.

(2)(i) In the case of a taxable year of the plan for which employer contributions are made on behalf of only owner-employees, an excess contribution is the amount of any contribution for such taxable year on behalf of such owner-employee which is not deductible under section 404 (determined without regard to section 404(a)(10)). This rule applies irrespective of whether the plan provides for contributions on behalf of common-law employees, or self-employed individuals who are not owner-employees, when such employees or individuals become eligible for coverage under the plan, and irrespective of whether contributions are in fact made for such employees or such individuals for other taxable years of the plan.

(ii) In the case of a taxable year of the plan for which employer contributions are made on behalf of both owner-employees and either common-law employees or self-employed individuals who are not owner-employees, an excess contribution is the amount of any employer contribution on behalf of any owner-employee for such taxable year which exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) unless such amount may be treated as an employee contribution under the plan in accordance with the rules of paragraph (d)(3) of § 1.401–11 and is a permissible employee contribution under subparagraph (3) of this paragraph.

(3)(i) In the case of a taxable year of the plan for which employer contributions are made on behalf of both an owner-employee and either common-law employees or self-employed individuals who are not owner-employees, employee contributions on behalf of an owner-employee may be made for such taxable year of the plan. How-ever, the amount of such contributions, if any, which is described in subdivisions (ii), (iii), or (iv) of this subparagraph is an excess contribution.

(ii) An excess contribution is the amount of any employee contribution made on behalf of any owner-employee during a taxable year of the plan at a rate in excess of the rate of contributions which may be made as employee contributions by common-law employees, or by self-employed individuals who are not owner-employees, during such taxable year of the plan.

(iii) An excess contribution is the amount of any employee contribution made on behalf of an owner-employee which exceeds the lesser of $2,500 or 10

percent of the earned income (as defined in paragraph (c) of § 1.401–10) of such owner-employee for his taxable year in which such contributions are made.

(iv) In the case of a taxable year of an owner-employee in which contributions are made on behalf of such owner-employee under more than one plan, an excess contribution is the amount of any employee contribution made on behalf of such owner-employee under all such plans during such taxable year which exceeds $2,500. If such an excess contribution is made, the amount of the excess contribution made on behalf of the owner-employee with respect to any one of such plans is the amount by which the employee contribution on his behalf under such plan for the year exceeds an amount which bears the same ratio to $2,500 as the earned income of the owner-employee derived from the trade or business with respect to which the plan is established bears to his earned income derived from the trades or businesses with respect to which all such plans are established.

(4) An excess contribution is the amount of any contribution on behalf of an owner-employee for any taxable year of the plan with respect to which the plan is treated, under section 401(e)(2), as not meeting the requirements of section 401(d) with respect to such owner-employee.

(c) *Contributions for premiums on certain annuity, endowment, or life insurance contracts.* (1) The term ''excess contribution'' does not include the amount of any employer contributions on behalf of an owner-employee which, under the provisions of the plan, is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts, if—

(i) The employer contributions so applied meet the requirements of subparagraphs (2) through (4) of this paragraph, and

(ii) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $2,500. For purposes of computing such $2,500 limit, the total employer contributions includes amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2)(i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-employee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii) (see paragraph (f)(3) of § 1.401–12).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. Accordingly, for example, a nontransferable face-amount certificate (as defined in section 401(g) and the regulations thereunder) is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4)(i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the amounts deductible under section 404 (determined without regard

to section 404(a)(10)) by such employer on behalf of such owner-employee for the most recent three taxable years of the employer (ending prior to the date the latest contract was entered into or modified to provide additional benefits), in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the ''average of the amounts deductible'', only so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account. If such taxable years began prior to January 1, 1963, the amount deductible is determined as if section 404 included section 404(a) (8), (9), (10), and (e).

(5) The amount of any employer contribution which is not deductible but which is not treated as an excess contribution because of the provisions of this paragraph shall be taken into account as an employee contribution made on behalf of the owner-employee during the owner-employee's taxable year with, or within which, the taxable year of the person treated as his employer under section 401(c)(4) ends. However, such contribution is only treated as an employee contribution made on behalf of the owner-employee for the purpose of determining whether any other employee contribution made on behalf of the owner-employee during such period is an excess contribution described in paragraph (b)(3) of this section.

(d) *Effect of an excess contribution which is not willfully made.* (1) If an excess contribution (as defined in paragraph (b) of this section) is made on behalf of an owner-employee, and if such contribution is not willfully made, then the provisions of this paragraph describe the effect of such an excess contribution. However, if the excess contribution made on behalf of an owner-employee is determined to have been willfully made, then the provisions of paragraph (e) of this section are applicable to such contribution.

(2)(i) This paragraph does not apply to an excess contribution if the net amount of such excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to such amount are repaid to the owner-employee on whose behalf the excess contribution was made at any time before the end of six months beginning on the day on which the district director sends notice (by certified or registered mail) of the amount of the excess contribution to the trust, insurance company, or other person to whom such excess contribution was paid. The net income attributable to the net amount of the excess contribution is the aggregate of the amounts of net income attributable to the net amount of the excess contribution for each year of the plan beginning with the taxable year of the plan within which the excess contribution is made and ending with the close of the taxable year of the plan immediately preceding the taxable year of the plan in which the net amount of the excess contribution is repaid. The amount of net income attributable to the net amount of the excess contribution for each year is the amount of net income earned under the plan during the year which is allocated in a reasonable manner to the net amount of the excess contribution. For example, the amount of net income earned under the plan for the year which is attributable to the net amount of an excess contribution can be computed as the amount which bears the same ratio to the amount of the ''net income attributable to the interest of the owner-employee under the plan'' for such taxable year (determined in accordance with the provisions of subparagraph (5)(ii) of this paragraph) as the net amount of the excess contribution bears to the aggregate amount standing to the account of the owner-employee at the end of that

year (including the net amount of any excess contribution).

(ii) The notice described in subdivision (i) of this subparagraph shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for his taxable year in which such excess contribution was made. For purposes of this subdivision, a final determination of the amount of tax liability of the owner-employee includes—

(A)1 A decision by the Tax Court of the United States, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(B) A closing agreement authorized by section 7121; or

(C) The expiration of the period of limitation on suits by the taxpayer for refund, unless suit is instituted prior to the expiration of such period.

(iii) For purposes of this subparagraph, an amount is treated as repaid to an owner-employee if an adequate adjustment is made to the account of the owner-employee. An adequate adjustment is made to the account of an owner-employee, for example, if the amount of the excess contribution (without any reduction for any loading or other administrative charge) and the net income attributable to such amount is taken into account as a contribution under the plan for the current year. In such a case, the gross income of the owner-employee for his taxable year in which such adjustment is made includes the amount of the net income attributable to the excess contribution.

(iv) If the net amount of the excess contribution and the net income attributable thereto is repaid, within the period described in subdivision (i) of this subparagraph, to the owner-employee on whose behalf such contribution was made, then the net income attributable to the excess contribution is, pursuant to section 61(a), includible in the gross income of the owner-employee for his taxable year in which such amount is distributed, or made available, to him. However, such amount is not a distribution to which section 402 or 403 and section 72 apply (see subparagraph (6) of this paragraph).

(3)(i) If the net amount of any excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to that excess contribution are not repaid to the owner-employee on whose behalf the excess contribution was made before the end of the six-month period described in subparagraph (2)(i) of this paragraph, the plan under which the excess contribution has been made is considered, for purposes of section 404, as not satisfying the requirements for qualification with respect to such owner-employee for all taxable years of the plan described in subdivision (ii) of this subparagraph. However, such disqualification only applies to the interest of the owner-employee on whose behalf an excess contribution has been made and does not disqualify the plan with respect to the other participants thereunder.

(ii) The taxable years referred to in subdivision (i) of this subparagraph include the taxable year of the plan within which the excess contribution is made and each succeeding taxable year of the plan until the beginning of the taxable year of the plan in which the trust, insurance company, or other person to whom such excess contribution was paid repays to such owner-employee—

(A) The net amount of the excess contribution, and

(B) The amount of income attributable to his interest under the plan which is includible in his gross income for any taxable year by reason of the provisions of subparagraph (5) of this paragraph.

(4) For purposes of this paragraph, the net amount of an excess contribution is the amount of such excess contribution, as defined in paragraph (b) of this section, reduced by the amount of any loading charge or other administrative charge ratably allocable to such excess contribution.

(5)(i) If a plan is considered as not meeting the requirements for qualification with respect to an owner-employee by reason of the provisions of subparagraph (3) of this paragraph for any taxable year of the plan, such owner-employee's gross income for any of his

taxable years with or within which such taxable year of the plan ends shall, for purposes of chapter 1 of the Code, include the portion of the net income earned under the plan for such taxable year of the plan which is attributable to the interest of the owner-employee under the plan.

(ii) For purposes of this subparagraph, the term ''net income'' means the net income earned under the plan determined in accordance with generally accepted accounting principles consistently applied, and the ''net income attributable to the interest of the owner-employee under the plan'' is the amount which bears the same ratio to the aggregate amount of net income earned under the plan for the taxable year of the plan as the amount standing to the account of the owner-employee at the end of that year (including the amount of any excess contribution which is credited to his account) bears to the aggregate amount of all funds under the plan for all employees at the end of that year (including the aggregate amount of excess contributions credited to the accounts of all owner-employees for that year).

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. A is an owner-employee covered under the X Employees' Pension Trust who files his return on the basis of a calendar year. An excess contribution was made on behalf of A during the plan year beginning on January 1, 1966. The net amount of the excess contribution and the net income attributable thereto was not repaid to A before the end of the six-month period described in subparagraph (2)(i) of this paragraph. Accordingly, the net income earned under the plan during 1966 which is attributable to A's interest is to be included in his gross income for 1966. Assume that the trust which forms a part of the pension plan of the X Company also files its returns on a calendar year basis, and that during 1966 the trust had a gross income of $4,000 (including a long-term capital gain of $2,500) and expenses of $500. Assume, further, that the amount standing to A's account on December 31, 1966 (including the amount of the excess contribution), was $20,000, and that on that date the amount funded under the plan for all employees (including A) is $140,000. Then the net income of the trust for 1966 is $3,500 ($4,000 – $500). The net income attributable to the interest of A under the plan is $500 (the amount which bears the same ratio to $3,500 as $20,000 bears to $140,000). Accordingly, $500 is included in A's gross income in accordance with the provisions of section 401(e)(2)(B) as the ''net income attributable to the interest of the owner-employee under the plan''.

(6) The provisions of section 402 or 403 and section 72 do not apply to any amount distributed, or made available, to an owner-employee which is described in this paragraph. Accordingly, for example, the provisions of section 72(m)(5)(A)(i), relating to amounts subject to the penalty tax imposed by section 72(m), do not apply to the amount of the net income attributable to the interest of an owner-employee (as defined in subparagraph (5)(ii) of this paragraph) which is includible in his gross income. Furthermore, in such a case, the provisions of section 401(d)(5)(C) do not apply to such amount.

(7) Certain adjustments will be required with respect to the interest of an owner-employee after any amount previously allocated to his account has been returned to him pursuant to the provisions of this paragraph. For example, if the determination of whether life insurance benefits provided under the plan are incidental is made, in part, with regard to the contributions allocated to the accounts of the participants covered under the plan, an adjustment may have to be made with respect to the life insurance purchased under the plan for any owner-employee after any amount previously allocated to his account has been repaid to him. Furthermore, if, for example, an owner-employee has received annuity payments which were taxable under the exclusion ratio rule of section 72, and if such exclusion ratio took into account any amount credited to the account of the owner-employee which is subsequently repaid to him, then such exclusion ratio must be recomputed after the adjustment in such owner-employee's account has taken place.

(8) Notwithstanding any other provision of law, in any case in which the plan is treated as not satisfying the requirements for qualification with respect to any owner-employee by reason of the provisions of section 401(e), the period for assessing, with respect to such owner-employee, any deficiency arising by reason of—

(i) The disallowance of any deduction under section 404 by reason of the provisions of subparagraph (3) of this paragraph, or

(ii) The inclusion of amounts in the gross income of the owner-employee by reason of the provisions of subparagraph (5) of this paragraph,

shall not expire prior to 18 months after the day the district director mails the notice with respect to the excess contribution (described in subparagraph (2)(i) of this paragraph) which gives rise to such disallowance or inclusion. Thus, for example, notwithstanding the provisions of section 6212(c) (relating to the restriction on the determination of additional deficiencies), if, after a final determination by the Tax Court of the income tax liability of an owner-employee for a taxable year in which an excess contribution was made, the amount of such excess contribution and the net income attributable thereto is not paid to the owner-employee before the end of the six-month period described in subparagraph (2)(i) of this paragraph, an additional deficiency assessment may be made for such taxable year with respect to such excess contribution.

(e) *Effect of an excess contribution which is determined to have been willfully made.* If an excess contribution (as defined in paragraph (b) of this section) on behalf of an owner-employee is determined to have been willful ly made, then—

(1) Only the provisions of this paragraph apply to such contribution;

(2) There shall be distributed to the owner-employee on whose behalf such contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee;

(3) The amount distributed under each such plan is an amount to which section 72 does apply (see section 72(m)(5)(A)(iii)); and

(4) For purposes of section 404, no plan in which such individual is covered as an owner-employee shall be considered as meeting the requirements for qualification with respect to such owner-employee for any taxable year of the plan beginning with or within the calendar year in which it is determined that the excess contribution has been willfully made and with or within the five calendar years following such year.

(f) *Years to which this section applies.* This section applies to contributions made in taxable years of employers beginning before January 1, 1976. Thus, for example, in the case of willful contributions made in taxable years of employers beginning before January 1, 1976, paragraphs (e) (1), (2), and (3) of this section apply to such taxable years beginning on or after such date. However, in such a case, because the application of paragraph (e)(4) of this section affects contributions made in taxable years of employers beginning on or after January 1, 1976, paragraph (e)(4) of this section does not apply to such taxable years; see paragraph (c) of § 1.401(e)–4 (relating to transitional rules for excess contributions).

[T.D. 6676, 28 FR 10139, Sept. 17, 1963; as amended by T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401–14 Inclusion of medical benefits for retired employees in qualified pension or annuity plans.

(a) *Introduction.* Under section 401(h) a qualified pension or annuity plan may make provision for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents. The term ''medical benefits described in section 401(h)'' is used in this section to describe such payments.

(b) *In general*—(1) *Coverage.* Under section 401(h), a qualified pension or annuity plan may provide for the payment of medical benefits described in section 401(h) only for retired employees, their spouses, or their dependents. To be ''retired'' for purposes of eligibility to receive medical benefits described in section 401(h), an employee must be eligible to receive retirement benefits provided under the pension plan, or else be retired by an employer providing such medical benefits by reason of permanent disability. For purposes of the preceding sentence, an employee is not considered to be eligible to receive retirement benefits provided under the plan if he is still employed by the employer and a separation from employment is a condition to receiving the retirement benefits.

(2) *Discrimination*. A plan which provides medical benefits described in section 401(h) must not discriminate in favor of officers, shareholders, supervisory employees, or highly compensated employees with respect to coverage and with respect to the contributions or benefits under the plan. The determination of whether such a plan so discriminates is made with reference to the retirement portion of the plan as well as the portion providing the medical benefits described in section 401(h). Thus, for example, a plan will not be qualified under section 401 if it discriminates in favor of employees who are officers or shareholders with respect to either portion of the plan.

(3) *Funding medical benefits*. Contributions to provide the medical benefits described in section 401(h) may be made either on a contributory or noncontributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical benefits described in section 401(h) may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions.

(4) *Definitions*. For purposes of section 401(h) and this section:

(i) The term *dependent* shall have the same meaning as that assigned to it by section 152, and

(ii) The term *medical expense* means expenses for medical care as defined in section 213(e)(1).

(c) *Requirements*. The requirements which must be met for a qualified pension or annuity plan to provide medical benefits described in section 401(h) are set forth in subparagraphs (1) through (5) of this paragraph.

(1) *Benefits*. (i) The plan must specify the medical benefits described in section 401(h) which will be available and must contain provisions for determining the amount which will be paid. Such benefits, when added to any life insurance protection provided for under the plan, must be subordinate to the retirement benefits provided by such plan. For purposes of this section, life insurance protection includes any benefit paid under the plan on behalf of an employee-participant as a result of the employee-participant's death to the extent such payment exceeds the amount of the reserve to provide the retirement benefits for the employee-participant existing at his death. The medical benefits described in section 401(h) are considered subordinate to the retirement benefits if at all times the aggregate of contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions (made after such date) other than contributions to fund past service credits.

(ii) The meaning of the term *subordinate* may be illustrated by the following example:

Example. The X Corporation amends its qualified pension plan to provide medical benefits described in section 401(h) effective for the taxable year 1964. The total contributions under the plan (excluding those for past service credits) for the taxable year 1964 are $125,000, allocated as follows: $100,000 for retirement benefits, $10,000 for life insurance protection, and $15,000 for medical benefits described in section 401(h). The medical benefits described in section 401(h) are considered subordinate to the retirement benefits since the portion of the contributions allocated to the medical benefits described in section 401(h) ($15,000) and to life insurance protection after such medical benefits were included in the plan ($10,000), or $25,000, does not exceed 25 percent of $125,000. For the taxable year 1965, the X Corporation contributes $140,000 (exclusive of contributions for past service credits) allocated as follows: $100,000 for retirement benefits, $10,000 for life insurance protection, and $30,000 for medical benefits described in section 401(h). The medical benefits described in section 401(h) are considered subordinate to the retirement benefits since the aggregate contributions allocated to the medical benefits described in section 401(h) ($45,000) and to life insurance protection after such medical benefits were included in the plan ($20,000) or $65,000 does not exceed 25 percent of $265,000, the aggregate of the contributions made in 1964 and 1965.

(2) *Separate accounts*. Where medical benefits described in section 401(h) are provided for under a qualified pension or annuity plan, a separate account must be maintained with respect to contributions to fund such benefits. The separation required by this section

is for recordkeeping purposes only. Consequently, the funds in the medical benefits account need not be separately invested. They may be invested with funds set aside for retirement purposes without identification of which investment properties are allocable to each account. However, where the investment properties are not allocated to each account, the earnings on such properties must be allocated to each account in a reasonable manner.

(3) *Reasonable and ascertainable.* Section 401(h) further requires that amounts contributed to fund medical benefits therein described must be reasonable and ascertainable. For the rules relating to the deduction of such contributions, see paragraph (f) of §1.404(a)–3. The employer must, at the time he makes a contribution, designate that portion of such contribution allocable to the funding of medical benefits.

(4) *Impossibility of diversion prior to satisfaction of all liabilities.* Section 401(h) further requires that it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide for the payment of medical benefits described in section 401(h), for any part of the corpus or income of the medical benefits account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits. Consequently, a plan which, for example, under its terms, permits funds in the medical benefits account to be used for any retirement benefit provided under the plan does not satisfy the requirements of section 401(h) and will not qualify under section 401(a). However, the payment of any necessary or appropriate expenses attributable to the administration of the medical benefits account does not affect the qualification of the plan.

(5) *Reversion upon satisfaction of all liabilities.* The plan must provide that any amounts which are contributed to fund medical benefits described in section 401(h) and which remain in the medical benefits account upon the satisfaction of all liabilities arising out of the operation of the medical benefits portion of the plan are to be returned to the employer.

(6) *Forfeitures.* The plan must expressly provide that in the event an individual's interest in the medical benefits account is forfeited prior to termination of the plan an amount equal to the amount of the forfeiture must be applied as soon as possible to reduce employer contributions to fund the medical benefits described in section 401(h).

(d) *Effective date.* This section applies to taxable years of a qualified pension or annuity plan beginning after October 23, 1962.

[T.D. 6722, 29 FR 5072, Apr. 14, 1964]

§1.401(a)–1 Post-ERISA qualified plans and qualified trusts; in general.

(a) *Introduction*—(1) *In general.* This section and the following regulation sections under section 401 reflect the provisions of section 401 after amendment by the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406) (''ERISA'').

(2) [Reserved]

(b) *Requirements for pension plans*—(1) *Definitely determinable benefits.* (i) In order for a pension plan to be a qualified plan under section 401(a), the plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement.

(ii) Section 1.401–1(b)(1)(i), a pre-ERISA regulation, provides rules applicable to this requirement, and that regulation is applicable except as otherwise provided.

(iii) The use of the type of plan provision described in §1.415–1(d)(1) which automatically freezes or reduces the rate of benefit accrual or the annual addition to insure that the limitations of section 415 will not be exceeded, will not be considered to violate the requirements of this subparagraph provided that the operation of such provision precludes discretion by the employer.

[T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§1.401(a)–2 Impossibility of diversion under qualified plan or trust.

(a) *General rule.* Section 401(a)(2) requires that in order for a trust to be

qualified, it must be impossible under the trust instrument (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of those employees or their beneficiaries. Section 1.401–2, a pre-ERISA regulation, provides rules under section 401(a)(2) and that regulation is applicable except as otherwise provided.

(b) *Section 415 suspense account*. Paragraph (a) of this section does not apply to amounts properly allocated to a suspense account pursuant to §1.415–6(b)(6). The plan, or the trust forming part of the plan, may provide for the reversion to the employer, upon termination of the plan, of amounts held in the suspense account.

[T.D. 7748, 46 FR 1696, Jan. 7, 1981]

§1.401(a)–4 Optional forms of benefit (before 1994).

Q–1: How does section 401(a)(4) apply to optional forms of benefits?

A–1: (a) *In general*—(1) *Scope*. The nondiscrimination requirements of section 401(a)(4) apply to the amount of contributions or benefits, optional forms of benefit, and other benefits, rights and features (e.g., actuarial assumptions, methods of benefit calculation, loans, social security supplements, and disability benefits) under a plan. This section addresses the application of section 401(a)(4) only to optional forms of benefit under a plan. Generally, the determination of whether an optional form is nondiscriminatory under section 401(a)(4) is made by reference to the availability of such optional form, and not by reference to the utilization or actual receipt of such optional form. See Q&A–2 of this section. Even though an optional form of benefit under a plan may be nondiscriminatory under section 401(a)(4) and this §1.401(a)–4 because the availability of such optional form does not impermissibly favor employees in the highly compensated group, such plan may fail to satisfy section 401(a)(4) with respect to the amount of contributions or benefits or with respect to other benefits, rights and features if, for example, the method of calculation or the amount or value of benefits payable under such optional form impermissibly favors the highly compensated group. See §1.411(d)–4, Q&A–1 for the definition of ''optional form of benefit.''

(2) *Nondiscrimination requirements*. Each optional form of benefit provided under a plan is subject to the nondiscrimination requirement of section 401(a)(4) and thus the availability of each optional form of benefit must not discriminate in favor of the employees described in section 401(a)(4) in whose favor discrimination is prohibited (the ''highly compensated group''). See paragraph (b) of this Q&A–1 for a description of the employees included in such group. This is true without regard to whether a particular optional form of benefit is the actuarial equivalent of any other optional form of benefit under the plan. Thus, for example, a plan may not condition, or otherwise limit, the availability of a single sum distribution of an employee's benefit in a manner that impermissibly favors the highly compensated group.

(b) *Highly compensated group*. For plan years commencing prior to the applicable effective date for the amendment made to section 401(a)(4) by section 1114 of the Tax Reform Act of 1986 (TRA '86), the highly compensated group consists of those employees who are officers, shareholders, or highly compensated. For plan years beginning on or after the applicable effective date of the amendments to section 401(a)(4) made by TRA '86, the highly compensated group consists of those employees who are highly compensated within the meaning of section 414(q). The amendment to section 401(a)(4) made by section 1114 of TRA '86 is generally effective for plan years commencing after December 31, 1988. See section 1114(a) of TRA '86.

Q–2: How is it determined whether an optional form of benefit satisfies the nondiscrimination requirements of section 401(a)(4)?

A–2: (a) *Nondiscrimination requirement*.—(1) *In general*. An optional form of benefit under a plan is nondiscriminatory under section 401(a)(4) only if the requirements of paragraphs (a)(2) and (a)(3) of this Q&A–2 are satisfied

with respect to such optional form. The determination of whether an optional form of benefit satisfies these requirements is made by reference to the availability of the optional form, and not by reference to the utilization or actual receipt of such optional form. Thus, an optional form of benefit that satisfies the requirements of paragraphs (a)(2) and (a)(3) of this Q&A–2 is nondiscriminatory under section 401(a)(2) even though the highly compensated group disproportionately utilizes such optional form. However, the composition of the group of employees who actually receive benefits in an optional form may be relevant in determining whether such optional form satisfies the requirement of paragraph (a)(3) of this Q&A–2 with respect to effective availability.

(2) *Current availability*—(i) *Plan years prior to TRA '86 effective date.* Except as provided in paragraph (a)(2)(iii) of this Q&A–2, for plan years prior to the effective date of the amendments made to section 401(b) by section 1112(a) of TRA '86, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the seventy percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B).

(ii) *Plan years commencing on or after TRA '86 effective date.* Except as provided in paragraph (a)(2)(iii) of this Q&A–2, for plan years commencing on or after the effective date on which the amendments made to section 410(b) by section 1112(a) of TRA '86 first apply to a plan, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the percentage test set forth in section 410(b)(1)(A), the ratio test set forth in section 410(b)(1)(B), or the nondiscriminatory classification test set forth in section 410(b)(2)(A)(i). The employer need not satisfy the average benefit percentage test in section 410(b)(2)(A)(ii) in order for the optional form to be currently available to a nondiscriminatory group of employees.

(iii) *Special rule for certain governmental or church plans.* Plans described in section 410(c) will be treated as satisfying the current availability test of this paragraph (a)(2) if the group of employees with respect to whom the optional form is currently available satisfies the requirements of section 401(a)(3) as in effect on September 1, 1974.

(iv) *Effective data for TRA '86 amendments to section 410(b).* The amendments to section 410(b) made by section 1112(a) of TRA '86 are generally effective for plan years commencing after December 31, 1988. See section 1112(e)(1) of TRA '86.

(v) *Elimination of optional forms*—(A) *In general.* Notwithstanding paragraphs (a)(2)(i) and (a)(2)(ii) of this Q&A–2, in the case of an optional form of benefit that has been eliminated under a plan with respect to specified employees for benefits accrued after the later of the eliminating amendment's adoption date or effective date, the determination of whether such optional form satisfies this paragraph (a)(2) with respect to such employees is to be made immediately prior to the elimination. Accordingly, if, as of the later of the adoption date or effective date of an amendment eliminating an optional form with respect to future benefit accruals, the current availability of such optional form immediately prior to such amendment satisfies this paragraph (a)(2), then the optional form will be treated as satisfying this paragraph (a)(2) for all subsequent years.

(B) *Example.* A profit-sharing plan that provides for a single sum distribution available to all employees on termination of employment is amended January 1, 1990, to eliminate such single sum optional form of benefit with respect to benefits accrued after January 1, 1991. As of January 1, 1991, the single sum optional form of benefit is available to a group of employees that satisfies the percentage test of section 410(b)(1)(A). As of January 1, 1995, all nonhighly compensated employees who were entitled to the single sum optional form of benefit have terminated from employment with the employer and taken a distribution of their benefits. The only remaining employees who have a right to take a portion of their benefits in the form of a single sum distribution on termination of employment are highly compensated employees. Because the availability of the single sum optional form of benefit satisfied the current availability test as of January 1, 1991, the availability of such optional form of benefit is deemed to continue

to satisfy the current availability test of this paragraph (a)(2).

(3) *Effective availability*—(i) *In general.* The requirement of this paragraph (a)(3) is satisfied only if, based on the facts and circumstances, the group of employees to whom the optional form is effectively available does not substantially favor the highly compensated group. This is the case even if the optional form is, or has been, currently available to a group of employees that satisfies the applicable requirements in paragraph (a)(2) (i) or (ii) of this Q&A–2.

(ii) *Examples.* The provisions of paragraph (a)(3)(i) of this Q&A–2 can be illustrated by the following examples:

Example 1. Employer X maintains a defined benefit plan that covers both of the 2 highly compensated employees of the employer and 8 of the twelve nonhighly compensated employees of the employer. Plan X provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65, and an early retirement benefit payable upon termination in the form of an annuity to employees who terminate from service with the employer on or after age 55 with 30 or more years of service. Each of the 2 employees of employer X who are in the highly compensated group currently meet the age and service requirement, or will have 30 years of service by the time they reach age 55. All but 2 of the 8 nonhighly compensated employees of employer X who are covered by the plan were hired on or after age 35 and thus, cannot qualify for the early retirement benefit provision. Even though the group of employees to whom the early retirement benefit is currently available does not impermissibly favor the highly compensated group by reason of disregarding age and service, these facts and circumstances indicate that the effective availability of the early retirement benefit in plan X substantially favors the highly compensated group.

Example 2. Assume the same facts as in *Example 1* except that the early retirement benefit is added by a plan amendment first adopted, announced and effective December 1, 1991, and is available only to employees who terminate from employment with the employer prior to December 15, 1991. Further assume that all employees were hired prior to attaining age 25, and that the group of employees who have, or will have attained age 55 with 30 years of service, by December 15, 1991, satisfies the ratio test of section 410(b)(1)(B). Finally, assume that the only employees who terminate from employment with the employer during the two week period in which the early retirement benefit is available are employees in the highly compensated group. These facts and circumstances indicate that the effective availability of the early retirement benefit substantially favors the highly compensated group. This is the case even though the limitation of the early retirement benefit to a specified period satisfies section 411(d)(6).

Example 3. Employer Y amends plan Y on June 30, 1990, to provide for a single sum distribution for employees who terminate from employment with the employer after June 30, 1990, and prior to January 1, 1991. The availability of this single sum distribution is conditioned on the employee having a particular disability at the time of termination of employment. The only employee of the employer who meets this disability requirement at the time of the amendment and thereafter through December 31, 1990, is a highly compensated employee. Generally, a disability condition with respect to the availability of a single sum distribution may be disregarded in determining whether the current availability of such optional form of benefit is discriminatory. However, these facts and circumstances indicate that the effective availability of the optional form of benefit substantially favors the highly compensated group.

Example 4. Employer Z maintains a money purchase pension plan that covers all employees of the employer. The plan provides for distribution in the form of a joint and survivor annuity, a life annuity, or equal installments over 10 years. During the 1992 calendar year the employer winds up his business. In December of 1992, only two employees remain in the employment of the employer, both of whom are highly compensated. Employer Z then amends the plan to provide for a single sum distribution to employees who terminate from employment on or after the date of the amendment. Both highly compensated employees terminate from employment on December 31, 1992, taking a single sum distribution of their benefits. These facts and circumstances indicate that the effective availability of the single sum optional form of benefit substantially favors the highly compensated group.

(b) *Application of tests*—(1) *Current availability*—(i) *In general.* Except as otherwise provided in this paragraph (b), in determining whether an optional form of benefit that is subject to specified eligibility conditions is currently available to an employee for purposes of paragraph (a) of this Q&A–2, the determination of current availability generally is to be based on the current facts and circumstances with respect to the employee (e.g., the employee's

current compensation or the employee's current net worth). Thus, for example, the fact that an employee may, in the future, satisfy an eligibility condition generally does not cause an optional form of benefit to be treated as currently available to such employee.

(ii) *Exceptions for age, service, employment termination and certain other conditions*—(A) *Age and service conditions.* For purposes of applying paragraph (a)(2) of this Q&A–2, except as provided in paragraph (b)(1)(ii)(B) of this Q&A–2, an age condition, a service condition, or both are to be disregarded. For example, an employer that maintains a plan that provides for an early retirement benefit payable as an annuity for employees in division A, subject to a requirement that the employee has attained his or her 55th birthday and has at least twenty years of service with the employer, is to disregard the age and service conditions in determining the group of employees to whom the early retirement annuity benefit is currently available. Thus, the early retirement annuity benefit is treated as currently available to all employees of division A, without regard to their ages or years of service and without regard to whether they could potentially meet the age and service conditions prior to attaining the plan's normal retirement age.

(B) *Exception for certain age and service conditions.* Age and service conditions that must be satisfied within a specified period of time may not be disregarded pursuant to paragraph (b)(1)(ii)(A) of this Q&A–2. However, in determining the current availability of an optional form of benefit subject to such an age condition, service condition, or both, an employer may project the age and service of employees to the last date on which the optional form of benefit subject to the age condition or service condition (or both) is available under the plan. An employer's ability to protect age and service to the last date on which the optional form of benefit is available under the plan is not cut off by a plan termination occurring prior to that date. Thus, for example, assume that an employer maintaining a plan that permits employees terminating from employment on or after age 55 between June 1, 1991 to May 31, 1992, to elect a single sum distribution, decides to terminate the plan on December 31, 1991. In determining the group of employees to whom the single sum optional form of benefit is currently available, this employer may project employees' ages through May 31, 1992.

(C) *Certain other conditions disregarded.* Conditions on the availability of optional forms of benefit requiring termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, marital status, default on a plan loan secured by a participant's account balance, or execution of a covenant not to compete may be disregarded in determining the group of employees to whom an optional form of benefit is currently available.

(2) *Employees taken into account.* For purposes of applying paragraph (a) of this Q&A–2, the tests are to be applied on the basis of the employer's nonexcludable employees (whether or not they are participants in the plan) in the same manner as such tests would be applied in determining whether the plan providing the optional form of benefit satisfies the tests under section 410(b).

(3) *Definition of ''plan''.* For purposes of applying paragraph (a) of this Q&A–2, the term ''plan'' has the meaning that such term has for purposes of determining whether the amount of contributions or benefits and whether other benefits, rights, and features are nondiscriminatory under section 401(a)(4).

(4) *Restructuring optional forms of benefit*—(i) *In general.* For purposes of applying paragraph (a) of this Q&A–2, the availability of two or more optional forms of benefit under a plan may be tested by restructuring such benefits into two or more restructured optional forms of benefit and testing the availability of such restructured optional forms of benefit. If two or more optional forms of benefit under a plan contain both common and distinct components, such optional forms of benefit may be restructured as a single optional form of benefit comprising the common component, and one or more optional forms of benefit comprising

each distinct component. Components of optional forms of benefit may be treated as common only if they are identical with respect to all characteristics taken into account under Q&A–1(b) of §1.411(d)–4. The availability of each restructured optional form of benefit must satisfy the applicable nondiscrimination requirements of paragraph (a) of this Q&A–2.

(ii) *Example*. A profit-sharing plan covering all the employees of an employer provides a single sum distribution option upon termination from employment for all employees earning less than $50,000 and a single sum distribution option upon termination from employment after the attainment of age 55 for all employees earning $50,000 or more. These distribution options are identical in all other respects. For purposes of applying section 401(a)(4), such optional forms of benefit may be restructured into two different optional forms of benefit: (A) a single sum distribution option upon termination from employment after the attainment of age 55 for all employees (i.e., the common component), and (B) a single sum distribution option upon termination from employment before the attainment of age 55 for all employees earning less than $50,000. The availability of each of these restructured optional forms of benefit must satisfy section 401(a)(4).

(c) *Commissioner may provide additional tests*. The Commissioner may provide such additional factors, tests, and safe harbors as are necessary or appropriate for purposes of determining whether the availability of an optional form of benefit is discriminatory under section 401(a)(4). In addition, the Commissioner may provide that additional eligibility conditions not related directly or indirectly to compensation or wealth may be disregarded under paragraph (b)(1)(ii)(C) of this Q&A–2 in determining the current availability of an optional form of benefit. The Commissioner may provide such additional guidance only through the publication of revenue rulings, notices or other documents of general applicability.

Q–3: May a plan condition the availability of an optional form of benefit on employer discretion?

A–3: No. Even if the availability of an optional form of benefit that is conditioned on employer discretion satisfies the nondiscrimination requirements of section 401(a)(4), the plan providing the optional form of benefit will fail to satisfy certain other requirements of section 401(a), including, in applicable circumstances, the definitely determinable requirement of section 401(a) and the requirements of section 401(a)(25) and section 411(d)(6). See §1.411(d)–4.

Q–4: Will a plan provision violate section 401(a)(4) merely because it requires that an employee who terminates from service with the employer receive a single sum distribution in the event that the present value of the employee's benefit is not more than $3,500, as permitted by sections 411(a)(11) and 417(e)?

A–4: No. A plan will not be treated as discriminatory under section 401(a)(4) merely because the plan mandates a single sum distribution when the present value of an employee's benefit is not more than $3,500, as permitted by sections 411(a)(11) and 417(e). This is an exception to the general principles of this section. (No similar provision exists excepting such single sum distributions from the limits on employer discretion under section 411(d)(6). See §1.411(d)–4 Q&A–4.)

Q–5: If the availability of an optional form of benefit discriminates, or may reasonably be expected to discriminate, in favor of the highly compensated group, what acceptable alternatives exist for amending the plan without violating section 411(d)(6)?

A–5: (a) *Transitional rules*—(1) *In general*. The following rules apply for purposes of making necessary amendments to existing plans (as defined in Q&A–6 of this section) under which the availability of an optional form of benefit violates the nondiscrimination requirements of section 401(a)(4) or may reasonably be expected to violate such requirements. These transitional rules are provided under the authority of section 411(d)(6), which allows the elimination of certain optional forms of benefit if permitted by regulations, and section 7805(b).

(2) *Nondiscrimination*—(i) *In general*. The determination of whether the availability of an optional form of benefit violates section 401(a)(4) is to be made in accordance with Q&A–2 of this section. In addition, the availability of a particular optional form of benefit may reasonably be expected to violate the nondiscrimination requirements of

section 401(a)(4) if, under the applicable facts and circumstances, there is a significant possibility that the current availability of such optional form of benefit will impermissibly favor the highly compensated group. This determination must be made on the basis of the seventy percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B) as such tests existed prior to the effective date of the amendments made to section 410(b) by section 1112(a) of TRA '86. Thus, a condition may not reasonably be expected to discriminate for purposes of these rules merely because it results in a significant possibility that discrimination will result because of the amendments made to section 410(b) by section 1112(a) of TRA '86. In addition, the availability of an optional form of benefit may not reasonably be expected to discriminate merely because of an age or service condition that may be disregarded in determining the current availability of such optional form of benefit under paragraph (b)(1)(ii)(A) of Q&A–2 of this section. Similarly, the availability of an optional form of benefit may not reasonably be expected to discriminate merely because of an age or service condition that, after permitted projection, does not cause such optional form to fail to satisfy the requirement of this paragraph (a)(2).

(ii) *Examples*. The provisions of paragraph (a)(2)(i) of this Q&A–5 can be illustrated by the following examples:

Example (1). A plan provides that a single sum distribution option is available only to (A) employees earning $50,000 or more in the final year of employment, (B) employees who furnish evidence that they have a net worth above a certain specified amount, and (C) employees who present a letter from an accountant or attorney declaring that it is in the employee's best interest to receive a single sum distribution. Whether the availability of such optional form of benefit discriminates depends on whether it meets the requirements of Q&A–2 of this §1.401(a)–4. However, each of the specified conditions limiting the availability of the optional form of benefit may reasonably be expected to discriminate in favor of the highly compensated group in operation because of the likelihood of a significant positive correlation between the ability to meet any of the specified conditions and membership in the highly compensated group.

Example (2). A plan limits the availability of a single sum distribution option to employees employed in one particular division of the employer's company. All the employees of the company are participants in the plan. During the 1988 plan year, the division employs individuals who represent a nondiscriminatory classification of that company's employees (under section 410(b)(1)(B) prior to the effective date of the amendments made to section 410(b) by section 1112(a) of TRA '86) and is unlikely to cease employing such a nondiscriminatory classification in the future. The availability of a single sum distribution under this plan does not result in discrimination during the 1988 plan year and may not reasonably be expected to do so.

(b) *Transitional alternatives*. If the availability of an optional form of benefit under an existing plan is discriminatory under section 401(a)(4), the plan must be amended either to eliminate the optional form of benefit or to make the availability of the optional form of benefit nondiscriminatory. For example, the availability of an optional form of benefit may be made nondiscriminatory by making such benefit available to sufficient additional employees who are not in the highly compensated group or by imposing nondiscriminatory objective criteria on its availability such that the group of employees to whom the benefit is available is nondiscriminatory. See Q&A–6 of §1.411(d)–4 for requirements with respect to such objective criteria. If, under an exisitng plan, the availability of an optional form of benefit may reasonably be expected to discriminate, the plan may be amended in the same manner permitted where the availability of an optional form of benefit is discriminatory. See paragraph (d) of this Q&A–5 for rules limiting the period during which the availability of optional forms of benefit may be eliminated or reduced under this paragraph.

(c) *Compliance and amendment date provisions*—(1) *Operational compliance requirement*. On or before the applicable effective date for the plan (see Q&A–6 of this section), the plan sponsor must select one of the alternatives permitted under paragraph (b) of this Q&A–5 with respect to each affected optional form of benefit and the plan must be operated in accordance with this selection. This is an operational requirement and does not require a

plan amendment prior to the period set forth in paragraph (c)(2) of this Q&A–5. There is no special reporting requirement under the Code or this section with respect to this selection.

(2) *Deferred amendment date*. If paragraph (c)(1) of this Q&A–5 is satisfied, a plan amendment conforming the plan to the particular alternative selected under paragraph (b) of this Q&A–5 must be adopted within the time period permitted for amending plans in order to meet the requirements of section 410(b) as amended by TRA '86. Such conforming amendment must be consistent with the sponsor's selection as reflected by plan practice during the period from the effective date to the date the amendment is adopted. Thus, for example, if an existing calendar year noncollectively bargained defined benefit plan has a single sum distribution form subject to a discriminatory condition, that was available as of January 30, 1986 (subject to such condition), and such employer makes one or more single sum distributions available on or after the first day of the first plan year commencing on or after January 1, 1989, and before the plan amendment, then such employer may not adopt a plan amendment eliminating the single sum distribution form. Instead, such employer must adopt an amendment making the distribution form available to a nondiscriminatory group of employees while retaining the availability of such distribution form with respect to the group of employees to whom the benefit is already available. Similarly, any objective criteria that are adopted as part of such amendment must be consistent with the plan practice for the applicable period prior to the amendment. A conforming amendment under this paragraph (c)(2) must be made with respect to each optional form of benefit for which such amendment is required and must be retroactive to the applicable effective date.

(d) *Limitation on transitional alternatives*. The transitional alternatives permitting the elimination or reduction of optional forms of benefit will not violate section 411(d)(6) during the period prior to the applicable effective date for the plan (see Q&A–6 of this section). After the applicable effective date, any amendment (other than one described in paragraph (c)(2) of this Q&A–5) that eliminates or reduces an optional form of benefit or imposes new objective criteria restricting the availability of such optional form of benefit will fail to qualify for the exception to section 411(d)(6) provided in this Q&A–5. This is the case without regard to whether the availability of the optional form of benefit is discriminatory or may reasonably be expected to be discriminatory.

Q–6: For what period are the rules of this section effective?

A–6: (a) *General effective date*—(1) *In general*. Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986, and do not apply to plan years beginning on or after January 1, 1994. For rules applicable to plan years beginning on or after January 1, 1994, see §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

(2) *Plans of tax-exempt organizations*. In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), except as otherwise provided in this section, the provisions of this section are effective January 30, 1986, and do not apply to plan years beginning on or after January 1, 1996. For rules applicable to plan years beginning on or after January 1, 1996, see §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

(b) *New plans*—(1) *In general*. Unless otherwise provided in paragraph (b)(2) of this Q&A–6, plans that are either adopted or made effective on or after January 30, 1986, are ''new plans''. With respect to such new plans, this section is effective January 30, 1986. This effective date is applicable to such plans whether or not they are collectively bargained.

(2) *Exception with respect to certain new plans*. Plans that are new plans as defined in paragraph (b)(1) of this Q&A–6, under which the availability of an optional form of benefit is discriminatory or may reasonably be expected to be discriminatory, and that receive a favorable determination letter that covered such plan provisions with respect to an application submitted prior to July 11, 1988, will be treated as existing plans with respect to such optional

form of benefit for purposes of the transitional rules of this section. Thus, such plans are eligible for the compliance and amendment alternatives set forth in the transitional rule in Q&A–5 of this section.

(c) *Existing plans*—(1) *In general.* Plans that are both adopted and in effect prior to January 30, 1986, are ''existing plans''. In addition, new plans described in paragraph (b)(2) of this Q&A–6 are treated as existing plans with respect to certain forms of benefit. Subject to the limitations in paragraph (d) of this Q&A–6, the effective dates set forth in paragraphs (c)(2) and (c)(3) of this Q&A–6 apply to these existing plans for purposes of this section.

(2) *Existing noncollectively bargained plans.* With respect to existing noncollectively bargained plans, this section is effective for the first day of the first plan year commencing on or after January 1, 1989.

(3) *Existing collectively bargained plans.* With respect to existing collectively bargained plans, this section is effective for the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b) as amended by TRA '86 apply to such plan.

(d) *Delayed effective dates not applicable to new optional forms of benefit or conditions*—(1) *In general.* The delayed effective dates in paragraph (c) (2) and (3) of this Q&A–6 for existing plans are applicable with respect to an optional form of benefit only if both the optional form of benefit and any applicable condition either causing the availability of such optional form of benefit to be discriminatory or making it reasonable to expect that the availability of such optional form will be discriminatory were both adopted and in effect prior to January 30, 1986. If the preceding sentence is not satisfied with respect to an optional form of benefit, this section is effective with respect to such optional form of benefit as if the plan were a new plan.

(2) *Exception for certain amendments covered by a favorable determination letter.* If a condition causing the availability of an optional form of benefit to be discriminatory, or to be reasonably expected to discriminate, was adopted or made effective on or after January 30, 1986, and a favorable determination letter that covered such plan provision is or was received with respect to an application submitted before July 11, 1988, the effective date of this section with respect to such provision is the applicable effective date determined under the rules with respect to existing plans, as though such provision had been adopted and in effect prior to January 30, 1986.

(e) *Transitional rule effective date.* The transitional rule provided in Q&A–5 of this section is effective January 30, 1986.

[53 FR 26054, July 11, 1988, as amended by T.D. 8360, 56 FR 47536, Sept. 19, 1991; T.D. 8485, 58 FR 46778, Sept. 3, 1993; T.D. 8212, 61 FR 14247, Apr. 1, 1996]

§ 1.401(a)–11 Qualified joint and survivor annuities.

(a) *General rule*—(1) *Required provisions.* A trust, to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), which is a part of a plan providing for the payment of benefits in any form of a life annuity (as defined in paragraph (b)(1) of this section), shall not constitute a qualified trust under section 401(a)(11) and this section unless such plan provides that:

(i) Unless the election provided in paragraph (c)(1) of this section has been made, life annuity benefits will be paid in a form having the effect of a qualified joint and survivor annuity (as defined in paragraph (b)(2) of this section) with respect to any participant who—

(A) Begins to receive payments under such plan on or after the date the normal retirement age is attained, or

(B) Dies (on or after the date the normal retirement age is attained) while in active service of the employer maintaining the plan, or

(C) In the case of a plan which provides for the payment of benefits before the normal retirement age, begins to receive payments under such plan on or after the date the qualified early retirement age (as defined in paragraph (b)(4) of this section) is attained, or

(D) Separates from service on or after the date the normal retirement age (or

the qualified early retirement age) is attained and after satisfaction of eligibility requirements for the payment of benefits under the plan (except for any plan requirement that there be filed a claim for benefits) and thereafter dies before beginning to receive life annuity benefits;

(ii) Any participant may elect, as provided in paragraph (c)(1) of this section, not to receive life annuity benefits in the form of a qualified joint and survivor annuity; and

(iii) If the plan provides for the payment of benefits before the normal retirement age, any participant may elect, as provided in paragraph (c)(2) of this section, that life annuity benefits be payable as an early survivor annuity (as defined in paragraph (b)(3) of this section) upon his death in the event that he—

(A) Attains the qualified early retirement age (as defined in paragraph (b)(4) of this section), and

(B) Dies on or before the day normal retirement age is attained while employed by an employer maintaining the plan.

(2) *Certain cash-outs.* A plan will not fail to satisfy the requirements of section 401(a)(11) and this section merely because it provides that if the present value of the entire nonforfeitable benefit derived from employer contributions of a participant at the time of his separation from service does not exceed $1,750 (or such smaller amount as the plan may specify), such benefit will be paid to him in a lump sum.

(3) *Illustrations.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation Defined Contribution Plan was established in 1960. As in effect on January 1, 1974, the plan provided that, upon the participant's retirement, the participant may elect to receive the balance of his account in the form of (1) a single-sum cash payment, (2) a single-sum distribution consisting of X Corporation stock, (3) five equal annual cash payments, (4) a life annuity, or (5) a combination of options (1) through (4). The plan also provided that, if a participant did not elect another form of distribution, the balance of his account would be distributed to him in the form of a single-sum cash payment upon his retirement. Assume that section 401(a)(11) and this section became applicable to the plan as of its plan year beginning January 1, 1976, with respect to persons who were active participants in the plan as of such date (see paragraph (f) of this section). If X Corporation Defined Contribution Plan continues to allow the life annuity payment option after December 31, 1975, it must be amended to provide that if a participant elects a life annuity option the life annuity benefit will be paid in a form having the effect of a qualified joint and survivor annuity, except to the extent that the participant elects another form of benefit payment. However, the plan can continue to provide that, if no election is made, the balance will be paid as a single-sum cash payment. If the trust is not so amended, it will fail to qualify under section 401(a).

Example (2). The Corporation Retirement Plan provides that plan benefits are payable only in the form of a life annuity and also provides that a participant may retire before the normal retirement age of 65 and receive a benefit if he has completed 30 years of service. Under this plan, an employee who begins employment at the age of 18 will be eligible to receive retirement benefits at the age of 48 if he then has 30 years of service. This plan must allow a participant to elect in the time and manner prescribed in paragraph (c)(2) of this section an early survivor annuity (defined in paragraph (b)(3) of this section) to be payable on the death of the participant if death occurs while the participant is in active service for the employer maintaining the plan and on or after the date the participant reaches the qualified early retirement age of 55 (the later of the date the participant reaches the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) but before the day after the day the participant reaches normal retirement age (age 65).

Example (3). Assume the same facts as in Example (2). A, B, and C began employment with Y Corporation when they each attained age 18. A retires and begins to receive benefit payments at age 48 after completing 30 years of service. The plan is not required to pay a qualified joint and survivor annuity to A and his spouse at any time. B does not elect an early survivor annuity at age 55, but retires at age 57 after completing 39 years of service. Unless B makes an election under subparagraph (1)(ii) of this paragraph, the plan is required to pay a qualified joint and survivor annuity to B and his spouse. C makes no elections described in subparagraph (1) of this paragraph, and dies while in active service at age 66 after completing 48 years of service. The plan is required to pay a qualified survivor annuity to C's spouse.

(b) *Definitions.* As used in this section—(1) *Life annuity.* (i) The term ''life annuity'' means an annuity that provides retirement payments and requires the survival of the participant

or his spouse as one of the conditions for any payment or possible payment under the annuity. For example, annuities that make payments for 10 years or until death, whichever occurs first or whichever occurs last, are life annuities.

(ii) However, the term ''life annuity'' does not include an annuity, or that portion of an annuity, that provides those benefits which, under section 411(a)(9), would not be taken into account in the determination of the normal retirement benefit or early retirement benefit. For example, ''social security supplements'' described in the fourth sentence of section 411(a)(9) are not considered to be life annuities for the purposes of this section, whether or not an early retirement benefit is provided under the plan.

(2) *Qualified joint and survivor annuity*. The term ''qualified joint and survivor annuity'' means an annuity for the life of the participant with a survivor annuity for the life of his spouse which is neither (i) less than one-half of, nor (ii) greater than, the amount of the annuity payable during the joint lives of the participant and his spouse. For purposes of the preceding sentence, amounts described in §1.401(a)–11(b)(1)(ii) may be disregarded. A qualified joint and survivor annuity must be at least the actuarial equivalent of the normal form of life annuity or, if greater, of any optional form of life annuity offered under the plan. Equivalence may be determined, on the basis of consistently applied reasonable actuarial factors, for each participant or for all participants or reasonable groupings of participants, if such determination does not result in discrimination in favor of employees who are officers, shareholders, or highly compensated. An annuity is not a qualified joint and survivor annuity if payments to the spouse of a deceased participant are terminated, or reduced, because of such spouse's remarriage.

(3) *Early survivor annuity*. The term ''early survivor annuity'' means an annuity for the life of the participant's spouse the payments under which must not be less than the payments which would have been made to the spouse under the joint and survivor annuity if the participant had made the election described in paragraph (c)(2) of this section immediately prior to his retirement and if his retirement had occurred on the day before his death and within the period during which an election can be made under such paragraph (c)(2). For example, if a participant would be entitled to a single life annuity of $100 per month or a reduced amount under a qualified joint and survivor annuity of $80 per month, his spouse is entitled to a payment of at least $40 per month. However, the payments may be reduced to reflect the number of months of coverage under the survivor annuity pursuant to paragraph (e) of this section.

(4) *Qualified early retirement age*. The term ''qualified early retirement age'' means the latest of—

(i) The earliest date, under the plan, on which the participant could elect (without regard to any requirement that approval of early retirement be obtained) to receive retirement benefits (other than disability benefits).

(ii) The first day of the 120th month beginning before the participant reaches normal retirement age, or

(iii) The date on which the participant begins participation.

(5) *Normal retirement age*. The term ''normal retirement age'' has the meaning set forth in section 411(a)(8).

(6) *Annuity starting date*. The term ''annuity starting date'' means the first day of the first period with respect to which an amount is received as a life annuity, whether by reason of retirement or by reason of disability.

(7) *Day*. The term ''day'' means a calendar day.

(c) *Elections*—(1) *Election not to take joint and survivor annuity form*—(i) *In general*. (A) A plan shall not be treated as satisfying the requirements of this section unless it provides that each participant may elect, during the election period described in subdivision (ii) of this subparagraph, not to receive a qualified joint and survivor annuity. However, if a plan provides that a qualified joint and survivor annuity is the only form of benefit payable under the plan with respect to a married participant, no election need be provided.

(B) The election shall be in writing and clearly indicate that the participant is electing to receive all or, if permitted by the plan, part of his benefits under the plan in a form other than that of a qualified joint and survivor annuity. A plan will not fail to meet the requirements of this section merely because the plan requires the participant to obtain the written approval of his spouse in order for the participant to make this election or if the plan provides that such approval is not required.

(ii) *Election period.* (A) For purposes of the election described in paragraph (c)(1)(i) of this section, the plan shall provide an election period which shall include a period of at least 90 days following the furnishing of all of the applicable information required by subparagraph (3)(i) of this paragraph and ending prior to commencement of benefits. In no event may the election period end earlier than the 90th day before the commencement of benefits. Thus, for example, the commencement of benefits may be delayed until the end of such election period because the amount of payments to be made to a participant cannot be ascertained before the end of such period; see § 1.401(a)–14(d).

If a participant makes a request for additional information as provided in subparagraph (3)(iii) of this paragraph on or before the last day of the election period, the election period shall be extended to the extent necessary to include at least the 90 calendar days immediately following the day the requested additional information is personally delivered or mailed to the participant. Notwithstanding the immediately preceding sentence, a plan may provide in cases in which the participant has been furnished by mail or personal delivery all of the applicable information required by subparagraph (3)(i) of this paragraph, that a request for such additional information must be made on or before a date which is not less than 60 days from the date of such mailing or delivery; and if the plan does so provide, the election period shall be extended to the extent necessary to include at least the 60 calendar days following the day the requested additional information is personally delivered or mailed to the participant.

(B) In the case of a participant in a plan to which this subparagraph applies who separated from service after section 401(a)(11) and this section became applicable to such plan with respect to such participant, and to whom an election required by this subparagraph has not been previously made available (and will not become available in normal course), the plan must provide an election to receive the balance of his benefits (properly adjusted, if applicable, for payments received, prior to the exercise of such election, in the form of a qualified joint and survivor annuity) in a form other than that of a qualified joint and survivor annuity. The provisions of paragraph (c)(1)(ii)(A) shall apply except that in no event shall the election period end before the 90th day after the date on which notice of the availability of such election and the applicable information required by subparagraph (3)(i) of this paragraph is given directly to the participant. If such notice and information is given by mail, it shall be treated as given on the date of mailing. If such participant has died, such election shall be made available to such participant's personal representative.

(2) *Election of early survivor annuity*—(i) *In general.* (A) A plan described in subparagraph (a)(1)(iii) of this section shall not be treated as satisfying the requirements of this section unless it provides that each participant may elect, during the period described in subdivision (ii) of this subparagraph, an early survivor annuity as described in paragraph (a)(1)(iii) of this section. Breaks in service after the participant has attained the qualified early retirement age neither invalidate a previous election or revocation nor prevent an election from being made or revoked during the election period.

(B) The election shall be in writing and clearly indicate that the participant is electing the early survivor annuity form.

(C) A plan is not required to provide an election under this subparagraph if—

(*1*) The plan provides that an early survivor annuity is the only form of

benefit payable under the plan with respect to a married participant who dies while employed by an employer maintaining the plan,

(*2*) In the case of a defined contribution plan, the plan provides a survivor benefit at least equal in value to the vested portion of the participant's account balance, if the participant dies while in active service with an employer maintaining the plan, or

(*3*) In the case of a defined benefit plan, the plan provides a survivor benefit at least equal in value to the present value of the vested portion of the participant's normal form of the accrued benefit payable at normal retirement age (determined immediately prior to death), if the participant dies while in active service with an employer maintaining the plan. Any present values must be determined in accordance with either the actuarial assumptions or factors specified in the plan, or a variable standard independent of employer discretion for converting optional benefits specified in the plan.

(ii) *Election period.* (A) For purposes of the election described in paragraph (c)(2)(i) of this section the plan shall provide an election period which, except as provided in the following sentence, shall begin not later than the later of either the 90th day before a participant attains the qualified early retirement age or the date on which his participation begins, and shall end on the date the participant terminates his employment. If such a plan contains a provision that any election made under this subparagraph does not become effective or ceases to be effective if the participant dies within a certain period beginning on the date of such election, the election period prescribed in this subdivision (ii) shall begin not later than the later of (*1*) a date which is 90 days plus such certain period before the participant attains the qualified early retirement age or (*2*) the date on which his participation begins. For example, if a plan provides that an election made under this subparagraph does not become effective if the participant dies less than 2 years after the date of such election, the period for making an election under this subparagraph must begin not later than the later of (*1*) 2 years and 90 days before the participant attains the qualified early retirement age, or (*2*) the date on which his participation begins. However, the election period for an individual who was an active participant on the date this section became effective with regard to the plan need not begin earlier than such effective date.

(B) In the case of a participant in a plan to which this subparagraph applies who dies after section 401(a)(11) and this section became applicable to such plan with respect to such participant and to whom an election required by this subparagraph has not been previously made available, the plan must give the participant's surviving spouse or, if dead, such spouse's personal representative the option of electing an early survivor annuity. The plan may reduce the surviving spouse's annuity to take into account any benefits already received. The period for making such election shall not end before the 90th day after the date on which written notice of the availability of such election and applicable information required by subparagraph (3)(i) of this paragraph is given directly to such surviving spouse or personal representative. If such notice and information is given by mail, if shall be treated as given on the date of mailing.

(3) *Information to be provided by plan administrator.* (i) A plan which is required to provide either or both of the elections described in paragraph (c) (1) or (2) of this section must provide to the participants, at the time and in the manner specified in subdivision (ii) of this subparagraph, the following information, as applicable to the plan, in written nontechnical language:

(A) In the case of the election described in paragraph (c)(1) of this section, a general description or explanation of the qualified joint and survivor annuity, the circumstances in which it will be provided unless the participant has elected not to have benefits provided in that form, and the availability of such election;

(B) In the case of the election described in paragraph (c)(2) of this section, a general description of the early survivor annuity, the circumstances under which it will be paid if elected,

and the availability of such election; and

(C) A general explanation of the relative financial effect on a participant's annuity of either or both elections, as the case may be.

Various methods may be used to explain such relative financial effect. With regard to a qualified joint and survivor annuity, they include: information as to the benefits the participant would receive under the qualified joint and survivor annuity stated as an arithmetic or percentage reduction from a single life annuity; a table showing the difference between a straight life annuity and a qualified joint and survivor annuity in terms of a reduction in dollar amounts; a table showing a percentage reduction from the straight life annuity or, in the case of a profit-sharing plan, an approximate dollar amount reduction. The notice and explanation required by this subdivision (i) must also inform the participants of the availability of the additional information specified in subdivision (iii) of this subparagraph and how they may obtain such information.

(ii) The method or methods used to provide the information described in subdivision (i) of this subparagraph may vary. Posting which meets the requirements of §1.7476–2(c)(1) may be used; see §1.7476–2(c)(1) for examples of other methods which may be used. One or more methods may be used to provide the required information provided that all of the required information is provided by one method or a combination of methods by or within the time period specified in this subdivision (ii). If mail or personal delivery is used, then, whether or not the information has been previously provided, there must be a mailing or personal delivery of the information by such time as to reasonably assure that it will be received on or about: (*1*) In the case of a plan which does not provide for the payment of benefits before the normal retirement age, the date which is 9 months before the participant attains normal retirement age; (*2*) in the case of a plan which provides for the payment of benefits before the normal retirement age and which is required to provide the election described in paragraph (c)(2) of this section (whether or not it is also required to provide the election described in paragraph (c)(1) of this section), the date which is 90 days before the latest date prescribed by paragraph (c)(2)(ii)(A) for the beginning of the election period for the early survivor annuity; or (*3*) in the case of a plan which provides for the payment of benefits before the normal retirement age and which is required to provide only the election described in paragraph (c)(1) of this section, the date which is nine months before the participant attains the qualified early retirement age; except that in the case of a plan described in (*2*) or (*3*), if the qualified early retirement age is the date the participant begins participation in the plan, the information may be provided on or about such date. If a method other than mail or personal delivery is used to provide participants with some or all of such information, if must be a method which is reasonably calculated to reach the attention of a participant on or about the date prescribed in the immediately preceding sentence and to continue to reach the attention of such participant during the election period applicable to him for which the information is being provide (as, for example, by permanent posting, repeated publication, etc.).

(iii) The plan administrator must furnish to a particular participant, upon a timely written request, a written explanation in nontechnical language of the terms and conditions of the qualified joint and survivor annuity and the financial effect upon the particular participant's annuity of making any election under this paragraph. Such financial effect shall be given in terms of dollars per annuity payment; and in the case of a defined contribution plan, the projected annuity for a particular participant may be based on his account balance as of the most recent valuation date. The plan administrator need not comply with more than one such request made by a particular participant. This explanation must be personally delivered or mailed (first class mail, postage prepaid) to the participant within 30 days from the date of the participant's written request.

(4) *Election is revocable.* A plan to which this section applies must provide that any election made under this

paragraph may be revoked in writing during the specified election period, and that after such election has been revoked, another election under this paragraph may be made during the specified election period.

(5) *Election by surviving spouse.* A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it provides that the spouse of a deceased participant may elect to have benefits paid in a form other than a survivor annuity. If the plan provides that such a spouse may make such an election, the plan administrator must furnish to this spouse, within a reasonable amount of time after a written request has been made by this spouse, a written explanation in non-technical language of the survivor annuity and any other form of payment which may be selected. This explanation must state the financial effect (in terms of dollars) of each form of payment. A plan need not respond to more than one such request.

(d) *Permissible additional plan provisions*—(1) *In general.* A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it contains one or more of the provisions described in paragraphs (d)(2) through (5) of this section.

(2) *Claim for benefits.* A plan may provide that as a condition precedent to the payment of benefits, a participant must express in writing to the plan administrator the form in which he prefers benefits to be paid and provide all the information reasonably necessary for the payment of such benefits. However, if a participant files a claim for benefits with the plan administrator and provides the plan administrator with all the information necessary for the payment of benefits but does not indicate a preference as to the form for the payment of benefits, benefits must be paid in the form of a qualified joint and survivor annuity if the participant has attained the qualified early retirement age unless such participant has made an effective election not to receive benefits in such form. For rules relating to provisions in a plan to the effect that a claim for benefits must be filed before the payment of benefits will commence, see § 1.401(a)–14.

(3) *Marriage requirements.* A plan may provide that a joint and survivor annuity will be paid only if—

(i) The participant and his spouse have been married to each other throughout a period (not exceeding one year) ending on the annuity starting date.

(ii) The spouse of the participant is not entitled to receive a survivor annuity (whether or not the election described in paragraph (c)(2) of this section has been made) unless the participant and his spouse have been married to each other throughout a period (not exceeding one year) ending on the date of such participant's death.

(iii) The same spouse must satisfy the requirements of subdivisions (i) and (ii) of this subparagraph.

(iv) The participant must notify the plan administrator (as defined by section 414(g)) of his marital status within any reasonable time period specified in the plan.

(4) *Effect of participant's death on an election or revocation of an election under paragraph (c).* A plan may provide that any election described in paragraph (c) of this section or any revocation of any such election does not become effective or ceases to be effective if the participant dies within a period, not in excess of 2 years, beginning on the date of such election or revocation. However, a plan containing a provision described in the preceding sentence shall not satisfy the requirements of this section unless it also provides that any such election or any revocation of any such election will be given effect in any case in which—

(i) The participant dies from accidental causes,

(ii) A failure to give effect to the election or revocation would deprive the participant's survivor of a survivor annuity, and

(iii) Such election or revocation is made before such accident occurred.

(5) *Benefit option approval by third party.* (i) A plan may provide that an optional form of benefit elected by a participant is subject to the approval of an administrative committee or similar third party. However, the administrative committee cannot deny a participant any of the benefits required by section 401(a)(11). For example, if a

plan offers a life annuity option, the committee may deny the participant a qualified joint and survivor annuity only by denying the participant access to all life annuity options without knowledge of whether the participant wishes to receive a qualified joint and survivor annuity. Alternatively, if the committee knows which form of life annuity the participant has chosen before the committee makes its decision, the committee cannot withhold its consent for payment of a qualified joint and survivor annuity event though it denies all other life annuity options. This subparagraph (5) only applies before the effective date of the amendment made to section 411(d)(6) by section 301 of the Retirement Equity Act of 1984. See section 411(d)(6) and the regulations thereunder for rules limiting employer discretion.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. In 1980 plan M provides that the automatic form of benefit is a single sum distribution. The plan also permits, subject to approval by the administrative committee, the election of several optional forms of life annuity. On the election form that is reviewed by the administrative committee the participant indicates whether any life annuity option is preferred, without indicating the particular life annuity chosen. Thus, the committee approves or disapproves the election without knowledge of whether a qualified joint and survivor annuity will be elected. The administrative committee approval provision in Plan M does not cause the plan to fail to satisfy this section. On the other hand, if the form indicates which form of life annuity is preferred, committee disapproval of any election of the qualified joint and survivor annuity would cause the plan to fail to satisfy this section.

(e) *Costs of providing qualified joint and survivor annuity form or early survivor annuity form.* A plan may take into account in any equitable manner consistent with generally accepted actuarial principles applied on a consistent basis any increased costs resulting from providing qualified joint and survivor annuity and early survivor annuity benefits. A plan may give a participant the option of paying premiums only if it provides another option under which an out-of-pocket expense by the participant is not required.

(f) *Application and effective date.* Section 401(a)(11) and this section shall apply to a plan only with respect to plan years beginning after December 31, 1975, and shall apply only if—

(1) The participant's annuity starting date did not fall within a plan year beginning before January 1, 1976, and

(2) The participant was an active participant in the plan on or after the first day of the first plan year beginning after December 31, 1975.

For purposes of this paragraph, the term ''active participant'' means a participant for whom benefits are being accrued under the plan on his behalf (in the case of a defined benefit plan), the employer is obligated to contribute to or under the plan on his behalf (in the case of a defined contribution plan other than a profit-sharing plan), or the employer either is obligated to contribute to or under the plan on his behalf or would have been obligated to contribute to or under the plan on his behalf if any contribution were made to or under the plan (in the case of a profit-sharing plan).

If benefits under a plan are provided by the distribution to the participants of individual annuity contracts, the annuity starting date will be considered for purposes of this paragraph to fall within a plan year beginning before January 1, 1976, with respect to any such individual contract that was distributed to the participant during a plan year beginning before January 1, 1976, if no premiums are paid with respect to such contract during a plan year beginning after December 31, 1975. In the case of individual annuity contracts that are distributed to participants before January 1, 1978, and which contain an option to provide a qualified joint and survivor annuity, the requirements of this section will be considered to have been satisfied if, not later than January 1, 1978, holders of individual annuity contracts who are participants described in the first sentence of this paragraph are given an opportunity to have such contracts amended, so as to provide for a qualified joint and survivor annuity in the absence of a contrary election, within a period of not less than one year from the date such opportunity was offered. In no event, however, shall the preceding sentence

apply with respect to benefits attributable to premiums paid after December 31, 1977.

(g) *Effect of REA 1984*—(1) *In general.* The Retirement Equity Act of 1984 (REA 1984) significantly changed the qualified joint and survivor annuity rules generally effective for plan years beginning after December 31, 1984. The new survivor annuity rules are primarily in sections 401(a)(11) and 417 as revised by REA 1984 and §§ 1.401(a)–20 and 417(e)–1.

(2) *Regulations after REA 1984.* (i) REA and the regulations thereunder to the extent inconsistent with pre-REA 1984 section 401(a)(11) and this section are controlling for years to which REA 1984 applies. See *e.g.*, paragraphs (a)(1) and (2) of this section, relating to required provisions and certain cash-outs, respectively and (e), relating to costs of providing annuities, for rules that are inconsistent with REA 1984 and, therefore, are not applicable to REA 1984 years.

(ii) To the extent that the pre-REA 1984 law either is the same as or consistent with REA 1984 and the new regulations hereunder, the rules in this section shall continue to apply for years to which REA 1984 applies. (See, *e.g.*, paragraph (c) (relating to how information is furnished participants and spouses) and paragraph (b) (defining a life annuity) for some of the rules that apply to REA 1984 years.) The rules in this section shall not apply for such years to the extent that they are inconsistent with REA 1984 and the regulations thereunder.

(iii) The Commissioner may provide additional guidance as to the continuing effect of the various rules in this section for years to which REA 1984 applies.

(Secs. 401(a)(11), 7805 Internal Revenue Code of 1954, (88 Stat. 935, 68A Stat. 917; (26 U.S.C. 401(a)(11), 7805)))

[T.D. 7458, 42 FR 1466, Jan. 7, 1977; 42 FR 6367, Feb. 2, 1977; T.D. 7510, 42 FR 53956, Oct. 4, 1977; T.D. 8219, 53 FR 31841, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.401(a)–12 Mergers and consolidations of plans and transfers of plan assets.

A trust will not be qualified under section 401 unless the plan of which the trust is a part provides that in the case of any merger or consolidation with, or transfer of assets or liabilities to, another plan after September 2, 1974, each participant in the plan would receive a minimum benefit if the plan terminated immediately after the merger, consolidation, or transfer. This benefit must be equal to or greater than the benefit the participant would have been entitled to receive immediately before the merger, consolidation, or transfer if the plan in which he was a participant had then terminated. This section applies to a multiemployer plan only to the extent determined by the Pension Benefit Guaranty Corporation. For additional rules concerning mergers or consolidations of plans and transfers of plan assets, see section 414(l) and § 1.414(l)–1.

[T.D. 7638, 44 FR 48195, Aug. 17, 1979]

§ 1.401(a)–13 Assignment or alienation of benefits.

(a) *Scope of the regulations.* This section applies only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, it does not apply to a governmental plan, within the meaning of section 414(d); a church plan, within the meaning of section 414(e), for which there has not been made the election under section 410(a) to have the participation, vesting, funding, etc. requirements apply; or a plan which at no time after September 2, 1974, provided for employer contributions.

(b) *No assignment or alienation*—(1) *General rule.* Under section 401(a)(13), a trust will not be qualified unless the plan of which the trust is a part provides that benefits provided under the plan may not be anticipated, assigned (either at law or in equity), alienated or subject to attachment, garnishment, levy, execution or other legal or equitable process.

(2) *Federal tax levies and judgments.* A plan provision satisfying the requirements of subparagraph (1) of this paragraph shall not preclude the following:

(i) The enforcement of a Federal tax levy made pursuant to section 6331.

(ii) The collection by the United States on a judgment resulting from an unpaid tax assessment.

(c) *Definition of assignment and alienation*—(1) *In general.* For purposes of this section, the terms ''assignment'' and ''alienation'' include—

(i) Any arrangement providing for the payment to the employer of plan benefits which otherwise would be due the participant under the plan, and

(ii) Any direct or indirect arrangement (whether revocable or irrevocable) whereby a party acquires from a participant or beneficiary a right or interest enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary.

(2) *Specific arrangements not considered an assignment or alienation.* The terms ''assignment'' and ''alienation'' do not include, and paragraph (e) of this section does not apply to, the following arrangements:

(i) Any arrangement for the recovery of amounts described in section 4045(b) of the Employee Retirement Income Security Act of 1974, 88 Stat. 1027 (relating to the recapture of certain payments),

(ii) Any arrangement for the withholding of Federal, State or local tax from plan benefit payments,

(iii) Any arrangement for the recovery by the plan of overpayments of benefits previously made to a participant,

(iv) Any arrangement for the transfer of benefit rights from the plan to another plan, or

(v) Any arrangement for the direct deposit of benefit payments to an account in a bank, savings and loan association or credit union, provided such arrangement is not part of an arrangement constituting an assignment or alienation. Thus, for example, such an arrangement could provide for the direct deposit of a participant's benefit payments to a bank account held by the participant and the participant's spouse as joint tenants.

(d) *Exceptions to general rule prohibiting assignments or alienations*—(1) *Certain voluntary and revocable assignments or alienations.* Not withstanding paragraph (b)(1) of this section, a plan may provide that once a participant or beneficiary begins receiving benefits under the plan, the participant or beneficiary may assign or alienate the right to future benefit payments provided that the provision is limited to assignments or alienations which—

(i) Are voluntary and revocable;

(ii) Do not in the aggregate exceed 10 percent of any benefit payment; and

(iii) Are neither for the purpose, nor have the effect, of defraying plan administration costs.

For purposes of this subparagraph, an attachment, garnishment, levy, execution, or other legal or equitable process is not considered a voluntary assignment or alienation.

(2) *Benefits assigned or alienated as security for loans.* (i) Notwithstanding paragraph (b)(1) of this section, a plan may provide for loans from the plan to a participant or a beneficiary to be secured (by whatever means) by the participant's accrued nonforfeitable benefit provided that the following conditions are met.

(ii) The plan provision providing for the loans must be limited to loans from the plan. A plan may not provide for the use of benefits accrued or to be accrued under the plan as security for a loan from a party other than the plan, regardless of whether these benefits are nonforfeitable within the meaning of section 411 and the regulations thereunder.

(iii) The loan, if made to a participant or beneficiary who is a disqualified person (within the meaning of section 4975(e)(2)), must be exempt from the tax imposed by section 4975 (relating to the tax imposed on prohibited transactions) by reason of section 4975(d)(1). If the loan is made to a participant or beneficiary who is not a disqualified person, the loan must be one which would the exempt from the tax imposed by section 4975 by reason of section 4975(d)(1) if the loan were made to a disqualified person.

(e) *Special rule for certain arrangements*—(1) *In general.* For purposes of this section and notwithstanding paragraph (c)(1) of this section, an arrangement whereby a participant or beneficiary directs the plan to pay all, or any portion, of a plan benefit payment to a third party (which includes the participant's employer) will not constitute an ''assignment or alienation'' if—

(i) It is revocable at any time by the participant or beneficiary; and

(ii) The third party files a written acknowledgement with the plan administrator pursuant to subparagraph (2) of this paragraph.

(2) *Acknowledgement requirement for third party arrangements.* In accordance with paragraph (e)(1)(ii) of this section, the third party is required to file a written acknowledgement with the plan administrator. This acknowledgement must state that the third party has no enforceable right in, or to, any plan benefit payment or portion thereof (except to the extent of payments actually received pursuant to the terms of the arrangement). A blanket written acknowledgement for all participants and beneficiaries who are covered under the arrangement with the third party is sufficient. The written acknowledgement must be filed with the plan administrator no later than the later of—

(i) August 18, 1978; or

(ii) 90 days after the arrangement is entered into.

(f) *Effective date.* Section 401(a)(13) is applicable as of January 1, 1976, and the plan provision required by this section must be effective as of that date. However, regardless of when the provision is adopted, it will not affect—

(1) Attachments, garnishments, levies, or other legal or equitable process permitted under the plan that are made before January 1, 1976;

(2) Assignments permitted under the plan that are irrevocable on December 31, 1975, including assignments made before January 1, 1976, as security for loans to a participant or beneficiary from a party other than the plan; and

(3) Renewals or extensions of loans described in subparagraph (2) of this paragraph, if—

(i) The principal amount of the obligation outstanding on December 31, 1975 (or, if less, the principal amount outstanding on the date of renewal or extension), is not increased;

(ii) The loan, as renewed or extended, does not bear a rate of interest in excess of the rate prevailing for similar loans at the time of the renewal or extensions; and

(iii) With respect to loans that are renewed or extended to bear a variable interest rate, the formula for determining the applicable rate is consistent with the formula for formulae prevailing for similar loans at the time of the renewal or extension. For purposes of subparagraphs (2) and (3) of this paragraph, a loan from a party other than the plan made after December 31, 1975, will be treated as a new loan. This is so even if the lender's security interest for the loan arises from an assignment of the participant's accrued nonforfeitable benefit made before that date.

(g) *Special rules for qualified domestic relations orders*—(1) *Definition.* The term ''qualified domestic relations order'' (QDRO) has the meaning set forth in section 414(p). For purposes of the Internal Revenue Code, a QDRO also includes any domestic relations order described in section 303(d) of the Retirement Equity Act of 1984.

(2) *Plan amendments.* A plan will not fail to satisfy the qualification requirements of section 401(a) or 403(a) merely because it does not include provisions with regard to a QDRO.

(3) *Waiver of distribution requirements.* A plan shall not be treated as failing to satisfy the requirements of sections 401 (a) and (k) and 409(d) solely because of a payment to an alternate payee pursuant to a QDRO. This is the case even if the plan provides for payments pursuant to a QDRO to an alternate payee prior to the time it may make payments to a participant. Thus, for example, a pension plan may pay an alternate payee even though the participant may not receive a distribution because he continues to be employed by the employer.

(4) *Coordination with section 417*—(i) *Former spouse.* (A) *In general.* Under section 414(p)(5), a QDRO may provide that a former spouse shall be treated as the current spouse of a participant for all or some purposes under sections 401(a)(11) and 417.

(B) *Consent.* (*1*) To the extent a former spouse is treated as the current spouse of the participant by reason of a QDRO, any current spouse shall not be treated as the current spouse. For example, assume H is divorced from W, but a QDRO provides that H shall be treated as W's current spouse with respect to all of W's benefits under a

plan. H will be treated as the surviving spouse under the QPSA and QJSA unless W obtains H's consent to waive the QPSA or QJSA or both. The fact that W married S after W's divorce from H is disregarded. If, however, the QDRO had provided that H shall be treated as W's current spouse only with respect to benefits that accrued prior to the divorce, then H's consent would be needed by W to waive the QPSA or QJSA with respect to benefits accrued before the divorce. S's consent would be required with respect to the remainder of the benefits.

(*2*) In the preceding examples, if the QDRO ordered that a portion of W's benefit (either through separate accounts or a percentage of the benefit) must be distributed to H rather than ordering that H be treated as W's spouse, the survivor annuity requirements of sections 401(a)(11) and 417 would not apply to the part of W's benefit awarded H. Instead, the terms of the QDRO would determine how H's portion of W's accrued benefit is paid. W is required to obtain S's consent if W elects to waive either the QJSA or QPSA with respect to the remaining portion of W's benefit.

(C) *Amount of the QPSA or QJSA.* (*1*) Where, because of a QDRO, more than one individual is to be treated as the surviving spouse, a plan may provide that the total amount to be paid in the form of a QPSA or survivor portion of a QJSA may not exceed the amount that would be paid if there were only one surviving spouse. The QPSA or survivor portion of the QJSA, as the case may be, payable to each surviving spouse must be paid as an annuity based on the life of each such spouse.

(*2*) Where the QDRO splits the participant's accrued benefit between the participant and a former spouse (either through separate accounts or percentage of the benefit), the surviving spouse of the participant is entitled to a QPSA or QJSA based on the participant's accrued benefit as of the date of death or the annuity starting date, less the separate account or percentage that is payable to the former spouse. The calculation is made as if the separate account or percentage had been distributed to the participant prior to the relevant date.

(ii) *Current spouse.* Under section 414(p)(5), even if the applicable election periods (*i.e.*, the first day of the year in which the participant attains age 35 and 90 days before the annuity starting date) have not begun, a QDRO may provide that a current spouse shall not be treated as the current spouse of the participant for all or some purposes under sections 401(a)(11) and 417. A QDRO may provide that the current spouse waives all future rights to a QPSA or QJSA.

(iii) *Effects on benefits.* (A) A plan is not required to provide additional vesting or benefits because of a QDRO.

(B) If an alternate payee is treated pursuant to a QDRO as having an interest in the plan benefit, including a separate account or percentage of the participant's account, then the QDRO cannot provide the alternate payee with a greater right to designate a beneficiary for the alternate payee's benefit amount than the participant's right. The QJSA or QPSA provisions of section 417 do not apply to the spouse of an alternate payee.

(C) If the former spouse who is treated as a current spouse dies prior to the participant's annuity starting date, then any actual current spouse of the participant is treated as the current spouse, except as otherwise provided in a QDRO.

(iv) *Section 415 requirements.* Even though a participant's benefits are awarded to an alternate payee pursuant to a QDRO, the benefits are benefits of the participant for purposes of applying the limitations of section 415 to the participant's benefits.

[T.D. 7534, 43 FR 6943, Feb. 17, 1978, as amended by T.D. 8219, 53 FR 31850, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.401(a)–14 Commencement of benefits under qualified trusts.

(a) *In general.* Under section 401(a)(14), a trust to which section 411 applies (without regard to section 411(e)(2) is not qualified under section 401 unless the plan of which such trust is a part provides that the payment of benefits under the plan to the participant will begin not later than the 60th day after the close of the plan year in which the latest of the following events occurs—

(1) The attainment by the participant of age 65, or, if earlier, the normal retirement age specified under the plan,

(2) The 10th anniversary of the date on which the participant commenced participation in the plan,

(3) The termination of the participant's service with the employer, or

(4) The date specified in an election made pursuant to paragraph (b) of this section.

Notwithstanding the preceding sentence, a plan may require that a participant file a claim for benefits before payment of benefits will commence.

(b) *Election of later date*—(1) *General rule*. A plan may permit a participant to elect that the payment to him of any benefit under a plan will commence at a date later than the dates specified under paragraphs (a)(1), (2), and (3) of this section.

(2) *Manner of election*. A plan permitting an election under this paragraph shall require that such election must be made by submitting to the plan administrator a written statement, signed by the participant, which describes the benefit and the date on which the payment of such benefit shall commence.

(3) *Restriction*. An election may not be made pursuant to a plan provision permitted by this paragraph if the exercise of such election will cause benefits payable under the plan with respect to the participant in the event of his death to be more than ''incidental'' within the meaning of paragraph (b)(1)(i) of § 1.401–1.

(c) *Special early retirement rule*—(1) *Separation prior to early retirement age*. A trust forming part of a plan which provides for the payment of an early retirement benefit is not qualified under section 401 unless, upon satisfaction of the age requirement for such early retirement benefit, a participant who—

(i) Satisfied the service requirements for such early retirement benefit, but

(ii) Separated from service (with any nonforfeitable right to an accrued benefit) before satisfying such age requirement,

is entitled to receive not less than the reduced normal retirement benefit described in paragraph (c)(2) of this section. A plan may establish reasonable conditions for payments of early retirement benefits (including for example, a requirement that a claim for benefits be made) if the conditions are equally applicable to participants who separate from service when eligible for an early retirement benefit and participants who separate from service earlier.

(2) *Reduced normal retirement benefit*. For purposes of this section, the reduced normal retirement benefit is the benefit to which the participant would have been entitled under the plan at normal retirement age, reduced in accordance with reasonable actuarial assumptions.

(3) *Separation prior to effective date of this section*. The provisions of this paragraph shall not apply in the case of a plan participant who separates from service before attainment of early retirement age and prior to the effective date of this section set forth in paragraph (e) of this section.

(4) *Illustration*. The provisions of this paragraph may be illustrated by the following example:

Example. The X Corporation Defined Benefit Plan provides that a normal retirement benefit will be payable to a participant upon attainment of age 65. The plan also provides that an actuarially reduced retirement benefit will be payable, upon application, to any participant who has completed 10 years of service with the X Corporation and attained age 60. When he is 55 years of age and has completed 10 years of service with X Corporation, A, a participant in the plan, leaves the service of X Corporation and does not return. The plan will not be qualified under section 401 unless, upon attainment of age 60 and application for benefits, A is entitled to receive a reduced normal retirement benefit described in subparagraph (2) of this paragraph.

(d) *Retroactive payment rule*. If the amount of the payment required to commence on the date determined under this section cannot be ascertained by such date, or if it is not possible to make such payment on such date because the plan administrator has been unable to locate the participant after making reasonable efforts to do so, a payment retroactive to such date may be made no later than 60 days after the earliest date on which the amount of such payment can be ascertained under the plan or the date

on which the participant is located (whichever is applicable).

(e) *Effective date.* This section shall apply to a plan for those plan years to which section 411 of the Code applies without regard to section 411(e)(2).

(Secs. 401(a)(14), 7805, Internal Revenue Code of 1954 (88 Stat. 937, 68A Stat. 917; 26 U.S.C. 401(a)(14), 7805))

[T.D. 7436, 41 FR 42651, Sept. 28, 1976; 41 FR 44690, Oct. 12, 1976]

§ 1.401(a)–15 Requirement that plan benefits are not decreased on account of certain Social Security increases.

(a) *In general.* Under section 401(a)(15), a trust which is part of a plan to which section 411 applies (without regard to section 411(e)(2)) is not qualified under section 401 unless, under the plan of which such trust is a part:

(1) *Benefit being received by participant or beneficiary.* A benefit (including a death or disability benefit) being received under the plan by a participant or beneficiary (other than a participant to whom subparagraph (2)(ii) of this paragraph applies, or a beneficiary of such a participant) is not decreased by reason of any post-separation social security benefit increase effective after the later of—

(i) September 2, 1974, or

(ii) The date of first receipt of any retirement benefit, death benefit, or disability benefit under the plan by the participant or by a beneficiary of the participant (whichever receipt occurs first).

(2) *Benefit to which participant separated from service has nonforfeitable right.* In the case of a benefit to which a participant has a nonforfeitable right under such plan—

(i) If such participant is separated from service and does not subsequently return to service and resume participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after the later of September 2, 1974, or separation from service, or

(ii) If such participant is separated from service and subsequently returns to service and resumes participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after September 2, 1974, which occurs during separation from service and which would decrease such benefit to a level below the level of benefits to which he would have been entitled had he not returned to service after his separation.

(b) *Post-separation social security benefit increase.* For purposes of this section, the term ''post-separation social security benefit increase'' means, with respect to a participant or a beneficiary of the participant, an increase in a benefit level or wage base under title II of the Social Security Act (whether such increase is a result of an amendment of such title II or is a result of the application of the provisions of such title II) occurring after the earlier of such participant's separation from service or commencement of benefits under the plan.

(c) *Illustrations.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title II of the Social Security Act at age 65, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan does not satisfy the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will reduce the benefit the participant will receive under the plan.

Example (2). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title

II of the Social Security Act at age 65 based upon the assumption that he will continue to receive until reaching age 65 compensation which would be treated as wages for purposes of the Social Security Act at the same rate as he received such compensation at the time he separated from service, but determined without regard to any post-separation social security benefit increase, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan satisfies the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will not reduce the benefit the participant will receive under the plan.

(d) *Other Federal or State laws*. To the extent applicable, the rules discussed in this section will govern classifications under a plan supplementing the benefits provided by other Federal or State laws, such as the Railroad Retirement Act of 1937. See section 206(b) of the Employee Retirement Income Security Act of 1974 (Public Law 93–406, 88 Stat. 864).

(e) *Effect on prior law*. Nothing in this section shall be construed as amending or modifying the rules applicable to post-separation social security increases prior to September 2, 1974. See paragraph (e) of § 1.401–3.

(f) *Effective date*. Section 401(a)(15) and this section shall apply to a plan only with respect to plan years to which section 411 (relating to minimum vesting standards) is applicable to the plan without regard to section 411(e)(2).

[T.D. 7434, 41 FR 42650, Sept. 28, 1976]

§ 1.401(a)–16 Limitations on benefits and contributions under qualified plans.

A trust will not be a qualified trust and a plan will not be a qualified plan if the plan provides for benefits or contributions which exceed the limitations of section 415. Section 415 and the regulations thereunder provide rules concerning these limitations on benefits and contributions.

[T.D. 7748, 46 FR 1696, Jan. 7, 1981]

§ 1.401(a)–19 Nonforfeitability in case of certain withdrawals.

(a) *Application of section*. Section 401(a)(19) and this section apply to a plan to which section 411(a) applies. (See section 411(e) and § 1.411(a)–2 for applicability of section 411).

(b) *Prohibited forfeitures*—(1) *General rule*. A plan to which this section applies is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if, under such plan, any part of a participant's accrued benefit derived from employer contributions is forfeitable solely because a benefit derived from the participant's contributions under the plan is voluntarily withdrawn by him after he has become a 50 percent vested participant.

(2) *50 percent vested participant*. For purposes of subparagraph (1) of this paragraph, a participant is a 50 percent vested participant when he has a nonforfeitable right (within the meaning of section 411 and the regulations thereunder) to at least 50 percent of his accrued benefit derived from employer contributions. Whether or not a participant is 50 percent vested shall be determined by the ratio of the participant's total nonforfeitable employer-derived accrued benefit under the plan to his total employer-derived accrued benefit under the plan.

(3) *Certain forfeitures*. Paragraph (b)(1) of this section does not apply in the case of a forfeiture permitted by section 411(a)(3)(D)(iii) and § 1.411(a)–7(d)(3) (relating to forfeitures of certain benefits accrued before September 2, 1974).

(c) *Supersession*. Section 11.401(a)–(19) of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this section.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42320, Aug. 23, 1977]

§ 1.401(a)–20 Requirements of qualified joint and survivor annuity and qualified preretirement survivor annuity.

Q–1: What are the survivor annuity requirements added to the Code by the Retirement Equity Act of 1984 (REA 1984)?

A–1: REA 1984 replaced section 401(a)(11) with a new section 401(a)(11) and added section 417. Plans to which new section 401(a)(11) applies must

comply with the requirements of sections 401(a)(11) and 417 in order to remain qualified under sections 401(a) or 403(a). In general, these plans must provide both a qualified joint and survivor annuity (QJSA) and a qualified preretirement survivor annuity (QPSA) to remain qualified. These survivor annuity requirements are applicable to any benefit payable under a plan, including a benefit payable to a participant under a contract purchased by the plan and paid by a third party.

Q–2: Must annuity contracts purchased and distributed to a participant or spouse by a plan subject to the survivor annuity requirements of sections 401(a)(11) and 417 satisfy the requirements of those sections?

A–2: Yes. Rights and benefits under section 401(a)(11) or 417 may not be eliminated or reduced because the plan uses annuity contracts to provide benefits merely because (a) such a contract is held by a participant or spouse instead of a plan trustee, or (b) such contracts are distributed upon plan termination. Thus, the requirements of sections 401(a)(11) and 417 apply to payments under the annuity contracts, not to the distributions of the contracts.

Q–3: What plans are subject to the survivor annuity requirements of section 401(a)(11)?

A–3: (a) Section 401(a)(11) applies to any defined benefit plan and to any defined contribution plan that is subject to the minimum funding standards of section 412. This section also applies to any participant under any other defined contribution plan unless all of the following conditions are satisfied—

(1) The plan provides that the participant's nonforfeitable accrued benefit is payable in full, upon the participant's death, to the participant's surviving spouse (unless the participant elects, with spousal consent that satisfies the requirements of section 417(a)(2), that such benefit be provided instead to a designated beneficiary);

(2) The participant does not elect the payment of benefits in the form of a life annuity; and

(3) With respect to the participant, the plan is not a transferee or an offset plan. (See Q&A 5 of this section.)

(b) A defined contribution plan not subject to the minimum funding standards of section 412 will not be treated as satisfying the requirement of paragraph (a)(1) unless both of the following conditions are satisfied—

(1) The benefit is available to the surviving spouse within a reasonable time after the participant's death. For this purpose, availability within the 90-day period following the date of death is deemed to be reasonable and the reasonableness of longer periods shall be determined based on the particular facts and circumstances. A time period longer than 90 days, however, is deemed unreasonable if it is less favorable to the surviving spouse than any time period under the plan that is applicable to other distributions. Thus, for example, the availability of a benefit to the surviving spouse would be unreasonable if the distribution was required to be made by the close of the plan year including the participant's death while distributions to employees who separate from service were required to be made within 90 days of separation.

(2) The benefit payable to the surviving spouse is adjusted for gains or losses occurring after the participant's death in accordance with plan rules governing the adjustment of account balances for other plan distributions. Thus, for example, the plan may not provide for distributions of an account balance to a surviving spouse determined as of the last day of the quarter in which the participant's death occurred with no adjustments of an account balance for gains or losses after death if the plan provides for such adjustments for a participant who separates from service within a quarter.

(c) For purposes of determining the extent to which section 401(a)(11) applies to benefits under an employee stock ownership plan (as defined in section 4975(e)(7)), the portion of a participant's accrued benefit that is subject to section 409(h) is to be treated as though such benefit were provided under a defined contribution plan not subject to section 412.

(d) The requirements set forth in section 401(a)(11) apply to other employee benefit plans that are covered by applicable provisions under Title I of the Employee Retirement Income Security Act of 1974. For purposes of applying

the regulations under sections 401(a)(11) and 417, plans subject to ERISA section 205 are treated as if they were described in section 401(a). For example, to the extent that section 205 covers section 403(b) contracts and custodial accounts they are treated as section 401(a) plans. Individual retirement plans (IRAs), including IRAs to which contributions are made under simplified employee pensions described in section 408(k) and IRAs that are treated as plans subject to Title I, are not subject to these requirements.

Q–4: What rules apply to a participant who elects a life annuity option under a defined contribution plan not subject to section 412?

A–4: If a participant elects at any time (irrespective of the applicable election period defined in section 417(a)(6)) a life annuity option under a defined contribution plan not subject to section 412, the survivor annuity requirements of sections 401(a)(11) and 417 will always thereafter apply to all of the participant's benefits under such plan unless there is a separate accounting of the account balance subject to the election. A plan may allow a participant to elect an annuity option prior to the applicable election period described in section 417(a)(6). If a participant elects an annuity option, the plan must satisfy the applicable written explanation, consent, election, and withdrawal rules of section 417, including waiver of the QJSA within 90 days of the annuity starting date. If a participant selecting such an option dies, the surviving spouse must be able to receive the QPSA benefit described in section 417(c)(2) which is a life annuity, the actuarial equivalent of which is not less than 50 percent of the nonforfeitable account balance (adjusted for loans as described in Q&A 24(d) of this section). The remaining account balance may be paid to a designated nonspouse beneficiary.

Q–5: How do sections 401(a)(11) and 417 apply to transferee plans which are defined contribution plans not subject to section 412?

A–5: (a) *Transferee plans.* Although the survivor annuity requirements of sections 401(a)(11) and 417 generally do not apply to defined contribution plans not subject to section 412, such plans are subject to the survivor annuity requirements to the extent that they are transferee plans with respect to any participant. A defined contribution plan is a transferee plan with respect to any participant if the plan is a direct or indirect transferee of such participant's benefits held on or after January 1, 1985, by:

(1) A defined benefit plan,

(2) A defined contribution plan subject to section 412 or

(3) A defined contribution plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 with respect to that participant.

If through a merger, spinoff, or other transaction having the effect of a transfer, benefits subject to the survivor annuity requirements of sections 401(a)(11) and 417 are held under a plan that is not otherwise subject to such requirements, such benefits will be subject to the survivor annuity requirements even though they are held under such plan. Even if a plan satisfies the survivor annuity requirements, other rules apply to these transactions. See, *e.g.*, section 411(d)(6) and the regulations thereunder. A transfer made before January 1, 1985, and any rollover contribution made at any time, are not transactions that subject the transferee plan to the survivor annuity requirements with respect to a participant. If a plan is a transferee plan with respect to a participant, the survivor annuity requirements do not apply with respect to other plan participants solely because of the transfer. Any plan that would not otherwise be subject to the survivor annuity requirements of sections 401(a)(11) and 417 whose benefits are used to offset benefits in a plan subject to such requirements is subject to the survivor annuity requirements with respect to those participants whose benefits are offset. Thus, if a stock bonus or profit-sharing plan offsets benefits under a defined benefit plan, such a plan is subject to the survivor annuity requirements.

(b) *Benefits covered.* The survivor annuity requirements apply to all accrued benefits held for a participant with respect to whom the plan is a transferee plan unless there is an acceptable separate accounting between the transferred benefits and all other

benefits under the plan. A separate accounting is not acceptable unless gains, losses, withdrawals, contributions, forfeitures, and other credits or charges are allocated on a reasonable and consistent basis between the accrued benefits subject to the survivor annuity requirements and other benefits. If there is an acceptable separate accounting between transferred benefits and any other benefits under the plan, only the transferred benefits are subject to the survivor annuity requirements.

Q–6: Is a frozen or terminated plan required to satisfy the survivor annuity requirements of sections 401(a)(11) and 417?

A–6: In general, benefits provided under a plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 must be provided in accordance with those requirements even if the plan is frozen or terminated. However, any plan that has a termination date prior to September 17, 1985, and that distributed all remaining assets as soon as administratively feasible after the termination date, is not subject to the survivor annuity requirements. The date of termination is determined under section 411(d)(3) and § 1.411(d)–2(c).

Q–7: If the Pension Benefit Guaranty Corporation (PBGC) is administering a plan, are benefits payable in the form of a QPSA or QJSA-

A–7: Yes, the PBGC will pay benefits in such forms.

Q–8: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply to participants?

A–8: (a) If a participant dies before the annuity starting date with vested benefits attributable to employer or employee contributions (or both), benefits must be paid to the surviving spouse in the form of a QPSA. If a participant survives until the annuity starting date with vested benefits attributable to employer or employee contributions (or both), benefits must be provided to the participant in the form of a QJSA.

(b) A participant may waive the QPSA or the QJSA (or both) if the applicable notice, election, and spousal consent requirements of section 417 are satisfied.

(c) Benefits are not required to be paid in the form of a QPSA or QJSA if at the time of death or distribution the participant was vested only in employee contributions and such death occurred, or distribution commenced, before October 22, 1986.

(d) *Certain mandatory distributions.* A distribution may occur without satisfying the spousal consent requirements of section 417 (a) and (e) if the present value of the nonforfeitable benefit does not exceed the cash-out limit in effect under§ 1.411(a)–11(c)(3)(ii). See § 1.417(e)–1.

Q–9: May separate portions of a participant's accrued benefit be subject to QPSA and QJSA requirements at any particular point in time?

A–9: (a) *Dual QPSA and QJSA rights.* One portion of a participant's benefit may be subject to the QPSA and another portion to the QJSA requirements at the same time. For example, in order for a money purchase pension plan to distribute any portion of a married participant's benefit to the participant, the plan must distribute such portion in the form of a QJSA (unless the plan satisfies the applicable consent requirements of section 417 (a) and (e) with respect to such portion of the participant's benefit). This rule applies even if the distribution is merely an in-service distribution attributable to voluntary employee contributions and regardless of whether the participant has attained the normal retirement age under the plan. The QJSA requirements apply to such a distribution because the annuity starting date has occurred with respect to this portion of the participant's benefit. In the event of a participant's death following the commencement of a distribution in the form of a QJSA, the remaining payments must be made to the surviving spouse under the QJSA. In addition, the plan must satisfy the QPSA requirements with respect to any portion of the participant's benefits for which the annuity starting date had not yet occurred.

(b) *Example.* Assume that participant A has a $100,000 account balance in a money purchase pension plan. A makes an in-service withdrawal of $20,000 attributable to voluntary employee contributions. The QJSA requirements apply to A's withdrawal of the

$20,000. Accordingly, unless the QJSA form is properly waived such amount must be distributed in the form of a QJSA. A's remaining account balance ($80,000) remains subject to the QPSA requirements because the annuity starting date has not occurred with respect to the $80,000. (If A survives until the annuity starting date, the $80,000 would be subject to the QJSA requirements.) If A died on the day following the annuity starting date for the withdrawal, A's spouse would be entitled to a QPSA with a value equal to at least $40,000 with respect to the $80,000 account balance, in addition to any survivor benefit without respect to the $20,000. If the $20,000 payment to A had been the first payment of an annuity purchased with the entire $100,000 account balance rather than an in-service distribution, then the QJSA requirements would apply to the entire account balance at the time of the annuity starting date. In such event, the plan would have no obligation to provide A's spouse with a QPSA benefit upon A's death. Of course, A's spouse would receive the QJSA benefit (if the QJSA had not been waived) based on the full $100,000.

Q–10: What is the relevance of the annuity starting date with respect to the survivor benefit requirements?

A–10: (a) *Relevance.* The annuity starting date is relevant to whether benefits are payable as either a QJSA or QPSA, or other selected optional form of benefit. If a participant is alive on the annuity starting date, the benefits must be payable as a QJSA. If the participant is not alive on the annuity starting date, the surviving spouse must receive a QPSA. The annuity starting date is also used to determine when a spouse may consent to and a participant may waive a QJSA. A waiver is only effective if it is made 90 days before the annuity starting date. Thus, a deferred annuity cannot be selected and a QJSA waived until 90 days before payments commence under the deferred annuity. In some cases, the annuity starting date will have occurred with respect to a portion of the participant's accrued benefit and will not have occurred with respect to the remaining portion. (See Q&A–9.)

(b) *Annuity starting date*—(1) *General rule.* For purposes of sections 401(a)(11), 411(a)(11) and 417, the annuity starting date is the first day of the first period for which an amount is paid as an annuity or any other form.

(2) *Annuity payments.* The annuity starting date is the first date for which an amount is paid, not the actual date of payment. Thus, if participant A is to receive annuity payments as of the first day of the first month after retirement but does not receive any payments until three months later, the annuity starting date is the first day of the first month. For example, if an annuity is to commence on January 1, January 1 is the annuity starting date even though the payment for January is not actually made until a later date. In the case of a deferred annuity, the annuity starting date is the date for which the annuity payments are to commence, not the date that the deferred annuity is elected or the date the deferred annuity contract is distributed.

(3) *Administrative delay.* A payment shall not be considered to occur after the annuity starting date merely because actual payment is reasonably delayed for calculation of the benefit amount if all payments are actually made.

(4) *Forfeitures on death.* Prior to the annuity starting date, section 411(a)(3)(A) allows a plan to provide for a forfeiture of a participant's benefit, except in the case of a QPSA or a spousal benefit described in section 401(a)(11)(B)(iii)(I). Once the annuity starting date has occurred, even if actual payment has not yet been made, a plan must pay the benefit in the distribution form elected.

(5) *Surviving spouses, alternate payees, etc.* The definition of ''annuity starting date'' for surviving spouses, other beneficiaries and alternate payees under section 414(p) is the same as it is for participants.

(c) *Disability auxiliary benefit*—(1) *General rule.* The annuity starting date for a disability benefit is the first day of the first period for which the benefit becomes payable unless the disability benefit is an auxiliary benefit. The payment of any auxiliary disability benefits is disregarded in determining the annuity starting date. A disability benefit is an auxiliary benefit if upon attainment of early or normal retirement age, a participant receives a benefit that satisfies the accrual and vesting rules of section 411 without taking into account the disability benefit payments up to that date.

Example. (i) Assume that participant A at age 45 is entitled to a vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity under Plan X. If prior to age 65 A receives a disability benefit under Plan X and the payment of such benefit does not reduce the amount of A's retirement benefit of $100 per month commencing at age 65, any disability benefit payments made to A between ages 45 and 65 are auxiliary benefits. Thus, A's annuity starting date does not occur until A attains age 65. A's surviving spouse B would be entitled to receive a QPSA if A died before age 65. B would be entitled to receive the survivor portion of a QJSA (unless waived) if A died after age 65. The QPSA payable to B upon A's death prior to age 65 would be computed by reference to the QJSA that would have been payable to A and B had A survived to age 65.

(ii) If in the above example A's benefit payable at age 65 is reduced to $99 per month because a disability benefit is provided to A prior to age 65, the disability benefit would not be an auxiliary benefit. The benefit of $99 per month payable to A at age 65 would not, without taking into account the disability benefit payments to A prior to age 65, satisfy the minimum vesting and accrual rules of section 411. Accordingly, the first day of the first period for which the disability payments are to be made to A would constitute A's annuity starting date, and any benefit paid to A would be required to be paid in the form of a QJSA (unless waived by A with the consent of B).

(d) *Other rules*—(1) *Suspension of benefits*. If benefit payments are suspended after the annuity starting date pursuant to a suspension of benefits described in section 411(a)(3)(B) after an employee separates from service, the recommencement of benefit payments after the suspension is not treated as a new annuity starting date unless the plan provides otherwise. In such case, the plan administrator is not required to provide new notices nor to obtain new waivers for the recommenced distributions if the form of distribution is the same as the form that was appropriately selected prior to the suspension. If benefits are suspended for an employee who continues in service without a separation and who never receives payments, the commencement of payments after the period of suspension is treated as the annuity starting date unless the plan provides otherwise.

(2) *Additional accruals*. In the case of an annuity starting date that occurs on or after normal retirement age, such date applies to any additional accruals after the annuity starting date, unless the plan provides otherwise. For example, if a participant who continues to accrue benefits elects to have benefits paid in an optional form at normal retirement age, the additional accruals must be paid in the optional form selected unless the plan provides otherwise. In the case of an annuity starting date that occurs prior to normal retirement age, such date does not apply to any additional accruals after such date.

Q–11: Do the survivor annuity requirements apply to benefits derived from both employer and employee contributions?

A–11: Yes. The survivor annuity benefit requirements apply to benefits derived from both employer and employee contributions. Benefits are not required to be paid in the form of a QPSA or a QJSA if the participant was vested only in employee contributions at the time of death or distribution and such death or distribution occurred before October 22, 1986. All benefits provided under a plan, including benefits attributable to rollover contributions, are subject to the survivor annuity requirements.

Q–12: To what benefits do the survivor annuity requirements of sections 401(a)(11) and 417 apply?

A–12: (a) *Defined benefit plans*. Under a defined benefit plan, sections 401(a)(11) and 417 apply only to benefits in which a participant was vested immediately prior to death. They do not apply to benefits to which a participant's beneficiary becomes entitled by reason of death or to the proceeds of a life insurance contract to the extent such proceeds exceed the present value of the participant's nonforfeitable benefits that existed immediately prior to death.

(b) *Defined contribution plans*. Sections 401(a)(11) and 417 apply to all nonforfeitable benefits which are payable under a defined contribution plan, whether nonforfeitable before or upon death, including the proceeds of insurance contracts.

Q–13: Does the rule of section 411(a)(3)(A) which permits forfeitures on account of death apply to a QPSA or

the spousal benefit described in section 401(a)(11)(B)(iii)?

A–13: No. Section 411(a)(3)(A) permits forfeiture on account of death prior to the time all the events fixing payment occur. However, this provision does not operate to deprive a surviving spouse of a QPSA or the spousal benefit described in section 401(a)(11)(B)(iii). Therefore, sections 401(a)(11) and 417 apply to benefits that were nonforfeitable immediately prior to death (determined without regard to section 411(a)(3)(A)). Thus, in the case of the death of a married participant in a defined contribution plan not subject to section 412 which provides that, upon a participant's death, the entire nonforfeitable accrued benefit is payable to the participant's spouse, the nonforfeitable benefit is determined without regard to the provisions of section 411(a)(3)(A).

Q–14: Do sections 411(a)(11), 401(a)(11) and 417 apply to accumulated deductible employee contributions, as defined in section 72(o)(5)(B) (Accumulated DECs)?

A–14: (a) *Employee consent, section 411.* The requirements of section 411(a)(11) apply to Accumulated DECs. Thus, Accumulated DECs may not be distributed without participant consent unless the applicable exemptions apply.

(b) *Survior requirements.* Accumulated DECs are treated as though held under a separate defined contribution plan that is not subject to section 412. Thus, section 401(a)(11) applies to Accumulated DECs only as provided in section 401(a)(11)(B)(iii). All Accumulated DECs are treated in this manner, including Accumulated DECs that are the only benefit held under a plan and Accumulated DECs that are part of a defined benefit or a defined contribution plan.

(c) *Effective date.* Sections 401(a)(11) and 411(a)(11) shall not apply to distributions of accumulated DECs until the first plan year beginning after December 31, 1988.

Q–15: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply to a defined benefit plan that includes an accrued benefit based upon a contribution to a separate account or mandatory employee contributions?

A–15: (a) *414(k) plans.* In the case of a section 414(k) plan that includes both a defined benefit plan and a separate account, the rules of sections 401(a)(11) and 417 apply separately to the defined benefit portion and the separate account portion of the plan. The separate account portion is subject to the survivor annuity requirements of sections 401(a)(11) and 417 and the special QPSA rules in section 417(c)(2).

(b) *Employee contributions*—(1) *Voluntary.* In the case of voluntary employee contributions to a defined benefit plan, the plan must maintain a separate account with respect to the voluntary employee contributions. This separate account is subject to the survivor annuity requirements of sections 401(a)(11) and 417 and the special QPSA rules in section 417(c)(2).

(2) *Mandatory.* In the case of a defined benefit plan providing for mandatory employee contributions, the entire accrued benefit is subject to the survivor annuity requirements of sections 401(a)(11) and 417 as a defined benefit plan.

(c) *Accumulated DECs.* See Q&A 14 of this section for the rule applicable to accumulated deductible employee contributions.

Q–16: Can a plan provide a benefit form more valuable than the QJSA and if a plan offers more than one annuity option satisfying the requirements of a QJSA, is spousal consent required when the participant chooses among the various forms?

A–16: In the case of an unmarried participant, the QJSA may be less valuable than other optional forms of benefit payable under the plan. In the case of a married participant, the QJSA must be at least as valuable as any other optional form of benefit payable under the plan at the same time. Thus, if a plan has two joint and survivor annuities that would satisfy the requirements for a QJSA, but one has a greater actuarial value than the other, the more valuable joint and survivor annuity is the QJSA. If there are two or more actuarially equivalent joint and survivor annuities that satisfy the requirements for a QJSA, the plan must designate which one is the QJSA and, therefore, the automatic form of benefit payment. A plan, however, may

allow a participant to elect out of such a QJSA, without spousal consent, in favor of another actuarially equivalent joint and survivor annuity that satisfies the QJSA conditions. Such an election is not subject to the requirement that it be made within the 90-day period before the annuity starting date. For example, if a plan designates a joint and 100% survivor annuity as the QJSA and also offers an actuarially equivalent joint and 50% survivor annuity that would satisfy the requirements of a QJSA, the participant may elect the joint and 50% survivor annuity without spousal consent. The participant, however, does need spousal consent to elect a joint and survivor annuity that was not actuarially equivalent to the automatic QJSA.

Q–17: When must distributions to a participant under a QJSA commence?

A–17: (a) *QJSA benefits upon earliest retirement.* A plan must permit a participant to receive a distribution in the form of a QJSA when the participant attains the earliest retirement age under the plan. Written consent of the participant is required. However, the consent of the participant's spouse is not required. Any payment not in the form of a QJSA is subject to spousal consent. For example, if the participant separates from service under a plan that allows for distributions on separation from service or if a plan allows for in-service distributions, the participant may receive a QJSA without spousal consent in such events. Payments in any other form, including a single sum, would require waiver of the QJSA by the participant's spouse.

(b) *Earliest retirement age.* (1) This paragraph (b) defines the term ''earliest retirement age'' for purposes of sections 401(a)(11), 411(a)(11) and 417.

(2) In the case of a plan that provides for voluntary distributions that commence upon the participant's separation from service, earliest retirement age is the earliest age at which a participant could separate from service and receive a distribution. Death of a participant is treated as a separation from service.

(3) In the case of a plan that provides for in-service distributions, earliest retirement age is the earliest age at which such distributions may be made.

(4) In the case of a plan not described in subparagraph (2) or (3) of this paragraph, the rule below applies. Earliest retirement age is the early retirement age determined under the plan, or if no early retirement age, the normal retirement age determined under the plan. If the participant dies or separates from service before such age, then only the participant's actual years of service at the time of the participant's separation from service or death are taken into account. Thus, in the case of a plan under which benefits are not payable until the attainment of age 65, or upon attainment of age 55 and completion of 10 years of service, the earliest retirement age of a participant who died or separated from service with 8 years of service is when the participant would have attained age 65 (if the participant had survived). On the other hand, if a participant died or separated from service after 10 years of service, the earliest retirement age is when the participant would have attained age 55 (if the participant had survived).

Q–18: What is a qualified preretirement survivor annuity (QPSA) in a defined benefit plan?

A–18: A QPSA is an immediate annuity for the life of the surviving spouse of a participant. Each payment under a QPSA under a defined benefit plan is not to be less than the payment that would have been made to the survivor under the QJSA payable under the plan if (a) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with a QJSA on the day before the participant's death, and (b) in the case of a participant who dies on or before the participant's earliest retirement age under the plan, the participant had separated from service at the earlier of the actual time of separation or death, survived until the earliest retirement age, retired at that time with a QJSA, and died on the day thereafter. If the participant elects before the annuity starting date a form of joint and survivor annuity that satisfies the requirements for a QJSA and dies before the annuity starting date, the elected form is treated as the QJSA and the QPSA must be based on such form.

Q–19: What rules apply in determining the amount and forfeitability of a QPSA?

A–19: The QPSA is calculated as of the earliest retirement age if the participant dies before such time, or at death if the participant dies after the earliest retirement age. The plan must make reasonable actuarial adjustments to reflect a payment earlier or later than the earliest retirement age. A defined benefit plan may provide that the QPSA is forfeited if the spouse does not survive until the date prescribed under the plan for commencement of the QPSA (*i.e.*, the earliest retirement age). Similarly, if the spouse survives past the participant's earliest retirement age (or other earlier QPSA distribution date under the plan) and elects after the death of the participant to defer the commencement of the QPSA to a later date, a defined benefit plan may provide for a forfeiture of the QPSA benefit if the spouse does not survive until the deferred commencement date. The account balance in a defined contribution plan may not be forfeited even though the spouse does not survive until the time the account balance is used to purchase the QPSA. See Q&A–17 of this section for the meaning of earliest retirement age.

Q–20: What preretirement survivor annuity benefits must a defined contibution plan subject to the survivor annuity requirements of sections 401(a)(11) and 417 provide?

A–20: A defined contribution plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 must provide a preretirement survivor annuity with a value which is not less than 50 percent of the nonforfeitable account balance of the participant as of the date of the participant's death. If a contributory defined contribution plan has a forfeiture provision permitted by section 411(a)(3)(A), not more than a proportional percent of the account balance attributable to contributions that may not be forfeited at death (for example, employee and section 401(k) contributions) may be used to satisfy the QPSA benefit. Thus, for example, if the QPSA benefit is to be provided from 50 percent of the account balance, not more than 50 percent of the nonforfeitable contributions may be used for the QPSA.

Q–21: May a defined benefit plan charge the participant for the cost of the QPSA benefit?

A–21: Prior to the later of the time the plan allows the participant to waive the QPSA or provides notice of the ability to waive the QPSA, a defined benefit plan may not charge the participant for the cost of the QPSA by reducing the participant's plan benefits or by any other method. The preceding sentence does not apply to any charges prior to the first plan year beginning after December 31, 1988. Once the participant is given the opportunity to waive the QPSA or the notice of the QPSA is later, the plan may charge the participant for the cost of the QPSA. A charge for the QPSA that reasonably reflects the cost of providing the QPSA will not fail to satisfy section 411 even if it reduces the accrued benefit.

Q–22: When must distributions to a surviving spouse under a QPSA commence?

A–22: (a) In the case of a defined benefit plan, the plan must permit the surviving spouse to direct the commencement of payments under QPSA no later than the month in which the participant would have attained the earliest retirement age. However, a plan may permit the commencement of payments at an earlier date.

(b) In the case of a defined contribution plan, the plan must permit the surviving spouse to direct the commencement of payments under the QPSA within a reasonable time after the participant's death.

Q–23: Must a defined benefit plan obtain the consent of a participant and the participant's spouse to commence payments in the form of a QJSA in order to avoid violating section 415 or 411(b)?

A–23: No. A defined benefit plan may commence distributions in the form of a QJSA without the consent of the participant and spouse, even if consent would otherwise be required (see §1.417(e)–1(b)), to the extent necessary to avoid a violation of section 415 or 411(b). For example, assume a plan has a normal retirement age of 55. A is a married participant, age 55, and has accrued a $75,000 joint and 100 percent

survivor annuity that satisfies section 415. If an actuarial increase would be required under section 411 because of deferred commencement and the increase would cause the benefit to exceed the applicable limit under section 415, the plan may commence payment of a QJSA at age 55 without the participant's election or consent and without the spouse's concent.

Q–24: What are the rules under sections 401(a)(11) and 417 applicable to plan loans?

A–24: (a) *Consent rules.* (1) A plan does not satisfy the survivor annuity requirements of sections 401(a)(11) and 417 unless the plan provides that, at the time the participant's accrued benefit is used as security for a loan, spousal consent to such use is obtained. Consent is required even if the accrued benefit is not the primary security for the loan. No spousal consent is necessary if, at the time the loan is secured, no consent would be required for a distribution under section 417(a)(2)(B). Spousal consent is not required if the plan or the participant is not subject to section 401(a)(11) at the time the accrued benefit is used as security, or if the total accrued benefit subject to the security is not in excess of the cash-out limit in effect under § 1.411(a)–11(c)(3)(ii). The spousal consent must be obtained no earlier than the beginning of the 90-day period that ends on the date on which the loan is to be so secured. The consent is subject to the requirements of section 417(a)(2). Therefore, the consent must be in writing, must acknowledge the effect of the loan and must be witnessed by a plan representative or a notary public.

(2) Participant consent is deemed obtained at the time the participant agrees to use his accrued benefit as security for a loan for purposes of satisfying the requirements for participant consent under sections 401(a)(11), 411(a)(11) and 417.

(b) *Change in status.* If spousal consent is obtained or is not required under paragraph (a) of this Q&A 24 at the time the benefits are used as security, spousal consent is not required at the time of any setoff of the loan against the accrued benefit resulting from a default, even if the participant is married to a different spouse at the time of the setoff. Similarly, in the case of a participant who secured a loan while unmarried, no consent is required at the time of a setoff of the loan against the accrued benefit even if the participant is married at the time of the setoff.

(c) *Renegotiation.* For purposes of obtaining any required spousal consent, any renegotiation, extension, renewal, or other revision of a loan shall be treated as a new loan made on the date of the renegotiation, extension, renewal, or other revision.

(d) *Effect on benefits.* For purposes of determining the amount of a QPSA or QJSA, the accrued benefit of a participant shall be reduced by any security interest held by the plan by reason of a loan outstanding to the participant at the time of death or payment, if the security interest is treated as payment in satisfaction of the loan under the plan. A plan may offset any loan outstanding at the participant's death which is secured by the participant's account balance against the spousal benefit required to be paid under section 401(a)(11)(B)(iii).

(e) *Effective date.* Loans made prior to August 19, 1985, are deemed to satisfy the consent requirements of paragraph (a) of this Q&A 24.

Q–25: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply with respect to participants who are not married or to surviving spouses and participants who have a change in marital status?

A–25: (a) *Unmarried participant rule.* Plans subject to the survivor annuity requirements of sections 401(a)(11) and 417 must satisfy those requirements applicable to QJSAs with respect to participants who are not married. A QJSA for a participant who is not married is an annuity for the life of the participant. Thus, an unmarried participant must be provided the written explanation described in section 417(a)(3)(A) and a single life annuity unless another form of benefit is elected by the participant. An unmarried participant is deemed to have waived the QPSA requirements. This deemed waiver is null and void if the participant later marries.

(b) *Marital status change.*—(1) *Remarriage.* If a participant is married on the

date of death, payments to a surviving spouse under a QPSA or QJSA must continue even if the surviving spouse remarries.

(2) *One-year rule.* (i) A plan is not required to treat a participant as married unless the participant and the participant's spouse have been married throughout the one-year period ending on the earlier of (A) the participant's annuity starting date or (B) the date of the participant's death. Nevertheless, for purposes of the preceding sentence, a participant and the participant's spouse must be treated as married throughout the one-year period ending on the participant's annuity starting date even though they are married to each other for less than one year before the annuity starting date if they remain married to each other for at least one year. See section 417(d)(2). If a plan adopts the one-year rule provided in section 417(d), the plan must treat the participant and spouse who are married on the annuity starting date as married and must provide benefits which are to commence on the annuity starting date in the form of a QJSA unless the participant (with spousal consent) elects another form of benefit. The plan is not required to provide the participant with a new or retroactive election or the spouse with a new consent when the one-year period is satisfied. If the participant and the spouse do not remain married for at least one year, the plan may treat the participant as having not been married on the annuity starting date. In such event, the plan may provide that the spouse loses any survivor benefit right; further, no retroactive correction of the amount paid the participant is required.

(ii) *Example.* Plan X provides that participants who are married on the annuity starting date for less than one year are treated as unmarried participants. Plan X provides benefits in the form of a QJSA or an optional single sum distribution. Participant A was married 6 months prior to the annuity starting date. Plan X must treat A as married and must commence payments to A in the form of a QJSA unless another form of benefit is elected by A with spousal consent. If a QJSA is paid and A is divorced from his spouse S, within the first year of the marriage, S will no longer have any survivor rights under the annuity (unless a QDRO provides otherwise). If A continues to be married to S, and A dies within the one-year period, Plan X may treat A as unmarried and forfeit the OJSA benefit payable to S.

(3) *Divorce.* If a participant divorces his spouse prior to the annuity starting date, any elections made while the participant was married to his former spouse remain valid, unless otherwise provided in a QDRO, or unless the participant changes them or is remarried. If a participant dies after the annuity starting date, the spouse to whom the participant was married on the annuity starting date is entitled to the QJSA protection under the plan. The spouse is entitled to this protection (unless waived and consented to by such spouse) even if the participant and spouse are not married on the date of the participant's death, except as provided in a QDRO.

Q–26: In the case of a defined contribution plan not subject to section 412, does the requirement that a participant's nonforfeitable accrued benefit be payable in full to a surviving spouse apply to a spouse who has been married to the participant for less than one year?

A–26: A plan may provide that a spouse who has not been married to a participant throughout the one-year period ending on the earlier of (a) the participant's annuity starting date or (b) the date of the participant's death is not treated as a surviving spouse and is not required to receive the participant's account balance. The special exception described in section 417(d)(2) and Q&A 25 of this section does not apply.

Q–27: Are there circumstances when spousal consent to a participant's election to waive the QJSA or the QPSA is not required?

A–27: Yes. If it is established to the satisfaction of a plan representative that there is no spouse or that the spouse cannot be located, spousal consent to waive the QJSA or the QPSA is not required. If the spouse is legally incompetent to give consent, the spouse's legal guardian, even if the guardian is the participant, may give consent. Also, if the participant is legally separated or the participant has been abandoned (within the meaning of local law) and the participant has a

court order to such effect, spousal consent is not required unless a QDRO provides otherwise. Similar rules apply to a plan subject to the requirements of section 401(a)(11)(B)(iii)(I).

Q–28: Does consent contained in an antenuptial agreement or similar contract entered into prior to marriage satisfy the consent requirements of sections 401(a)(11) and 417?

A–28: No. An agreement entered into prior to marriage does not satisfy the applicable consent requirements, even if the agreement is executed within the applicable election period.

Q–29: If a participant's spouse consents under section 417(a)(2)(A) to the participant's waiver of a survivor annuity form of benefit, is a subsequent spouse of the same participant bound by the consent?

A–29: No. A consent under section 417(a)(2)(A) by one spouse is binding only with respect to the consenting spouse. See Q&A–24 of this section for an exception in the case of plan benefits securing plan loans.

Q–30: Does the spousal consent requirement of section 417(a)(2)(A) require that a spouse's consent be revocable?

A–30: No. A plan may preclude a spouse from revoking consent once it has been given. Alternatively, a plan may also permit a spouse to revoke a consent after it has been given, and thereby to render ineffective the participant's prior election not to receive a QPSA or QJSA. A participant must always be allowed to change his election during the applicable election period. Spousal consent is required in such cases to the extent provided in Q&A 31, except that spousal consent is never required for a QJSA or QPSA.

Q–31: What rules govern a participant's waiver of a QPSA or QJSA under section 417(a)(2)?

A–31: (a) *Specific beneficiary*. Both the participant's waivers of a QPSA and QJSA and the spouse's consents thereto must state the specific nonspouse beneficiary (including any class of beneficiaries or any contingent beneficiaries) who will receive the benefit. Thus, for example, if spouse B consents to participant A's election to waive a QPSA, and to have any benefits payable upon A's death before the annuity starting date paid to A's children, A may not subsequently change beneficiaries without the consent of B (except if the change is back to a QPSA). If the designated beneficiary is a trust, A's spouse need only consent to the designation of the trust and need not consent to the designation of trust beneficiaries or any changes of trust beneficiaries.

(b) *Optional form of benefit*—(1) *QJSA*. Both the participant's waiver of a QJSA (and any required spouse's consent thereto) must specify the particular optional form of benefit. The participant who has waived a QJSA with the spouse's consent in favor of another form of benefit may not subsequently change the optional form of benefit without obtaining the spouse's consent (except back to a QJSA). Of course, the participant may change the form of benefit if the plan so provides after the spouse's death or a divorce (other than as provided in a QDRO). A participant's waiver of a QJSA (and any required spouse's consent thereto) made prior to the first plan year beginning after December 31, 1986, is not required to specify the optional form of benefit.

(2) *QPSA*. A participant's waiver of a QPSA and the spouse's consent thereto are not required to specify the optional form of any preretirement benefit. Thus, a participant who waives the QPSA with spousal consent may subsequently change the form of the preretirement benefit, but not the nonspouse beneficiary, without obtaining the spouse's consent.

(3) *Change in form*. After the participant's death, a beneficiary may change the optional form of survivor benefit as permitted by the plan.

(c) *General consent*. In lieu of satisfying paragraphs (a) and (b) of this Q&A 31, a plan may permit a spouse to execute a general consent that satisfies the requirements of this paragraph (c). A general consent permits the participant to waive a QPSA or QJSA, and change the designated beneficary or the optional form of benefit payment without any requirement of further consent by such spouse. No general consent is valid unless the general consent acknowledges that the spouse has the right to limit consent to a specific

beneficiary and a specific optional form of benefit, where applicable, and that the spouse voluntarily elects to relinquish both of such rights. Notwithstanding the previous sentence, a spouse may execute a general consent that is limited to certain beneficiaries or forms of benefit payment. In such case, paragraphs (a) and (b) of this Q&A 31 shall apply to the extent that the limited general consent is not applicable and this paragraph (c) shall apply to the extent that the limited general consent is applicable. A general consent, including a limited general consent, is not effective unless it is made during the applicable election period. A general consent executed prior to October 22, 1986 does not have to satisfy the specificity requirements of this Q&A 31.

Q–32: What rules govern a participant's waiver of the spousal benefit under section 401(a)(11)(B)?

A–32: (a) *Application*. In the case of a defined contribution plan that is not subject to the survivor annuity requirements of sections 401(a)(11) and 417, a participant may waive the spousal benefit of section 401(a)(11)(B)(iii) if the conditions of paragraph (b) are satisfied. In general, a spousal benefit is the nonforfeitable account balance on the participant's date of death.

(b) *Conditions*. In general, the same conditions, other than the age 35 requirement, that apply to the participant's waiver of a QPSA and the spouse's consent thereto apply to the participant's waiver of the spousal benefit and the spouse's consent thereto. See Q&A–31. Thus, the participant's waiver of the spousal benefit must state the specific nonspouse beneficiary who will receive such benefit. The waiver is not required to specify the optional form of benefit. The participant may change the optional form of benefit, but not the nonspouse beneficiary, without obtaining the spouse's consent.

Q–33: When and in what manner, may a participant waive a spousal benefit or a QPSA?

A–33: (a) *Plans not subject to section 401(a)(11)*. A participant in a plan that is not subject to the survivor annuity requirements of section 401(a)(11) (because of subparagraph (B)(iii) thereof) may waive the spousal benefit at any time, provided that no such waiver shall be effective unless the spouse has consented to the waiver. The spouse may consent to a waiver of the spousal benefit at any time, even prior to the participant's attaining age 35. No spousal consent is required for a payment to the participant or the use of the accrued benefit as security for a plan loan to the participant.

(b) *Plans subject to section 401(a)(11)*. A participant in a plan subject to the survivor annuity requirements of section 401(a)(11) generally may waive the QPSA benefit (with spousal consent) only on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver (with spousal consent), provided that a written explanation of the QPSA is given to the participant and such waiver becomes invalid upon the beginning of the plan year in which the participant's 35th birthday occurs. If there is no new waiver after such date, the participant's spouse must receive the QPSA benefit upon the participant's death.

Q–34: Must the written explanations required by section 417(a)(3) be provided to nonvested participants?

A–34: Such written explantions must be provided to nonvested participants who are employed by an employer maintaining the plan. Thus, they are not required to be provided to those nonvested participants who are no longer employed by such an employer.

Q–35: When must a plan provide the written explanation, required by section 417(a)(3)(B), of the QPSA to a participant?

A–35: (a) *General rule*. A plan must provide the written explanation of the QPSA to a participant within the applicable period. Except as provided in paragraph (b), the applicable period means, with respect to a participant, whichever of the following periods ends last:

(1) The period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35.

(2) A reasonable period ending after the individual becomes a participant.

(3) A reasonable period ending after the QPSA is no longer fully subsidized.

(4) A reasonable period ending after section 401(a)(11) first applies to the participant. Section 401(a)(11) would first apply when a benefit is transferred from a plan not subject to the survivor annuity requirements of section 401(a)(11) to a plan subject to such section or at the time of an election of an annuity under a defined contribution plan described in section 401(a)(11)(B)(iii).

(b) *Pre-35 separations*. In the case of a participant who separates from service before attaining age 35, the applicable period means the period beginning one year before the separation from service and ending one year after such separation. If such a participant returns to service, the plan must also comply with pragraph (a).

(c) *Reasonable period*. For purposes of applying paragraph (a), a reasonable period ending after the enumerated events described in paragraphs (a) (2), (3) and (4) is the end of the one-year period beginning with the date the applicable event occurs. The applicable period for such events begins one year prior to the occurrence of the enumerated events.

(d) *Transition rule*. In the case of an individual who was a participant in the plan on August 23, 1984, and, as of that date had attained age 34, the plan will satisfy the requriement of section 417(a)(3)(B) if it provided the explanation not later than December 31, 1985.

Q–36: How do plans satisfy the requirements of providing participants explanations of QPSAs and QJSAs?

A–36: Section 417(a)(3) sets forth the requirements for providing plan participants written explanations of QPSAs and QJSAs. The requirement that the terms and conditions of the QJSA or QPSA, as the case may be, be furnished to participants is not satisfied unless the written explanation complies with the requirements set forth in § 1.401(a)–11(c)(3). Also, for plan years beginning after December 31, 1988, participants must be furnished a general description of the eligibility conditions and other material features of the optional forms of benefit and sufficient additional information to explain the relative values of the optional forms of benefit available under the plan (*e.g.*, the extent to which optional forms are subsidized relative to the normal form of benefit or the interest rates used to calculate the optional forms).

Q–37: What are the consequences of fully subsidizing the cost of either a QJSA or a QPSA in accordance with section 417(a)(5)?

A–37: If a plan fully subsidizes a QJSA or QPSA in accordance with section 417(a)(5) and does not allow a participant to waive such QJSA or QPSA or to select a nonspouse beneficiary, the plan is not required to provide the written explanation required by section 417(a)(3). However, if the plan offers an election to waive the benefit or designate a beneficiary, it must satisfy the election, consent, and notice requirements of section 417(a) (1), (2), and (3), with respect to such subsidized QJSA or QPSA, in accordance with section 417(a)(5).

Q–38: What is a fully subsidized benefit?

A–38: (a) *QJSA*—(1) *General rule*. A fully subsidized QJSA is one under which no increase in cost to, or decrease in actual amounts received by, the participant may result from the participant's failure to elect another form of benefit.

(2) *Examples*.

Example (1) . If a plan provides a joint and survivor annuity and a single sum option, the plan does not fully subsidize the joint and survivor annuity, regardless of the actuarial value of the joint and survivor annuity because, in the event of the participant's early death, the participant would have received less under the annuity than he would have received under the single sum option.

Example (2) . If a plan provides for a life annuity of $100 per month and a joint and 100% survivor benefit of $99 per month, the plan does not fully subsidize the joint and survivor benefit.

(b) *QPSA*. A QPSA is fully subsidized if the amount of the participant's benefit is not reduced because of the QPSA coverage and if no charge to the participant under the plan is made for the coverage. Thus, a QPSA is fully subsidized in a defined contribution plan.

Q–39: When do the survivor annuity requirements of sections 401(a)(11) and 417 apply to plans?

A–39: Sections 401(a)(11) and 417 generally apply to plan years beginning after December 31, 1984. Sections 302 and 303 of REA 1984 provide specific effective dates and transitional rules under which the QJSA or QPSA (or pre-REA 1984 section 401(a)(11)) requirements may be applicable to particular plans or with respect to benefits provided to (as amended by REA 1984) particular participants. In general, the section 401(a)(11) (as amended by REA 1984) survivor annuity requirements do not apply with respect to a participant who does not have at least one hour of service or one hour of paid leave under the plan after August 22, 1984.

Q–40: Are there special effective dates for plans maintained pursuant to collective bargaining agreements?

A–40: Yes. Section 302(b) of REA 1984 as amended by section 1898(g) of the Tax Reform Act of 1986 provides a special deferred effective date for such plans. Whether a plan is described in section 302(b) of REA 1984 is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan will not be treated as maintained under a collective bargaining agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See § 301.7701–17T for other requirements for a plan to be considered to be collectively bargained. Nothing in section 302(b) of REA 1984 denies a participant or spouse the rights set forth in sections 303(c)(2), 303(c)(3), 303(e)(1), and 303(e)(2) of REA 1984.

Q–41: What is one hour of service or paid leave under the plan for purposes of the transition rules in section 303 of REA 1984?

A–41: One hour of service or paid leave under the plan is one hour of service or paid leave recognized or required to be recognized under the plan for any purpose, *e.g.*, participation, vesting percentage, or benefit accrual purposes. For plans that do not compute hours of service, one hour of service or paid leave means any service or paid leave recognized or required to be recognized under the plan for any purpose.

Q–42: Must a plan be amended to provide for the QPSA required by section 303(c)(2) of REA 1984, or for the survivor annuities required by section 303(e) of REA 1984?

A–42: A plan will not fail to satisfy the qualification requirements of section 401(a) or 403(a) merely because it is not amended to provide the QPSA required by section 303(c)(2) or the survivor annuities required by section 303(e). The plan must, however, satisfy those requirements in operation.

Q–43: Is a participant's election, or a spouse's consent to an election, with respect to a QPSA, made before August 23, 1984, valid?

A–43: No.

Q–44: Is spousal consent required for certain survivor annuity elections made by the participant after December 31, 1984, and before the first plan year to which new sections 401(a)(11) and 417 apply?

A–44: Yes. Section 303(c)(3) of REA 1984 provides that any election not to take a QJSA made after December 31, 1984, and before the date sections 401(a)(11) and 417 apply to the plan by a participant who has 1 hour of service or leave under the plan after August 23, 1984, is not effective unless the spousal consent requirements of section 417 are met with respect to such election. Unless the participant's annuity starting date occurred before January 1, 1985, the spousal consent required by section 417 (a)(2) and (e) must be obtained even though the participant elected the benefit prior to January 1, 1985. The plan is not required to be amended to comply with section 303(c)(3) of REA 1984, but the plan must satisfy this requirement in operation.

Q–45: Are there special rules for certain participants who separated from service prior to August 23, 1984?

A–45: Yes. Section 303(e) of REA 1984 provides special rules for certain participants who separated from service before August 23, 1984. Section 303(e)(1), which applies only to plans subject to section 401(a)(11) of the Code (as in effect on August 22, 1984), provides that participants whose annuity starting date did not occur before August 24, 1984, and who had one hour of service on or after September 2, 1974, but not

in a plan year beginning after December 31, 1975, may elect to receive the benefits required to be provided under section 401(a)(11) of the Code (as in effect on August 22, 1984). Section 303(e)(2) provides that certain participants who had one hour of service in a plan year beginning on or after January 1, 1976, but not after August 22, 1984, may elect QPSA coverage under new sections 401(a)(11) and 417 in plans subject to these provisions. Section 303(e)(4)(A) requires plans or plan administrators to notify those participants of the provisions of section 303(e).

Q–46: When must a plan provide the notice required by section 303(e)(4)(A) of REA 1984?

A–46: The notice required by section 303(e)(4)(A) must be provided no later than the earlier of:

(a) The date the first summary annual report provided after September 17, 1985, is distributed to participants; or

(b) September 30, 1985.

A plan will not fail to satisfy the preceding sentence if the plan provides a fully subsidized QPSA with respect to any participant described in section 303(e) who dies on or after July 19, 1985, and before the notice is received. If the plan ceases to fully subsidize the QPSA, the cessation must not be effective until the notice is given. For this purpose, an annuity payable to a nonspouse beneficiary elected by the participant, in lieu of a spouse, shall satisfy the QPSA requirement, so long as the survivor benefit is fully subsidized. The notice required by this paragraph must be in writing and sent to the participant's last known address.

Q–47: Is there another time when plans must provide notice of the right, described in section 303(e)(1) of REA '84, to elect a pre-REA 1984 qualified joint and survivor annuity?

A–47: Yes. Notice of this right must also be provided to a participant at the time the participant applies for benefit payments.

[53 FR 31842, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8891, 65 FR 44682, July 19, 2000]

§ 1.401(a)–30 Limit on elective deferrals.

(a) *General Rule.* A trust that is part of a plan under which elective deferrals may be made during a calendar year is not qualified under section 401(a) unless the plan provides that the elective deferrals on behalf of an individual under the plan and all other plans, contracts, or arrangements of the employer maintaining the plan may not exceed the applicable limit for the individual's taxable year beginning in the calendar year. A plan may incorporate the applicable limit by reference. In the case of a plan maintained by more than one employer to which section 413 (b) or (c) applies, section 401(a)(30) and this section are applied as if each employer maintained a separate plan. See § 1.402(g)–1(e) for rules permitting the distribution of excess deferrals to prevent disqualification of a plan or trust for failure to comply in operation with section 401(a)(30).

(b) *Definitions.* For purposes of this section:

(1) *Applicable limit.* The term ''applicable limit'' has the meaning provided in § 1.402(g)–1(d).

(2) *Elective deferrals.* The term ''elective deferrals'' has the meaning provided in § 1.402(g)–1(b).

(c) *Effective date*—(1) *In general.* Except as otherwise provided in this paragraph (c), this section is effective for plan years beginning after December 31, 1987.

(2) *Transition rule.* For plan years beginning in 1988, a plan may rely on a reasonable interpretation of the law as in effect on December 31, 1987.

(3) *Deferrals under collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, this section does not apply to contributions made pursuant to a collective bargaining agreement for plan years beginning before the earlier of:

(i) The later of January 1, 1988, or the date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986), or

(ii) January 1, 1989.

[T.D. 8357, 56 FR 40516, Aug. 15, 1991]

§ 1.401(a)–50 Puerto Rican trusts; election to be treated as a domestic trust.

(a) *In general.* Section 401(a) requires, among other things, that a trust forming part of a pension, profit-sharing, or stock bonus plan must be created or organized in the United States to be a qualified trust. Section 1022(i)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 942) provides that trusts under certain pension, etc., plans created or organized in Puerto Rico whose administrators have made the election referred to in section 1022(i)(2) are to be treated as trusts created or organized in the United States for purposes of section 401(a). Thus, if a plan otherwise satisfies the qualification requirements of section 401(a), any trust forming part of the plan for which an election is made will be treated as a qualified trust under that section.

(b) *Manner and effect of election.* A plan administrator may make an election under ERISA section 1022(i)(2) by filing a statement making the election, along with a copy of the plan, with the Director's Representative of the Internal Revenue Service in Puerto Rico. The statement making the election must indicate that it is being made under ERISA section 1022(i)(2). The statement may also be filed in conjunction with a written request for a determination letter. If the election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will be irrevocable upon issuance of such letter. Otherwise, once made, an election is irrevocable. It is generally effective for plan years beginning after the date it has been made. However, an election made before March 3, 1983 may, at the option of the plan administrator at the time he or she makes the election, be considered to have been made on any date between September 2, 1974, and the actual date of the election. The election will then be effective for plan years beginning on or after the date chosen by the plan administrator.

(c) *Annuities, custodial accounts, etc.* See section 401 (f) for rules relating to the treatment of certain annuities, custodial accounts or other contracts, as trusts for purposes of section 401(a).

(d) *Source of plan distributions to participants and beneficiaries residing outside the United States.* Except as provided under section 871(f) (relating to amounts received as an annuity by nonresident aliens), the amount of a distribution from an electing plan that is to be treated as income from sources within the United States is determined as described below. The portion of the distribution considered to be a return of employer contributions is to be treated as income from sources within the United States in an amount equal to the portion of the distribution considered to be a return of employer contributions multiplied by the following fraction:

$$\frac{\text{Days of performance of labor or services within the United States for the employer.}}{\text{Total days of performance of labor or services for the employer.}}$$

The days of performance of labor or services within the United States shall not include the time period for which the employee's compensation is deemed not to be income from sources within the United States under subtitle A of the Code. Thus, for example, if an employee's compensation was not deemed to be income from sources within the United States under section 861(a)(3), then the time the emloyee was present in the United States while such compensation was earned would not be included in determining the days of performance of labor or services within the United States in the numerator of the above fraction. In addition, days of performance of labor or services for the employer in both the numerator and denominator of the above fraction are limited to days of plan participation by the employee and any service used for determining an employee's accrued benefit under the plan. The remaining portion of the distribution, that is, any amount other than the portion of the distribution considered to be a return of employer contributions, is not to be treated as income from sources within the United

States. For example, if a distribution consists of amounts representing employer contributions, employee contributions, and earnings on employer and employee contributions, no part of the portion of the distribution attributable to employee contributions, or earnings on employer and employee contributions, will be treated as income from sources within the United States.

[T.D. 7859, 47 FR 54297, Dec. 2, 1982]

§ 1.401(a)(4)–0 Table of contents.

This section contains a listing of the major headings of §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

§ 1.401(a)(4)–1 Nondiscrimination requirements of section 401(a)(4)

(a) In general.
(b) Requirements a plan must satisfy.
(1) In general.
(2) Nondiscriminatory amount of contributions or benefits.
(3) Nondiscriminatory availability of benefits, rights, and features.
(4) Nondiscriminatory effect of plan amendments and terminations.
(c) Application of requirements.
(1) In general.
(2) Interpretation.
(3) Plan-year basis of testing.
(4) Application of section 410(b) rules.
(5) Collectively-bargained plans.
(6) Former employees.
(7) Employee-provided contributions and benefits.
(8) Allocation of earnings.
(9) Rollovers, transfers, and buybacks.
(10) Vesting.
(11) Crediting service.
(12) Governmental plans.
(13) Employee stock ownership plans.
(14) Section 401(h) benefits.
(15) Definitions.
(16) Effective dates and fresh-start rules.
(d) Additional guidance.

§ 1.401(a)(4)–2 Nondiscrimination in amount of employer contributions under a defined contribution plan

(a) Introduction.
(1) Overview.
(2) Alternative methods of satisfying nondiscriminatory amount requirement.
(b) Safe harbors.
(1) In general.
(2) Safe harbor for plans with uniform allocation formula.
(3) Safe harbor for plans with uniform points allocation formula.
(4) Use of safe harbors not precluded by certain plan provisions.
(c) General test for nondiscrimination in amount of contributions.
(1) General rule.
(2) Determination of allocation rates.
(3) Satisfaction of section 410(b) by a rate group.
(4) Examples.

§ 1.401(a)(4)–3 Nondiscrimination in amount of employer-provided benefits under a defined benefit plan

(a) Introduction.
(1) Overview.
(2) Alternative methods of satisfying nondiscriminatory amount requirement.
(b) Safe harbors.
(1) In general.
(2) Uniformity requirements.
(3) Safe harbor for unit credit plans.
(4) Safe harbor for plans using fractional accrual rule.
(5) Safe harbor for insurance contract plans.
(6) Use of safe harbors not precluded by certain plan provisions.
(c) General test for nondiscrimination in amount of benefits.
(1) General rule.
(2) Satisfaction of section 410(b) by a rate group.
(3) Certain violations disregarded.
(4) Examples.
(d) Determination of accrual rates.
(1) Definitions.
(2) Rules of application.
(3) Optional rules.
(4) Examples.
(e) Compensation rules.
(1) In general.
(2) Average annual compensation.
(3) Examples.
(f) Special rules.
(1) In general.
(2) Certain qualified disability benefits.
(3) Accruals after normal retirement age.
(4) Early retirement window benefits.
(5) Unpredictable contingent event benefits.
(6) Determination of benefits on other than plan-year basis.
(7) Adjustments for certain plan distributions.
(8) Adjustment for certain QPSA charges.
(9) Disregard of certain offsets.
(10) Special rule for multiemployer plans.

§ 1.401(a)(4)–4 Nondiscriminatory availability of benefits, rights, and features

(a) Introduction.
(b) Current availability.
(1) General rule.
(2) Determination of current availability.
(3) Benefits, rights, and features that are eliminated prospectively.
(c) Effective availability.
(1) General rule.

(2) Examples.
(d) Special rules.
(1) Mergers and acquisitions.
(2) Frozen participants.
(3) Early retirement window benefits.
(4) Permissive aggregation of certain benefits, rights, or features.
(5) Certain spousal benefits.
(6) Special ESOP rules.
(7) Special testing rule for unpredictable contingent event benefits.
(e) Definitions.
(1) Optional form of benefit.
(2) Ancillary benefit.
(3) Other right or feature.

§ 1.401(a)(4)–5 Plan amendments and plan terminations

(a) Introduction.
(1) Overview.
(2) Facts-and-circumstances determination.
(3) Safe harbor for certain grants of benefits for past periods.
(4) Examples.
(b) Pre-termination restrictions.
(1) Required provisions in defined benefit plans.
(2) Restriction of benefits upon plan termination.
(3) Restrictions on distributions.
(4) Operational restrictions on certain money purchase pension plans.

§ 1.401(a)(4)–6 Contributory defined benefit plans

(a) Introduction.
(b) Determination of employer-provided benefit.
(1) General rule.
(2) Composition-of-work-force method.
(3) Minimum-benefit method.
(4) Grandfather rules for plans in existence on May 14, 1990.
(5) Government-plan method.
(6) Cessation of employee contributions.
(c) Rules applicable in determining whether employee-provided benefits are nondiscriminatory in amount.
(1) In general.
(2) Same rate of contributions.
(3) Total-benefits method.
(4) Grandfather rule for plans in existence on May 14, 1990.

§ 1.401(a)(4)–7 Imputation of permitted disparity

(a) Introduction.
(b) Adjusting allocation rates.
(1) In general.
(2) Employees whose plan year compensation does not exceed taxable wage base.
(3) Employees whose plan year compensation exceeds taxable wage base.
(4) Definitions.
(5) Example.
(c) Adjusting accrual rates.
(1) In general.
(2) Employees whose average annual compensation does not exceed covered compensation.
(3) Employees whose average annual compensation exceeds covered compensation.
(4) Definitions.
(5) Employees with negative unadjusted accrual rates.
(6) Example.
(d) Rules of general application.
(1) Eligible plans.
(2) Exceptions from consistency requirements.
(3) Overall permitted disparity.

§ 1.401(a)(4)–8 Cross-testing

(a) Introduction.
(b) Nondiscrimination in amount of benefits provided under a defined contribution plan.
(1) General rule and gateway.
(2) Determination of equivalent accrual rates.
(3) Safe-harbor testing method for target benefit plans.
(c) Nondiscrimination in amount of contributions under a defined benefit plan.
(1) General rule.
(2) Determination of equivalent allocation rates.
(3) Safe harbor testing method for cash balance plans.
(d) Safe-harbor testing method for defined benefit plans that are part of a floor-offset arrangement.
(1) General rule.
(2) Application of safe-harbor testing method to qualified offset arrangements.

§ 1.401(a)(4)–9 Plan aggregation and restructuring

(a) Introduction.
(b) Application of nondiscrimination requirements to DB/DC plans.
(1) General rule.
(2) Special rules for demonstrating nondiscrimination in amount of contributions or benefits.
(3) Optional rules for demonstrating nondiscrimination in availability of certain benefits, rights, and features.
(c) Plan restructuring.
(1) General rule.
(2) Identification of component plans.
(3) Satisfaction of section 401(a)(4) by a component plan.
(4) Satisfaction of section 410(b) by a component plan.
(5) Effect of restructuring under other sections.
(6) Examples.

§ 1.401(a)(4)–10 Testing of former employees

(a) Introduction.

(b) Nondiscrimination in amount of contributions or benefits.
(1) General rule.
(2) Permitted disparity.
(3) Examples.
(c) Nondiscrimination in availability of benefits, rights, or features.

§ 1.401(a)(4)–11 Additional rules

(a) Introduction.
(b) Rollovers, transfers, and buybacks.
(1) Rollovers and elective transfers.
(2) Other transfers. [Reserved]
(3) Employee buybacks.
(c) Vesting.
(1) General rule.
(2) Deemed equivalence of statutory vesting schedules.
(3) Safe harbor for vesting schedules.
(4) Examples.
(d) Service-crediting rules.
(1) Overview.
(2) Manner of crediting service.
(3) Service-crediting period.
(e) Family aggregation rules. [Reserved]
(f) Governmental plans. [Reserved]
(g) Corrective amendments.
(1) In general.
(2) Scope of corrective amendments.
(3) Conditions for corrective amendments.
(4) Corrective amendments must have substance.
(5) Effect under other statutory requirements.
(6) Examples.

§ 1.401(a)(4)–12 Definitions

§ 1.401(a)(4)–13 Effective dates and fresh-start rules

(a) General effective dates.
(1) In general.
(2) Plans of tax-exempt organizations.
(3) Compliance during transition period.
(b) Effective date for governmental plans.
(c) Fresh-start rules for defined benefit plans.
(1) Introduction.
(2) General rule.
(3) Definition of frozen.
(4) Fresh-start formulas.
(5) Rules of application.
(6) Examples.
(d) Compensation adjustments to frozen accrued benefits.
(1) Introduction.
(2) In general.
(3) Plan requirements.
(4) Meaningful coverage as of fresh-start date.
(5) Meaningful ongoing coverage.
(6) Meaningful current benefit accruals.
(7) Minimum benefit adjustment.
(8) Adjusted accrued benefit.
(9) Examples.
(e) Determination of initial theoretical reserve for target benefit plans.
(1) General rule.
(2) Example.
(f) Special fresh-start rules for cash balance plans.
(1) In general.
(2) Alternative formula.
(3) Limitations on formulas.

[T.D. 8485, 58 FR 46778, Sept. 3, 1993, as amended by T.D. 8954, 66 FR 34540, June 29, 2001]

§ 1.401(a)(4)–1 Nondiscrimination requirements of section 401(a)(4).

(a) *In general.* Section 401(a)(4) provides that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of HCEs. Whether a plan satisfies this requirement depends on the form of the plan and on its effect in operation. In making this determination, intent is irrelevant. This section sets forth the exclusive rules for determining whether a plan satisfies section 401(a)(4). A plan that complies in form and operation with the rules in this section therefore satisfies section 401(a)(4).

(b) *Requirements a plan must satisfy*—(1) *In general.* In order to satisfy section 401(a)(4), a plan must satisfy each of the requirements of this paragraph (b).

(2) *Nondiscriminatory amount of contributions or benefits*—(i) *General rule.* Either the contributions or the benefits provided under the plan must be nondiscriminatory in amount. It need not be shown that both the contributions and the benefits provided are nondiscriminatory in amount, but only that either the contributions alone or the benefits alone are nondiscriminatory in amount.

(ii) *Defined contribution plans*—(A) *General rule.* A defined contribution plan satisfies this paragraph (b)(2) if the contributions allocated under the plan (including forfeitures) are nondiscriminatory in amount under § 1.401(a)(4)–2. Alternatively, a defined contribution plan (other than an ESOP) satisfies this paragraph (b)(2) if the equivalent benefits provided under the plan are nondiscriminatory in amount under § 1.401(a)(4)–8(b). Section 1.401(a)(4)–8(b) includes a safe-harbor testing method for contributions provided under a target benefit plan.

(B) *Section 401(k) plans and section 401(m) plans.* A section 401(k) plan is deemed to satisfy this paragraph (b)(2) because §1.410(b)–9 defines a section 401(k) plan as a plan consisting of elective contributions under a qualified cash or deferred arrangement (i.e., one that satisfies section 401(k)(3), the nondiscriminatory amount requirement applicable to qualified cash or deferred arrangements). A section 401(m) plan satisfies this paragraph (b)(2) only if the plan satisfies §§1.401(m)–1(b) and 1.401(m)–2. Contributions under a nonqualified cash or deferred arrangement, elective contributions described in §1.401(k)–1(b)(4)(iv) that fail to satisfy the allocation and compensation requirements of §1.401(k)–1(b)(4)(i), matching contributions that fail to satisfy §1.401(m)–1(b)(4)(ii)(A), and qualified nonelective contributions treated as elective or matching contributions for certain purposes under §§1.401(k)–1(b)(5) and 1.401(m)–1(b)(5), respectively, are not subject to the special rule in this paragraph (b)(2)(ii)(B), because they are not treated as part of a section 401(k) plan or section 401(m) plan as those terms are defined in §1.410(b)–9. The contributions described in the preceding sentence must satisfy paragraph (b)(2)(ii)(A) of this section.

(iii) *Defined benefit plans.* A defined benefit plan satisfies this paragraph (b)(2) if the benefits provided under the plan are nondiscriminatory in amount under §1.401(a)(4)–3. Alternatively, a defined benefit plan satisfies this paragraph (b)(2) if the equivalent allocations provided under the plan are nondiscriminatory in amount under §1.401(a)(4)–8(c). Section 1.401(a)(4)–8(c) includes a safe-harbor testing method for benefits provided under a cash balance plan. In addition, §1.401(a)(4)–8(d) provides a safe-harbor testing method for benefits provided under a defined benefit plan that is part of a floor-offset arrangement.

(3) *Nondiscriminatory availability of benefits, rights, and features.* All benefits, rights, and features provided under the plan must be made available in the plan in a nondiscriminatory manner. Rules for determining whether this requirement is satisfied are set forth in §1.401(a)(4)–4.

(4) *Nondiscriminatory effect of plan amendments and terminations.* The timing of plan amendments must not have the effect of discriminating significantly in favor of HCEs. Rules for determining whether this requirement is satisfied are set forth in §1.401(a)(4)–5(a). Section 1.401(a)(4)–5(b) provides additional requirements regarding plan terminations.

(c) *Application of requirements*—(1) *In general.* The requirements of paragraph (b) of this section must be applied in accordance with the rules set forth in this paragraph (c).

(2) *Interpretation.* The provisions of §§1.401(a)(4)–1 through 1.401(a)(4)–13 must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of HCEs.

(3) *Plan-year basis of testing.* The requirements of paragraph (b) of this section are generally applied on the basis of the plan year and on the basis of the terms of the plan in effect during the plan year. Thus, unless otherwise provided, the compensation, contributions, benefit accruals, and other items used to apply these requirements must be determined with respect to the plan year being tested. However, §1.401(a)(4)–11(g) provides rules allowing for corrective amendments made after the close of the plan year to be taken into account in satisfying certain requirements under paragraph (b) of this section.

(4) *Application of section 410(b) rules*—(i) *Relationship between sections 401(a)(4) and 410(b).* To be a qualified plan, a plan must satisfy both sections 410(b) and 401(a)(4). Section 410(b) requires that a plan benefit a nondiscriminatory group of employees, and section 401(a)(4) requires that the contributions or benefits provided to employees benefiting under the plan not discriminate in favor of HCEs. Consistent with this requirement, the definition of a plan subject to testing under section 401(a)(4) is the same as the definition of a plan subject to testing under section 410(b), i.e., the plan determined after applying the mandatory disaggregation rules of §1.410(b)–7(c) and the permissive aggregation rules of §1.410(b)–7(d). In addition, whichever testing option is used for the

plan year under §1.410(b)–8(a) (e.g., quarterly testing) must also be used for purposes of determining whether the plan satisfies section 401(a)(4) for the plan year.

(ii) *Special rules for certain aggregated plans*. Special rules are set forth in §1.401(a)(4)–9(b) for applying the nondiscriminatory amount and availability requirements of paragraphs (b)(2) and (b)(3) of this section to a plan that includes one or more defined benefit plans and one or more defined contribution plans that have been permissively aggregated under §1.410(b)–7(d).

(iii) *Restructuring*. In certain circumstances, a plan may be restructured on the basis of employee groups and treated as comprising two or more plans, each of which is treated as a separate plan that must independently satisfy sections 401(a)(4) and 410(b). Rules relating to restructuring plans for purposes of applying the requirements of paragraph (b) of this section are set forth in §1.401(a)(4)–9(c).

(iv) *References to section 410(b)*. Except as otherwise specifically provided, references to satisfying section 410(b) in §§1.401(a)(4)–1 through 1.401(a)(4)–13 mean satisfying §1.410(b)–2 (taking into account any special rules available in satisfying that section, other than the permissive aggregation rules of §1.410(b)–7(d)). In the case of a plan described in section 410(c)(1) that has not made the election described in section 410(d) and is not subject to section 403(b)(12)(A)(i), references in §§1.401(a)(4)–1 through 1.401(a)(4)–13 to satisfying section 410(b) mean satisfying section 410(c)(2).

(5) *Collectively-bargained plans*. The requirements of paragraph (b) of this section are treated as satisfied by a collectively-bargained plan that automatically satisfies section 410(b) under §1.410(b)–2(b)(7).

(6) *Former employees*. In applying the nondiscriminatory amount and availability requirements of paragraphs (b)(2) and (b)(3) of this section, former employees are tested separately from active employees, unless otherwise provided. Rules for applying paragraphs (b)(2) and (b)(3) of this section to former employees are set forth in §1.401(a)(4)–10.

(7) *Employee-provided contributions and benefits*. In applying the nondiscriminatory amount requirement of paragraph (b)(2) of this section, employee-provided contributions and benefits are tested separately from employer-provided contributions and benefits, unless otherwise provided. Rules for determining the amount of employer-provided benefits under a defined benefit plan that include employee contributions not allocated to separate accounts are set forth in §1.401(a)(4)–6(b), and rules for applying paragraph (b)(2) of this section to employee contributions under such a plan are set forth in §1.401(a)(4)–6(c). See paragraph (b)(2)(ii)(B) of this section for rules applicable to employee contributions allocated to separate accounts.

(8) *Allocation of earnings*. Notwithstanding any other provision in §§1.401(a)(4)–1 through 1.401(a)(4)–13, a defined contribution plan does not satisfy paragraph (b)(2) of this section if the manner in which income, expenses, gains, or losses are allocated to accounts under the plan discriminates in favor of HCEs or former HCEs.

(9) *Rollovers, transfers, and buybacks*. In applying the requirements of paragraph (b) of this section, rollover (including direct rollover) contributions described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 408(d)(3), elective transfers described in §1.411(d)–4, Q&A–3(b), transfers of assets and liabilities described in section 414(l), and employee buybacks are treated in accordance with the rules set forth in §1.401(a)(4)–11(b).

(10) *Vesting*. A plan does not satisfy the nondiscriminatory amount requirement of paragraph (b)(2) of this section unless it satisfies §1.401(a)(4)–11(c) with respect to the manner in which employees vest in their accrued benefits.

(11) *Crediting service*. A plan does not satisfy paragraphs (b)(2) and (b)(3) of this section unless it satisfies §1.401(a)(4)–11(d) with respect to the manner in which employees' service is credited under the plan. Service other than actual service with the employer may not be taken into account in determining whether the plan satisfies

paragraphs (b)(2) and (b)(3) of this section except as provided in § 1.401(a)(4)–11(d).

(12) *Governmental plans.* The rules of this section apply to a governmental plan within the meaning of section 414(d), except as provided in §§ 1.401(a)(4)–11(f) and 1.401(a)(4)–13(b).

(13) *Employee stock ownership plans.* [Reserved]

(14) *Section 401(h) benefits.* In applying the requirements of paragraph (b) of this section, the portion of a plan providing benefits described in section 401(h) is tested separately from the portion of the same plan providing retirement benefits, and thus is not required to satisfy this section. Rules applicable to section 401(h) benefits are set forth in § 1.401–14(b)(2).

(15) *Definitions.* In applying the requirements of this section, the definitions in § 1.401(a)(4)–12 govern.

(16) *Effective dates and fresh-start rules.* In applying the requirements of this section, the effective dates set forth in § 1.401(a)(4)–13 govern. Section 1.401(a)(4)–13 also provides certain transition and fresh-start rules that apply for purposes of this section.

(d) *Additional guidance.* The Commissioner may, in revenue rulings, notices, and other guidance, published in the Internal Revenue Bulletin, provide any additional guidance that may be necessary or appropriate in applying the nondiscrimination requirements of section 401(a)(4), including additional safe harbors and alternative methods and procedures for satisfying those requirements. See § 601.601(d)(2)(ii)(*b*) of this chapter.

[T.D. 8485, 58 FR 46780, Sept. 3, 1993]

§ 1.401(a)(4)–2 Nondiscrimination in amount of employer contributions under a defined contribution plan.

(a) *Introduction*—(1) *Overview.* This section provides rules for determining whether the employer contributions allocated under a defined contribution plan are nondiscriminatory in amount as required by § 1.401(a)(4)–1(b)(2)(ii)(A). Certain defined contribution plans that provide uniform allocations are permitted to satisfy this requirement by meeting one of the safe harbors in paragraph (b) of this section. Plans that do not provide uniform allocations may satisfy this requirement by satisfying the general test in paragraph (c) of this section. See § 1.401(a)(4)–1(b)(2)(ii)(B) for the exclusive tests applicable to section 401(k) plans and section 401(m) plans.

(2) *Alternative methods of satisfying nondiscriminatory amount requirement.* A defined contribution plan is permitted to satisfy paragraph (b)(2) or (c) of this section on a restructured basis pursuant to § 1.401(a)(4)–9(c). Alternatively, a defined contribution plan (other than an ESOP) is permitted to satisfy the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2)(ii)(A) on the basis of equivalent benefits pursuant to § 1.401(a)(4)–8(b).

(b) *Safe harbors*—(1) *In general.* The employer contributions allocated under a defined contribution plan are nondiscriminatory in amount for a plan year if the plan satisfies either of the safe harbors in paragraph (b)(2) or (b)(3) of this section. Paragraph (b)(4) of this section provides exceptions for certain plan provisions that do not cause a plan to fail to satisfy this paragraph (b).

(2) *Safe harbor for plans with uniform allocation formula*—(i) *General rule.* A defined contribution plan satisfies the safe harbor in this paragraph (b)(2) for a plan year if the plan allocates all amounts taken into account under paragraph (c)(2)(ii) of this section for the plan year under an allocation formula that allocates to each employee the same percentage of plan year compensation, the same dollar amount, or the same dollar amount for each uniform unit of service (not to exceed one week) performed by the employee during the plan year.

(ii) *Permitted disparity.* If a plan satisfies section 401(l) in form, differences in employees' allocations under the plan attributable to uniform disparities permitted under § 1.401(l)–2 (including differences in disparities that are deemed uniform under § 1.401(l)–2(c)(2)) do not cause the plan to fail to satisfy this paragraph (b)(2).

(3) *Safe harbor for plans with uniform points allocation formula*—(i) *General rule.* A defined contribution plan (other than an ESOP) satisfies the safe harbor in this paragraph (b)(3) for a plan year

if it satisfies both of the following requirements:

(A) The plan must allocate amounts under a uniform points allocation formula. A uniform points allocation formula defines each employee's allocation for the plan year as the product of the total of all amounts taken into account under paragraph (c)(2)(ii) of this section and a fraction, the numerator of which is the employee's points for the plan year and the denominator of which is the sum of the points of all employees in the plan for the plan year. For this purpose, an employee's points for a plan year equal the sum of the employee's points for age, service, and units of plan year compensation for the plan year. Under a uniform points allocation formula, each employee must receive the same number of points for each year of age, the same number of points for each year of service, and the same number of points for each unit of plan year compensation. (See §1.401(a)(4)–11(d)(3) regarding service that may be taken into account as years of service.) A uniform points allocation formula need not grant points for both age and service, but it must grant points for at least one of them. If the allocation formula grants points for years of service, the plan is permitted to limit the number of years of service taken into account to a single maximum number of years of service. A uniform points allocation formula need not grant points for units of plan year compensation, but if it does, the unit used must be a single dollar amount for all employees that does not exceed $200.

(B) For the plan year, the average of the allocation rates for the HCEs in the plan must not exceed the average of the allocation rates for the NHCEs in the plan. For this purpose, allocation rates are determined in accordance with paragraph (c)(2) of this section, without imputing permitted disparity and without grouping allocation rates under paragraphs (c)(2) (iv) and (v) of this section, respectively.

(ii) *Example.* The following example illustrates the safe harbor in this paragraph (b)(3):

Example. (a) Plan A has a single allocation formula that applies to all employees, under which each employee's allocation for the plan year equals the product of the total of all amounts taken into account for all employees for the plan year under paragraph (c)(2)(ii) of this section and a fraction, the numerator of which is the employee's points for the plan year and the denominator of which is the sum of the points of all employees for the plan year. Plan A grants each employee 10 points for each year of service (including pre-participation service and imputed service credited under Plan A that satisfies §1.401(a)(4)–11(d)(3)) and one point for each $100 of plan year compensation. For the 1994 plan year, the total allocations are $71,200, and the total points for all employees are 7,120. Each employee's allocation for the 1994 plan year is set forth in the table below.

Employee	Years of service	Plan year compensation	Points	Amount of allocation	Allocation rate (percent)
H1	20	$150,000	1,700	$17,000	11.3
H2	10	150,000	1,600	16,000	10.7
H3	30	100,000	1,300	13,000	13.0
H4	3	100,000	1,030	10,300	10.3
N1	10	40,000	500	5,000	12.5
N2	5	35,000	400	4,000	11.4
N3	3	30,000	330	3,300	11.0
N4	1	25,000	260	2,600	10.4
Total			7,120	71,200	

(b) Under these facts, for the 1994 plan year, Plan A allocates amounts under a uniform points allocation formula within the meaning of paragraph (b)(3)(i)(A) of this section.

(c) For the 1994 plan year, the average allocation rate for the HCEs (H1 through H4) is 11.3 percent, and the average allocation rate for NHCEs (N1 through N4) is 11.3 percent. Because the average of the allocation rates for the HCEs does not exceed the average of the allocation rates for the NHCEs, Plan A satisfies paragraph (b)(3)(i)(B) of this section and, thus, the safe harbor in this paragraph (b)(3) for the 1994 plan year.

(4) *Use of safe harbors not precluded by certain plan provisions*—(i) *In general.* A

plan does not fail to satisfy this paragraph (b) merely because the plan contains one or more of the provisions described in this paragraph (b)(4). Unless otherwise provided, any such provision must apply uniformly to all employees.

(ii) *Entry dates*. The plan provides one or more entry dates during the plan year as permitted by section 410(a)(4).

(iii) *Certain conditions on allocations*. The plan provides that an employee's allocation for the plan year is conditioned on either the employee's employment on the last day of the plan year or the employee's completion of a minimum number of hours of service during the plan year (not to exceed 1,000), or both. Such a provision may include an exception from this condition for all employees whose employment terminates during the plan year or only for those employees whose employment terminates during the plan year on account of one or more of the following circumstances: retirement, disability, death, or military service.

(iv) *Certain limits on allocations*. The plan limits allocations otherwise provided under the allocation formula to a maximum dollar amount or a maximum percentage of plan year compensation, limits the dollar amount of plan year compensation taken into account in determining the amount of allocations, or applies the restrictions of section 409(n) or the limits of section 415.

(v) *Lower allocations for HCEs*. The allocations provided to one or more HCEs under the plan are less than the allocations that would otherwise be provided to those employees if the plan satisfied this paragraph (b) (without regard to this paragraph (b)(4)(v)).

(vi) *Multiple formulas*—(A) *General rule*. The plan provides that an employee's allocation under the plan is the greater of the allocations determined under two or more formulas, or is the sum of the allocations determined under two or more formulas. This paragraph (b)(4)(vi) does not apply to a plan unless each of the formulas under the plan satisfies the requirements of paragraph (b)(4)(vi) (B) through (D) of this section.

(B) *Sole formulas*. The formulas must be the only formulas under the plan.

(C) *Separate testing*. Each of the formulas must separately satisfy this paragraph (b). A formula that is available solely to some or all NHCEs is deemed to satisfy this paragraph (b)(4)(vi)(C).

(D) *Availability*—(*1*) *General rule*. All of the formulas must be available on the same terms to all employees.

(*2*) *Formulas for NHCEs*. A formula does not fail to be available on the same terms to all employees merely because the formula is not available to any HCEs, but is available to some or all NHCEs on the same terms as all of the other formulas in the plan.

(*3*) *Top-heavy formulas*. In the case of a plan that provides the greater of the allocations under two or more formulas, one of which is a top-heavy formula, the top-heavy formula does not fail to be available on the same terms to all employees merely because it is available solely to all non-key employees on the same terms as all the other formulas under the plan. Furthermore, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan merely because it is conditioned on the plan's being top-heavy within the meaning of section 416(g). Finally, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan merely because it is available to all employees described in §1.416–1, Q&A M–10 (i.e., all non-key employees who have not separated from service as of the last day of the plan year). The preceding sentence does not apply, however, unless the plan would satisfy section 410(b) if all employees who are benefiting under the plan solely as a result of receiving allocations under the top-heavy formula were treated as not currently benefiting under the plan. For purposes of this paragraph (b)(4)(vi)(D)(*3*), a top-heavy formula is a formula that provides the minimum benefit described in section 416(c)(2) (taking into account, if applicable, the modification in section 416(h)(2)(A)(ii)(II)).

(E) *Provisions may be applied more than once*. The provisions of this paragraph (b)(4)(vi) may be applied more than once. For example, a plan satisfies this paragraph (b) if an employee's allocation under the plan is the greater

of the allocations under two or more formulas, and one or more of those formulas is the sum of the allocations under two or more other formulas, provided that each of the formulas under the plan satisfies the requirements of paragraph (b)(4)(vi) (B) through (D) of this section.

(F) *Examples*. The following examples illustrate the rules in this paragraph (b)(4)(vi):

Example 1. Under Plan A, each employee's allocation equals the sum of the allocations determined under two formulas. The first formula provides an allocation of five percent of plan year compensation. The second formula provides an allocation of $100. Plan A satisfies this paragraph (b)(4)(vi).

Example 2. Under Plan B, each employee's allocation equals the greater of the allocations determined under two formulas. The first formula provides an allocation of seven percent of plan year compensation and is available to all employees who complete at least 1,000 hours of service during the plan year and who have not separated from service as of the last day of the plan year. The second formula is a top-heavy formula that provides an allocation of three percent of plan year compensation and that is available to all employees described in §1.416–1, Q&A M–10. Plan B does not satisfy the general rule in paragraph (b)(4)(vi)(D)(*1*) of this section because the two formulas are not available on the same terms to all employees (i.e., an employee is required to complete 1,000 hours of service during the plan year to receive an allocation under the first formula, but not under the second formula). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(4)(vi)(D)(*3*) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available to all employees described in §1.416–1, Q&A M–10, as long as the plan would satisfy section 410(b) if all employees who are benefiting under the plan solely as a result of receiving allocations under the top-heavy formula were treated as not currently benefiting under the plan. This is true even if the plan conditions the availability of the second formula on the plan's being top-heavy for the plan year.

Example 3. The facts are the same as in *Example 2*, except that the first formula is available to all employees who have not separated from service as of the last day of the plan year, regardless of whether they complete at least 1,000 hours of service during the plan year. Plan B still does not satisfy the general rule in paragraph (b)(4)(vi)(D)(*1*) of this section because the two formulas are not available on the same terms to all employees (i.e., the second formula is only available to all non-key employees). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(4)(vi)(D)(*3*) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available solely to all non-key employees.

(c) *General test for nondiscrimination in amount of contributions*—(1) *General rule*. The employer contributions allocated under a defined contribution plan are nondiscriminatory in amount for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c), a rate group exists under a plan for each HCE and consists of the HCE and all other employees in the plan (both HCEs and NHCEs) who have an allocation rate greater than or equal to the HCE's allocation rate. Thus, an employee is in the rate group for each HCE who has an allocation rate less than or equal to the employee's allocation rate.

(2) *Determination of allocation rates*—(i) *General rule*. The allocation rate for an employee for a plan year equals the sum of the allocations to the employee's account for the plan year, expressed either as a percentage of plan year compensation or as a dollar amount.

(ii) *Allocations taken into account*. The amounts taken into account in determining allocation rates for a plan year include all employer contributions and forfeitures that are allocated or treated as allocated to the account of an employee under the plan for the plan year, other than amounts described in paragraph (c)(2)(iii) of this section. For this purpose, employer contributions include annual additions described in §1.415–6(b)(2)(i) (regarding amounts arising from certain transactions between the plan and the employer). In the case of a defined contribution plan subject to section 412, an employer contribution is taken into account in the plan year for which it is required to be contributed and allocated to employees' accounts under the plan, even if all or part of the required contribution is not actually made.

(iii) *Allocations not taken into account*. Allocations of income, expenses, gains,

and losses attributable to the balance in an employee's account are not taken into account in determining allocation rates.

(iv) *Imputation of permitted disparity.* The disparity permitted under section 401(l) may be imputed in accordance with the rules of §1.401(a)(4)–7.

(v) *Grouping of allocation rates*—(A) *General rule.* An employer may treat all employees who have allocation rates within a specified range above and below a midpoint rate chosen by the employer as having an allocation rate equal to the midpoint rate within that range. Allocation rates within a given range may not be grouped under this paragraph (c)(2)(v) if the allocation rates of HCEs within the range generally are significantly higher than the allocation rates of NHCEs in the range. The specified ranges within which all employees are treated as having the same allocation rate may not overlap and may be no larger than provided in paragraph (c)(2)(v)(B) of this section. Allocation rates of employees that are not within any of these specified ranges are determined without regard to this paragraph (c)(2)(v).

(B) *Size of specified ranges.* The lowest and highest allocation rates in the range must be within five percent (not five percentage points) of the midpoint rate. If allocation rates are determined as a percentage of plan year compensation, the lowest and highest allocation rates need not be within five percent of the midpoint rate, if they are no more than one quarter of a percentage point above or below the midpoint rate.

(vi) *Consistency requirement.* Allocation rates must be determined in a consistent manner for all employees for the plan year.

(3) *Satisfaction of section 410(b) by a rate group*—(i) *General rule.* For purposes of determining whether a rate group satisfies section 410(b), the rate group is treated as if it were a separate plan that benefits only the employees included in the rate group for the plan year. Thus, for example, under §1.401(a)(4)–1(c)(4)(iv), the ratio percentage of the rate group is determined taking into account all nonexcludable employees regardless of whether they benefit under the plan. Paragraph (c)(3)(ii) and (iii) of this section provide additional special rules for determining whether a rate group satisfies section 410(b).

(ii) *Application of nondiscriminatory classification test.* A rate group satisfies the nondiscriminatory classification test of §1.410(b)–4 (including the reasonable classification requirement of §1.410(b)–4(b)) if and only if the ratio percentage of the rate group is greater than or equal to the lesser of—

(A) The midpoint between the safe and the unsafe harbor percentages applicable to the plan; and

(B) The ratio percentage of the plan.

(iii) *Application of average benefit percentage test.* A rate group satisfies the average benefit percentage test of §1.410(b)–5 if the plan of which it is a part satisfies §1.410(b)–5 (without regard to §1.410(b)–5(f)). In the case of a plan that relies on §1.410(b)–5(f) to satisfy the average benefit percentage test, each rate group under the plan satisfies the average benefit percentage test (if applicable) only if the rate group separately satisfies §1.410(b)–5(f).

(4) *Examples.* The following examples illustrate the general test in this paragraph (c):

Example 1. Employer X maintains two defined contribution plans, Plan A and Plan B, that are aggregated and treated as a single plan for purposes of sections 410(b) and 401(a)(4) pursuant to §1.410(b)–7(d). For the 1994 plan year, Employee M has plan year compensation of $10,000 and receives an allocation of $200 under Plan A and an allocation of $800 under Plan B. Employee M's allocation rate under the aggregated plan for the 1994 plan year is 10 percent (i.e., $1,000 divided by $10,000).

Example 2. The employees in Plan C have the following allocation rates (expressed as a percentage of plan year compensation): 2.75 percent, 2.80 percent, 2.85 percent, 3.25 percent, 6.65 percent, 7.33 percent, 7.34 percent, and 7.35 percent. Because the first four rates are within a range of no more than one quarter of a percentage point above and below 3.0 percent (a midpoint rate chosen by the employer), under paragraph (c)(2)(v) of this section the employer may treat the employees who have those rates as having an allocation rate of 3.0 percent (provided that the allocation rates of HCEs within the range generally are not significantly higher than the allocation rates of NHCEs within the range). Because the last four rates are within a range of no more than five percent above and below 7.0 percent (a midpoint rate chosen by the employer), the employer may treat the

employees who have those rates as having an allocation rate of 7.0 percent (provided that the allocation rates of HCEs within the range generally are not significantly higher than the allocation rates of NHCEs within the range).

Example 3. (a) Employer Y has only six nonexcludable employees, all of whom benefit under Plan D. The HCEs are H1 and H2, and the NHCEs are N1 through N4. For the 1994 plan year, H1 and N1 through N4 have an allocation rate of 5.0 percent of plan year compensation. For the same plan year, H2 has an allocation rate of 7.5 percent of plan year compensation.

(b) There are two rate groups under Plan D. Rate group 1 consists of H1 and all those employees who have an allocation rate greater than or equal to H1's allocation rate (5.0 percent). Thus, rate group 1 consists of H1, H2, and N1 through N4. Rate group 2 consists only of H2 because no other employee has an allocation rate greater than or equal to H2's allocation rate (7.5 percent).

(c) The ratio percentage for rate group 2 is zero percent—i.e., zero percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group). Therefore rate group 2 does not satisfy the ratio percentage test under §1.410(b)–2(b)(2). Rate group 2 also does not satisfy the nondiscriminatory classification test of §1.410(b)–4 (as modified by paragraph (c)(3) of this section). Rate group 2 therefore does not satisfy section 410(b) and, as a result, Plan D does not satisfy the general test in paragraph (c)(1) of this section. This is true regardless of whether rate group 1 satisfies §1.410(b)–2(b)(2).

Example 4. (a) The facts are the same as in *Example 3*, except that N4 has an allocation rate of 8.0 percent.

(b) There are two rate groups in Plan D. Rate group 1 consists of H1 and all those employees who have an allocation rate greater than or equal to H1's allocation rate (5.0 percent). Thus, rate group 1 consists of H1, H2 and N1 through N4. Rate group 2 consists of H2, and all those employees who have an allocation rate greater than or equal to H2's allocation rate (7.5 percent). Thus, rate group 2 consists of H2 and N4.

(c) Rate group 1 satisfies the ratio percentage test under §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 100 percent—i.e., 100 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(d) Rate group 2 does not satisfy the ratio percentage test of §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 50 percent—i.e., 25 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(e) However, rate group 2 does satisfy the nondiscriminatory classification test of §1.410(b)–4 because the ratio percentage of the rate group (50 percent) is greater than the safe harbor percentage applicable to the plan under §1.410(b)–4(c)(4) (45.5 percent).

(f) Under paragraph (c)(3)(iii) of this section, rate group 2 satisfies the average benefit percentage test, if Plan D satisfies the average benefit percentage test. (The requirement that Plan D satisfy the average benefit percentage test applies even though Plan D satisfies the ratio percentage test and would ordinarily not need to run the average benefit percentage test.) If Plan D satisfies the average benefit percentage test, then rate group 2 satisfies section 410(b) and thus, Plan D satisfies the general test in paragraph (c)(1) of this section, because each rate group under the plan satisfies section 410(b).

Example 5. (a) Plan E satisfies section 410(b) by satisfying the nondiscriminatory classification test of §1.410(b)–4 and the average benefit percentage test of §1.410(b)–5 (without regard to §1.410(b)–5(f)). See §1.410(b)–2(b)(3). Plan E uses the facts-and-circumstances requirements of §1.410(b)–4(c)(3) to satisfy the nondiscriminatory classification test of §1.410(b)–4. The safe and unsafe harbor percentages applicable to the plan under §1.410(b)–4(c)(4) are 29 and 20 percent, respectively. Plan E has a ratio percentage of 22 percent.

(b) Rate group 1 under Plan E has a ratio percentage of 23 percent. Under paragraph (c)(3)(ii) of this section, the rate group satisfies the nondiscriminatory classification requirement of §1.410(b)–4, because the ratio percentage of the rate group (23 percent) is greater than the lesser of—

(1) The ratio percentage for the plan as a whole (22 percent); and

(2) The midpoint between the safe and unsafe harbor percentages (24.5 percent).

(c) Under paragraph (c)(3)(iii) of this section, the rate group satisfies section 410(b) because the plan satisfies the average benefit percentage test of §1.410(b)–5.

[T.D. 8485, 58 FR 46781, Sept. 3, 1993]

§1.401(a)(4)–3 Nondiscrimination in amount of employer-provided benefits under a defined benefit plan.

(a) *Introduction*—(1) *Overview.* This section provides rules for determining whether the employer-provided benefits under a defined benefit plan are

nondiscriminatory in amount as required by §1.401(a)(4)–1(b)(2)(iii). Certain defined benefit plans that provide uniform benefits are permitted to satisfy this requirement by meeting one of the safe harbors in paragraph (b) of this section. Plans that do not provide uniform benefits may satisfy this requirement by satisfying the general test in paragraph (c) of this section. Paragraph (d) of this section provides rules for determining the individual benefit accrual rates needed for the general test. Paragraph (e) of this section provides rules for determining compensation for purposes of applying the requirements of this section. Paragraph (f) of this section provides additional rules that apply generally for purposes of both the safe harbors in paragraph (b) of this section and the general test in paragraph (c) of this section. See §1.401(a)(4)–6 for rules for determining the amount of employer-provided benefits under a contributory DB plan, and for determining whether the employee-provided benefits under such a plan are nondiscriminatory in amount.

(2) *Alternative methods of satisfying nondiscriminatory amount requirement.* A defined benefit plan is permitted to satisfy paragraph (b) or (c) of this section on a restructured basis pursuant to §1.401(a)(4)–9(c). Alternatively, a defined benefit plan is permitted to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)–1(b)(2)(iii) on the basis of equivalent allocations pursuant to §1.401(a)(4)–8(c). In addition, a defined benefit plan that is part of a floor-offset arrangement is permitted to satisfy this section pursuant to §1.401(a)(4)–8(d).

(b) *Safe harbors*—(1) *In general.* The employer-provided benefits under a defined benefit plan are nondiscriminatory in amount for a plan year if the plan satisfies each of the uniformity requirements of paragraph (b)(2) of this section and any one of the safe harbors in paragraphs (b)(3) (unit credit plans), (b)(4) (fractional accrual plans), and (b)(5) (insurance contract plans) of this section. Paragraph (b)(6) of this section provides exceptions for certain plan provisions that do not cause a plan to fail to satisfy this paragraph (b). Paragraph (f) of this section provides additional rules that apply in determining whether a plan satisfies this paragraph (b).

(2) *Uniformity requirements*—(i) *Uniform normal retirement benefit.* The same benefit formula must apply to all employees. The benefit formula must provide all employees with an annual benefit payable in the same form commencing at the same uniform normal retirement age. The annual benefit must be the same percentage of average annual compensation or the same dollar amount for all employees who will have the same number of years of service at normal retirement age. (See §1.401(a)(4)–11(d)(3) regarding service that may be taken into account as years of service.) The annual benefit must equal the employee's accrued benefit at normal retirement age (within the meaning of section 411(a)(7)(A)(i)) and must be the normal retirement benefit under the plan (within the meaning of section 411(a)(9)).

(ii) *Uniform post-normal retirement benefit.* With respect to an employee with a given number of years of service at any age after normal retirement age, the annual benefit commencing at that employee's age must be the same percentage of average annual compensation or the same dollar amount that would be payable commencing at normal retirement age to an employee who had that same number of years of service at normal retirement age.

(iii) *Uniform subsidies.* Each subsidized optional form of benefit available under the plan must be currently available (within the meaning of §1.401(a)(4)–4(b)(2)) to substantially all employees. Whether an optional form of benefit is considered subsidized for this purpose may be determined using any reasonable actuarial assumptions.

(iv) *No employee contributions.* The plan must not be a contributory DB plan.

(v) *Period of accrual.* Each employee's benefit must be accrued over the same years of service that are taken into account in applying the benefit formula under the plan to that employee. For this purpose, any year in which the employee benefits under the plan (within the meaning of §1.410(b)–3(a)) is included as a year of service in which a

benefit accrues. Thus, for example, a plan does not satisfy the safe harbor in paragraph (b)(4) of this section unless the plan uses the same years of service to determine both the normal retirement benefit under the plan's benefit formula and the fraction by which an employee's fractional rule benefit is multiplied to derive the employee's accrued benefit as of any plan year.

(vi) *Examples*. The following examples illustrate the rules in this paragraph (b)(2):

Example 1. Plan A provides a normal retirement benefit equal to two percent of average annual compensation times each year of service commencing at age 65 for all employees. Plan A provides that employees of Division S receive their benefit in the form of a straight life annuity and that employees of Division T receive their benefit in the form of a life annuity with an automatic cost-of-living increase. Plan A does not provide a uniform normal retirement benefit within the meaning of paragraph (b)(2)(i) of this section because the annual benefit is not payable in the same form to all employees.

Example 2. Plan B provides a normal retirement benefit equal to 1.5 percent of average annual compensation times each year of service at normal retirement age for all employees. The normal retirement age under the plan is the earlier of age 65 or the age at which the employee completes 10 years of service, but in no event earlier than age 62. Plan B does not provide a uniform normal retirement benefit within the meaning of paragraph (b)(2)(i) of this section because the same uniform normal retirement age does not apply to all employees.

Example 3. Plan C is an accumulation plan under which the benefit for each year of service equals one percent of plan year compensation payable in the same form to all employees commencing at the same uniform normal retirement age. Under paragraph (e)(2) of this section, an accumulation plan may substitute plan year compensation for average annual compensation. Plan C provides a uniform normal retirement benefit within the meaning of paragraph (b)(2)(i) of this section, because all employees with the same number of years of service at normal retirement age will receive an annual benefit that is treated as the same percentage of average annual compensation.

Example 4. The facts are the same as in *Example 3*, except that the benefit for each year of service equals one percent of plan year compensation increased by reference to the increase in the cost of living from the year of service to normal retirement age. Plan C does not provide a uniform normal retirement benefit, because the annual benefit defined by the benefit formula can vary for employees with the same number of years of service at normal retirement age, depending on the age at which those years of service were credited to the employee under the plan.

Example 5. Plan D provides a normal retirement benefit of 50 percent of average annual compensation at normal retirement age (age 65) for employees with 30 years of service at normal retirement age. Plan D provides that, in the case of an employee with less than 30 years of service at normal retirement age, the normal retirement benefit is reduced on a pro rata basis for each year of service less than 30. However, if an employee with less than 30 years of service at normal retirement age continues to work past normal retirement age, Plan D provides that the additional years of service worked past normal retirement age are taken into account for purposes of the 30 years of service requirement. Thus, an employee who has 26 years of service at age 65 but who does not retire until age 69 with 30 years of service will receive a benefit of 50 percent of average annual compensation. Plan D provides uniform post-normal retirement benefits within the meaning of paragraph (b)(2)(ii) of this section.

Example 6. (a) Plan E is amended on February 14, 1994, to provide an early retirement window benefit that consists of an unreduced early retirement benefit to employees who terminate employment after attainment of age 55 with 10 years of service and between June 1, 1994, and November 30, 1994. The early retirement window benefit is a single subsidized optional form of benefit. Paragraph (b)(2)(iii) of this section requires that the subsidized optional form of benefit be currently available (within the meaning of §1.401(a)(4)–4(b)(2)) to substantially all employees. Section 1.401(a)(4)–4(b)(2)(ii)(A)(*2*) provides that age and service requirements are not disregarded in determining the current availability of an optional form of benefit if those requirements must be satisfied within a specified period of time. Thus, the early retirement window benefit is not currently available to an employee unless the employee will satisfy the eligibility requirements for the early retirement window benefit by the close of the early retirement window benefit period. Plan E will fail to satisfy paragraph (b)(2)(iii) of this section unless substantially all of the employees satisfy the eligibility requirements for the early retirement window benefit by November 30, 1994. However, see §1.401(a)(4)–9(c)(6), *Example 2*, for an example of how a plan with an early retirement window benefit may be restructured into two component plans, each of which satisfies the safe harbors of this paragraph (b).

(b) A similar analysis would apply if, instead of an unreduced early retirement benefit, the early retirement window benefit consisted of a special schedule of early retirement factors, defined by starting with the plan's usual schedule and then treating each employee eligible for the early retirement window benefit as being five years older than the employee actually is, but not older than the employee's normal retirement age.

Example 7. Plan F generally provides a normal retirement benefit of 1.5 percent of an employee's average annual compensation multiplied by the employee's years of service with the employer. For employees transferred outside of the group of employees covered by the plan, the plan's benefit formula takes into account only years of service prior to the transfer, but determines average annual compensation taking into account section 414(s) compensation both before and after the transfer. Plan F does not satisfy the requirements of paragraph (b)(2)(v) of this section with respect to transferred employees, because their benefits are accrued over years of service (i.e., after transfer) that are not taken into account in applying the plan's benefit formula to them. However, see *Example 2* of paragraph (b)(6)(x)(B) of this section for an example of how a plan that continues to take transferred employees' section 414(s) compensation into account after their transfer may still satisfy this paragraph (b).

(3) *Safe harbor for unit credit plans*—(i) *General rule.* A plan satisfies the safe harbor in this paragraph (b)(3) for a plan year if it satisfies both of the following requirements:

(A) The plan must satisfy the 133⅓ percent accrual rule of section 411(b)(1)(B).

(B) Each employee's accrued benefit under the plan as of any plan year must be determined by applying the plan's benefit formula to the employee's years of service and (if applicable) average annual compensation, both determined as of that plan year.

(ii) *Example.* The following example illustrates the rules in this paragraph (b)(3):

Example. Plan A provides that the accrued benefit of each employee as of any plan year equals the employee's average annual compensation times a percentage that depends on the employee's years of service determined as of that plan year. The percentage is 2 percent for each of the first 10 years of service, plus 1.5 percent for each of the next 10 years of service, plus 2 percent for all additional years of service. Plan A satisfies this paragraph (b)(3).

(4) *Safe harbor for plans using fractional accrual rule*—(i) *General rule.* A plan satisfies the safe harbor in this paragraph (b)(4) for a plan year if it satisfies each of the following requirements:

(A) The plan must satisfy the fractional accrual rule of section 411(b)(1)(C).

(B) Each employee's accrued benefit under the plan as of any plan year before the employee reaches normal retirement age must be determined by multiplying the employee's fractional rule benefit (within the meaning of §1.411(b)–1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age.

(C) The plan must satisfy one of the following requirements:

(*1*) Under the plan, it must be impossible for any employee to accrue in a plan year a portion of the normal retirement benefit described in paragraph (b)(2)(i) of this section that is more than one-third larger than the portion of the same benefit accrued in that or any other plan year by any other employee, when each portion of the benefit is expressed as a percentage of each employee's average annual compensation or as a dollar amount. In making this determination, actual and potential employees in the plan with any amount of service at normal retirement must be taken into account (other than employees with more than 33 years of service at normal retirement age). In addition, in the case of a plan that satisfies section 401(l) in form, an employee is treated as accruing benefits at a rate equal to the excess benefit percentage in the case of a defined benefit excess plan or at a rate equal to the gross benefit percentage in the case of an offset plan.

(*2*) The normal retirement benefit under the plan must be a flat benefit that requires a minimum of 25 years of service at normal retirement age for an employee to receive the unreduced flat benefit, determined without regard to section 415. For this purpose, a flat benefit is a benefit that is the same

percentage of average annual compensation or the same dollar amount for all employees who have a minimum number of years of service at normal retirement age (e.g., 50 percent of average annual compensation), with a pro rata reduction in the flat benefit for employees who have less than the minimum number of years of service at normal retirement age. An employee is permitted to accrue the maximum benefit permitted under section 415 over a period of less than 25 years, provided that the flat benefit under the plan, determined without regard to section 415, can accrue over no less than 25 years.

(*3*) The plan must satisfy the requirements of paragraph (b)(4)(i)(C)(*2*) of this section (other than the requirement that the minimum number of years of service for receiving the unreduced flat benefit is at least 25 years), and, for the plan year, the average of the normal accrual rates for all nonhighly compensated nonexcludable employees must be at least 70 percent of the average of the normal accrual rates for all highly compensated nonexcludable employees. The averages in the preceding sentence are determined taking into account all nonexcludable employees (regardless of whether they benefit under the plan). In addition, contributions and benefits under other plans of the employer are disregarded. For purposes of this paragraph (b)(4)(i)(C)(*3*), normal accrual rates are determined under paragraph (d) of this section.

(ii) *Examples*. The following examples illustrate the rules in this paragraph (b)(4). In each example, it is assumed that the plan has never permitted employee contributions.

Example 1. Plan A provides a normal retirement benefit equal to 1.6 percent of average annual compensation times each year of service up to 25. Plan A further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. The greatest benefit that an employee could accrue in any plan year is 1.6 percent of average annual compensation (this is the case for an employee with 25 or fewer years of projected service at normal retirement age). Among potential employees with 33 or fewer years of projected service at normal retirement age, the lowest benefit that an employee could accrue in any plan year is 1.212 percent of average annual compensation (this is the case for an employee with 33 years of projected service at normal retirement age). Plan A satisfies paragraph (b)(4)(i)(C)(*1*) of this section because 1.6 percent is not more than one third larger than 1.212 percent.

Example 2. Plan B provides a normal retirement benefit equal to 1.0 percent of average annual compensation up to the integration level, and 1.6 percent of average annual compensation above the integration level, times each year of service up to 35. Plan B further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year and the denominator of which is the employee's projected years of service as of normal retirement age. For purposes of satisfying the one third larger rule in paragraph (b)(4)(i)(C)(*1*) of this section, because Plan B satisfies section 401(l) in form, all employees with less than 35 projected years of service are assumed to accrue benefits at the rate of 1.6 percent of average annual compensation (the excess benefit percentage under the plan). Plan B satisfies paragraph (b)(4)(i)(C) of this section because all employees with 33 or fewer years of projected service at normal retirement age accrue in each plan year a benefit of 1.6 percent of average annual compensation.

Example 3. Plan C provides a normal retirement benefit equal to four percent of average annual compensation times each year of service up to 10 and one percent of average annual compensation times each year of service in excess of 10 and not in excess of 30. Plan C further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. The greatest benefit that an employee could accrue in any plan year is four percent of average annual compensation (this is the case for an employee with 10 or fewer years of projected service at normal retirement age). Among employees with 33 or fewer years of projected service at normal retirement age, the lowest benefit that an employee could accrue in a plan year is 1.82 percent of average annual compensation (this is the case of an employee with 33 years of projected service at normal retirement age). Plan C fails to satisfy this paragraph (b)(4) because four percent is more than one third larger than 1.82 percent. See also §1.401(a)(4)–9(c)(6), *Example 3*.

Example 4. Plan D provides a normal retirement benefit of 100 percent of average annual compensation, reduced by four percentage points for each year of service below 25 the employee has at normal retirement age. Plan D further provides that an employee's accrued benefit as of any plan year is equal to the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service at normal retirement age. In the case of an employee who has five years of service as of the current plan year, and who is projected to have 10 years of service at normal retirement age, the employee's fractional rule benefit would be 40 percent of average annual compensation, and the employee's accrued benefit as of the current plan year would be 20 percent of average annual compensation (the fractional rule benefit multiplied by a fraction of five years over 10 years). Plan D satisfies this paragraph (b)(4).

Example 5. The facts are the same as in *Example 4*, except that the normal retirement benefit is 125 percent of average annual compensation, reduced by five percentage points for each year of service below 25 that the employee has at normal retirement age. Plan D satisfies this paragraph (b)(4), even though an employee may accrue the maximum benefit allowed under section 415 (i.e., 100 percent of the participant's average compensation for the high three years of service) in less than 25 years.

Example 6. The facts are the same as in *Example 1*, except that the plan determines each employee's accrued benefit by multiplying the employee's projected normal retirement benefit (rather than the fractional rule benefit) by the fraction described in *Example 1*. In determining an employee's projected normal retirement benefit, the plan defines each employee's average annual compensation as the average annual compensation the employee would have at normal retirement age if the employee's annual section 414(s) compensation in future plan years equaled the employee's plan year compensation for the prior plan year. Under these facts, Plan A does not satisfy paragraph (b)(4)(i)(B) of this section because the employee's accrued benefit is determined on the basis of a projected normal retirement benefit that is not the same as the employee's fractional rule benefit determined in accordance with §1.411(b)–1(b)(3)(ii)(A).

Example 7. Plan E provides a normal retirement benefit of 50 percent of average annual compensation, with a pro rata reduction for employees with less than 30 years of service at normal retirement age. Plan E further provides that an employee's accrued benefit as of any plan year is equal to the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service at normal retirement age. For purposes of determining this fraction, the plan limits the years of service taken into account for an employee to the number of years the employee has participated in the plan. However, all years of service (including years of service before the employee commenced participation in the plan) are taken into account in determining an employee's normal retirement benefit under the plan's benefit formula. Plan E fails to satisfy this paragraph (b)(4) because the years of service over which benefits accrue differ from the years of service used in applying the benefit formula under the plan. See paragraph (b)(2)(v) of this section.

Example 8. (a) Plan F provides a normal retirement benefit equal to 2.0 percent of average annual compensation, plus 0.65 percent of average annual compensation above covered compensation, for each year of service up to 25. Plan F further provides that an employee's accrued benefit as of any plan year equals the sum of—

(1) The employee's fractional rule benefit (determined as if the normal retirement benefit under the plan equaled 2.0 percent of average annual compensation for each year of service up to 25) multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year and the denominator of which is the employee's projected years of service as of normal retirement age; plus

(2) 0.65 percent of the employee's average annual compensation above covered compensation multiplied by the employee's years of service (up to 25) as of the current plan year.

(b) Although Plan F satisfies the fractional accrual rule of section 411(b)(1)(C), the plan fails to satisfy this paragraph (b)(4) because the plan does not determine employees' accrued benefits in accordance with paragraph (b)(4)(i)(B) of this section.

(5) *Safe harbor for insurance contract plans.* A plan satisfies the safe harbor in this paragraph (b)(5) if it satisfies each of the following requirements:

(i) The plan must satisfy the accrual rule of section 411(b)(1)(F).

(ii) The plan must be an insurance contract plan within the meaning of section 412(i).

(iii) The benefit formula under the plan must be one that would satisfy the requirements of paragraph (b)(4) of this section if the stated normal retirement benefit under the formula accrued ratably over each employee's period of plan participation through normal retirement age in accordance with

paragraph (b)(4)(i)(B) of this section. Thus, the benefit formula may not recognize years of service before an employee commenced participation in the plan because, otherwise, the definition of years of service for determining the normal retirement benefit would differ from the definition of years of service for determining the accrued benefit under paragraph (b)(4)(i)(B) of this section. See paragraph (b)(4)(ii), *Example 7*, of this section. Notwithstanding the foregoing, an insurance contract plan adopted and in effect on September 19, 1991, may continue to recognize years of service prior to an employee's participation in the plan for an employee who is a participant in the plan on that date to the extent provided by the benefit formula in the plan on such date.

(iv) The scheduled premium payments under an individual or group insurance contract used to fund an employee's normal retirement benefit must be level annual payments to normal retirement age. Thus, payments may not be scheduled to cease before normal retirement age.

(v) The premium payments for an employee who continues benefiting after normal retirement age must be equal to the amount necessary to fund additional benefits that accrue under the plan's benefit formula for the plan year.

(vi) Experience gains, dividends, forfeitures, and similar items must be used solely to reduce future premiums.

(vii) All benefits must be funded through contracts of the same series. Among other requirements, contracts of the same series must have cash values based on the same terms (including interest and mortality assumptions) and the same conversion rights. A plan does not fail to satisfy this requirement, however, if any change in the contract series or insurer applies on the same terms to all employees. But see §1.401(a)(4)–5(a)(4), *Example 12* (change in insurer considered a plan amendment subject to §1.401(a)(4)–5(a)).

(viii) If permitted disparity is taken into account, the normal retirement benefit stated under the plan's benefit formula must satisfy §1.401(l)–3. For this purpose, the 0.75-percent factor in the maximum excess or offset allowance in §1.401(l)–3(b)(2)(i) or (b)(3)(i), respectively, adjusted in accordance with §1.401(l)–3(d)(9) and (e), is reduced by multiplying the factor by 0.80.

(6) *Use of safe harbors not precluded by certain plan provisions*—(i) *In general*. A plan does not fail to satisfy this paragraph (b) merely because the plan contains one or more of the provisions described in this paragraph (b)(6). Unless otherwise provided, any such provision must apply uniformly to all employees.

(ii) *Section 401(l) permitted disparity*. The plan takes permitted disparity into account in a manner that satisfies section 401(l) in form. Thus, differences in employees' benefits under the plan attributable to uniform disparities permitted under §1.401(l)–3 (including differences in disparities that are deemed uniform under §1.401(l)–3(c)(2)) do not cause a plan to fail to satisfy this paragraph (b).

(iii) *Different entry dates*. The plan provides one or more entry dates during the plan year as permitted by section 410(a)(4).

(iv) *Certain conditions on accruals*. The plan provides that an employee's accrual for the plan year is less than a full accrual (including a zero accrual) because of a plan provision permitted by the year-of-participation rules of section 411(b)(4).

(v) *Certain limits on accruals*. The plan limits benefits otherwise provided under the benefit formula or accrual method to a maximum dollar amount or to a maximum percentage of average annual compensation (e.g., by limiting service taken into account in the benefit formula) or in accordance with section 401(a)(5)(D), applies the limits of section 415, or limits the dollar amount of compensation taken into account in determining benefits.

(vi) *Dollar accrual per uniform unit of service*. The plan determines accruals based on the same dollar amount for each uniform unit of service (not to exceed one week) performed by each employee with the same number of years of service under the plan during the plan year. The preceding sentence applies solely for purposes of the unit credit safe harbor in paragraph (b)(3) of this section.

(vii) *Prior benefits accrued under a different formula*. The plan determines benefits for years of service after a

fresh-start date for all employees under a benefit formula and accrual method that differ from the benefit formula and accrual method previously used to determine benefit accruals for employees in a fresh-start group for years of service before the fresh-start date. This paragraph (b)(6)(vii) applies solely to plans that satisfy §1.401(a)(4)–13(c) with respect to the fresh start.

(viii) *Employee contributions.* The plan is a contributory DB plan that would satisfy the requirements of paragraph (b) of this section if the plan's benefit formula provided benefits at employees' employer-provided benefit rates determined under §1.401(a)(4)–6(b). This paragraph (b)(6)(viii) does not apply to a plan tested under paragraph (b)(4) or (b)(5) of this section unless the plan satisfies one of the methods in §1.401(a)(4)–6 (b)(4) through (b)(6). A minimum benefit added to the plan solely to satisfy §1.401(a)(4)–6(b)(3) is not taken into account in determining whether this paragraph (b)(6)(viii) is satisfied.

(ix) *Certain subsidized optional forms.* The plan provides a subsidized optional form of benefit that is available to fewer than substantially all employees because the optional form of benefit has been eliminated prospectively as provided in §1.401(a)(4)–4(b)(3).

(x) *Lower benefits for HCEs*—(A) *General rule.* The benefits (including any subsidized optional form of benefit) provided to one or more HCEs under the plan are inherently less valuable to those HCEs (determined by applying the principles of §1.401(a)(4)–4(d)(4)) than the benefits that would otherwise be provided to those HCEs if the plan satisfied this paragraph (b) (determined without regard to this paragraph (b)(6)(x)). These inherently less valuable benefits are deemed to satisfy this paragraph (b).

(B) *Examples.* The following examples illustrate the rules in this paragraph (b)(6)(x):

Example 1. Plan A would satisfy this paragraph (b) (determined without regard to this paragraph (b)(6)(x)), except for the fact that it fails to satisfy the requirement of paragraph (b)(2)(iii) of this section (i.e., a subsidized optional form must be available to substantially all employees on similar terms). Each subsidized optional form in the plan is available to all the NHCEs on similar terms, but one of the subsidized optional forms of benefit is not available to any of the HCEs. Plan A satisfies this paragraph (b), because Plan A is a safe harbor plan with respect to the NHCEs and provides inherently less valuable benefits to the HCEs.

Example 2. (a) Plan B would satisfy this paragraph (b) (determined without regard to this paragraph (b)(6)(x)), except for the fact that some employees are not being credited with years of service under the plan, but are continuing to accrue benefits as a result of compensation increases. These are employees who have been transferred from the employer that sponsors Plan B to another member of the controlled group whose employees are not covered by Plan B. For these employees, Plan B fails to satisfy the requirement of paragraph (b)(2)(v) of this section (i.e., each employee's benefit must accrue over the same years of service used in applying the benefit formula).

(b) Plan B is restructured into two component plans under the provisions of §1.401(a)(4)–9(c). One component plan (Component Plan B1) consists of all NHCEs who are not being credited with years of service under the plan's benefit formula but are continuing to accrue benefits as a result of compensation increases, and the other component plan (Component Plan B2) consists of the balance of the employees.

(c) Component Plan B1 satisfies this section and section 410(b), because it benefits only NHCEs.

(d) Component Plan B2 is treated as satisfying this paragraph (b), because Plan B would satisfy this paragraph (b) (determined without regard to this paragraph (b)(6)(x)) with respect to the employees in Component Plan B2 but for the fact that it provides inherently less valuable benefits to some HCEs in that component plan (i.e., the employees who are credited only with compensation increases rather than both years of service and compensation increases).

(e) Under §1.401(a)(4)–9(c), if Component Plan B2 satisfies section 410(b), then Plan B satisfies this section.

(xi) *Multiple formulas*—(A) *General rule.* The plan provides that an employee's benefit under the plan is the greater of the benefits determined under two or more formulas, or is the sum of the benefits determined under two or more formulas. This paragraph (b)(6)(xi) does not apply to a plan unless each of the formulas under the plan satisfies the requirements of paragraph (b)(6)(xi) (B) through (D) of this section.

(B) *Sole formulas.* The formulas must be the only formulas under the plan.

(C) *Separate testing*. Each of the formulas must separately satisfy the uniformity requirements of paragraph (b)(2) of this section and also separately satisfy one of the safe harbors in paragraphs (b)(3) through (b)(5) of this section. A formula that is available solely to some or all NHCEs is deemed to satisfy this paragraph (b)(6)(xi)(C).

(D) *Availability—(1) General rule*. All of the formulas must be available on the same terms to all employees.

(*2*) *Formulas for NHCEs*. A formula does not fail to be available on the same terms to all employees merely because the formula is not available to any HCEs, but is available to some or all NHCEs on the same terms as all of the other formulas in the plan.

(*3*) *Top-heavy formulas*. Rules parallel to those in §1.401(a)(4)–2(b)(4)(vi)(D)(*3*) apply in the case of a plan that provides the greater of the benefits under two or more formulas, one of which is a top-heavy formula. For purposes of this paragraph (b)(6)(xi)(D)(*3*), a top-heavy formula is a formula that provides a benefit equal to the minimum benefit described in section 416(c)(1) (taking into account, if applicable, the modification in section 416(h)(2)(A)(ii)(I)).

(E) *Provisions may be applied more than once*. The provisions of this paragraph (b)(6)(xi) may be applied more than once. See §1.401(a)(4)–2(b)(4)(vi)(E) for an example of the application of these provisions more than once.

(F) *Examples*. The following examples illustrate the rules in this paragraph (b)(6)(xi):

Example 1. Under Plan A, each employee's benefit equals the sum of the benefits determined under two formulas. The first formula provides one percent of average annual compensation per year of service. The second formula provides $10 per year of service. Plan A is eligible to apply the rules in this paragraph (b)(6)(xi).

Example 2. Under Plan B, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula provides $15 per year of service and is available to all employees who complete at least 500 hours of service during the plan year. The second formula provides 1.5 percent of average annual compensation per year of service and is available to all employees who complete at least 1,000 hours of service during the plan year. Plan B does not satisfy this paragraph (b)(6)(xi) because the two formulas are not available on the same terms to all employees.

Example 3. Under Plan C, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula provides $15 per year of service and is available to all employees who complete at least 1,000 hours of service during the plan year. The second formula provides the minimum benefit described in section 416(c)(1) and is available to all non-key employees who complete at least 1,000 hours of service during the plan year. Plan C does not satisfy the general rule in paragraph (b)(6)(xi)(D)(*1*) of this section because the two formulas are not available on the same terms to all employees (i.e., the second formula is only available to all non-key employees). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(6)(xi)(D)(*3*) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available solely to all non-key employees on the same terms. This is true even if the plan conditions the availability of the second formula on the plan's being top-heavy for the plan year.

Example 4. Under Plan D, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula is available to all employees and provides a benefit equal to 1.5 percent of average annual compensation per year of service. The second formula is only available to NHCEs and provides a benefit equal to two percent of average annual compensation per year of service, minus two percent of the primary insurance amount per year of service. The amount of the offset is not limited to the maximum permitted offset under §1.401(l)–3(b). Under paragraph (b)(6)(xi)(D)(*2*) of this section, both formulas are treated as available to all employees on the same terms. Furthermore, even though the second formula does not satisfy any of the safe harbors in this paragraph (b), the formula is deemed to satisfy the separate testing requirement under paragraph (b)(6)(xi)(C) of this section, because the formula is available solely to some or all NHCEs.

Example 5. Plan E is a unit credit plan that provides a benefit of one percent of average annual compensation per year of service to all employees. In 1994, the plan is amended to provide a benefit of two percent of average annual compensation per year of service after 1993, while continuing to provide a benefit of one percent of average annual compensation per year of service for all years of service before 1994. Thus, the plan's amended benefit formula provides a benefit equal to the sum of the benefits determined under two benefit formulas: one percent of average annual compensation per year of service,

plus one percent of average annual compensation per year of service after 1993. Plan E satisfies this paragraph (b)(6)(xi).

Example 6. The facts are the same as in *Example 5*, except that the plan amendment in 1994 decreases the benefit to 0.75 percent of average annual compensation per year of service after 1993, while retaining the one-percent formula for all years of service before 1994. Thus, the plan's amended benefit formula provides a benefit equal to the sum of the benefits determined under two benefit formulas: 0.75 percent of average annual compensation per year of service, plus 0.25 percent of average annual compensation per year of service before 1994. Under these facts, the second formula does not separately satisfy any of the safe harbors in this paragraph (b) because the years of service over which each employee's benefit accrues under the second formula (i.e., all years of service) are not the same years of service that are taken into account in applying the benefit formula under the plan to that employee (i.e., years of service before 1994). See paragraph (b)(2)(v) of this section. But see paragraph (b)(6)(vii) of this section and §1.401(a)(4)–13, which provide rules under which Plan E, as amended, may be able to satisfy this paragraph (b).

Example 7. Plan F provides a benefit to all employees of one percent of average annual compensation per year of service. Employee M was hired as the president of the employer in December 1994 and was not a HCE under section 414(q) during the 1994 calendar plan year. In 1994, Plan F is amended to provide a benefit that is the greater of the benefit determined under the pre-existing formula in the plan and a new formula that is available solely to some NHCEs (including Employee M). The new formula does not satisfy the uniformity requirements of paragraph (b)(2) of this section, because it provides a different benefit for some NHCEs than for other NHCEs. As a result of this change, Employee M receives a higher accrual in 1994 than the NHCEs who are not eligible for the new formula. In 1995, when Employee M first becomes a HCE, the second formula no longer applies to Employee M. It would be inconsistent with the purpose of preventing discrimination in favor of HCEs for Plan F to use the special rule for a formula that is available solely to some or all NHCEs to satisfy the separate testing requirement of paragraph (b)(6)(xi)(C) of this section for the 1994 calendar plan year. See §1.401(a)(4)–1(c)(2).

(c) *General test for nondiscrimination in amount of benefits*—(1) *General rule*. The employer-provided benefits under a defined benefit plan are nondiscriminatory in amount for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c)(1), a rate group exists under a plan for each HCE and consists of the HCE and all other employees (both HCEs and NHCEs) who have a normal accrual rate greater than or equal to the HCE's normal accrual rate, and who also have a most valuable accrual rate greater than or equal to the HCE's most valuable accrual rate. Thus, an employee is in the rate group for each HCE who has a normal accrual rate less than or equal to the employee's normal accrual rate, and who also has a most valuable accrual rate less than or equal to the employee's most valuable accrual rate.

(2) *Satisfaction of section 410(b) by a rate group*. For purposes of determining whether a rate group satisfies section 410(b), the same rules apply as in §1.401(a)(4)–2(c)(3). See paragraph (c)(4) of this section and §1.401(a)(4)–2(c)(4), *Example 3* through *Example 5*, for examples of this rule.

(3) *Certain violations disregarded*. A plan is deemed to satisfy paragraph (c)(1) of this section if the plan would satisfy that paragraph by treating as not benefiting no more than five percent of the HCEs in the plan, and the Commissioner determines that, on the basis of all of the relevant facts and circumstances, the plan does not discriminate with respect to the amount of employer-provided benefits. For this purpose, five percent of the number of HCEs may be determined by rounding to the nearest whole number (e.g., 1.4 rounds to 1 and 1.5 rounds to 2). Among the relevant factors that the Commissioner may consider in making this determination are—

(i) The extent to which the plan has failed the test in paragraph (c)(1) of this section;

(ii) The extent to which the failure is for reasons other than the design of the plan;

(iii) Whether the HCEs causing the failure are five-percent owners or are among the highest paid nonexcludable employees;

(iv) Whether the failure is attributable to an event that is not expected to recur (e.g., a plant closing); and

(v) The extent to which the failure is attributable to benefits accrued under a prior benefit structure or to benefits

accrued when a participant was not a HCE.

(4) *Examples*. The following examples illustrate the rules in this paragraph (c):

Example 1. (a) Employer X has 1100 nonexcludable employees, N1 through N1000, who are NHCEs, and H1 through H100, who are HCEs. Employer X maintains Plan A, a defined benefit plan that benefits all of these nonexcludable employees. The normal and most valuable accrual rates (determined as a percentage of average annual compensation) for the employees in Plan A for the 1994 plan year are listed in the following table.

Employee	Normal accrual rate	Most valuable accrual rate
N1 through N100	1.0	1.4
N101 through N500	1.5	3.0
N501 through N750	2.0	2.65
N751 through N1000	2.3	2.8
H1 through H50	1.5	2.0
H51 through H100	2.0	2.65

(b) There are 100 rate groups in Plan A because there are 100 HCEs in Plan A.

(c) Rate group 1 consists of H1 and all those employees who have a normal accrual rate greater than or equal to H1's normal accrual rate (1.5 percent) and who also have a most valuable accrual rate greater than or equal to H1's most valuable accrual rate (2.0 percent). Thus, rate group 1 consists of H1 through H100 and N101 through N1000.

(d) Rate group 1 satisfies the ratio percentage test of §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 90 percent, i.e., 90 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(e) Because H1 through H50 have the same normal accrual rates and the same most valuable accrual rates, the rate group with respect to each of them is identical. Thus, because rate group 1 satisfies section 410(b), rate groups 2 through 50 also satisfy section 410(b).

(f) Rate group 51 consists of H51 and all those employees who have a normal accrual rate greater than or equal to H51's normal accrual rate (2.0 percent) and who also have a most valuable accrual rate greater than or equal to H51's most valuable accrual rate (2.65 percent). Thus, rate group 51 consists of H51 through H100 and N501 through N1000. (Even though N101 through N500 have a most valuable accrual rate (3.0 percent) greater than H51's most valuable accrual rate (2.65 percent), they are not included in this rate group because their normal accrual rate (1.5 percent) is less than H51's normal accrual rate (2.0 percent).)

(g) Rate group 51 satisfies the ratio percentage test of §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 100 percent, i.e., 50 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(h) Because H51 through H100 have the same normal accrual rates and the same most valuable accrual rates, the rate group with respect to each of them is identical. Thus, because rate group 51 satisfies section 410(b), rate groups 52 through 100 also satisfy section 410(b).

(i) The employer-provided benefits under Plan A are nondiscriminatory in amount because each rate group under the plan satisfies section 410(b).

Example 2. The facts are the same as in *Example 1*, except that H96 has a most valuable accrual rate of 3.5. Each of the rate groups is the same as in *Example 1*, except that rate group 96 consists solely of H96 because no other employee has a most valuable accrual rate greater than 3.5. Because the plan would satisfy the test in paragraph (c)(1) of this section by treating H96 (who constitutes less than five percent of the HCEs in the plan) as not benefiting, the Commissioner may determine under paragraph (c)(3) of this section that, on the basis of all of the relevant facts and circumstances, the plan does not discriminate with respect to the amount of benefits.

(d) *Determination of accrual rates*—(1) *Definitions*—(i) *Normal accrual rate*. The normal accrual rate for an employee for a plan year is the increase in the employee's accrued benefit (within the meaning of section 411(a)(7)(A)(i)) during the measurement period, divided by the employee's testing service during the measurement period, and expressed either as a dollar amount or as a percentage of the employee's average annual compensation.

(ii) *Most valuable accrual rate*. The most valuable accrual rate for an employee for a plan year is the increase in the employee's most valuable optional form of payment of the accrued benefit during the measurement period, divided by the employee's testing service during the measurement period, and expressed either as a dollar amount or as a percentage of the employee's average annual compensation. The employee's most valuable optional form of

payment of the accrued benefit is determined by calculating for the employee the normalized QJSA associated with the accrued benefit that is potentially payable in the current or any future plan year at any age under the plan and selecting the largest (per year of testing service). If the plan provides a QSUPP, the most valuable accrual rate also takes into account the QSUPP payable in conjunction with the QJSA at each age under the plan. Thus, the most valuable accrual rate reflects the value of all benefits accrued or treated as accrued under section 411(d)(6) that are payable in any form and at any time under the plan, including early retirement benefits, retirement-type subsidies, early retirement window benefits, and QSUPPs. In addition, the most valuable accrual rate must take into account any such benefits that are available during a plan year, even if the benefits cease to be available before the end of the current or any future plan year.

(iii) *Measurement period*. The measurement period can be—

(A) The current plan year;

(B) The current plan year and all prior years; or

(C) The current plan year and all prior and future years.

(iv) *Testing service*—(A) *General rule*. Testing service means an employee's years of service as defined in the plan for purposes of applying the benefit formula under the plan, subject to the requirements of paragraph (d)(1)(iv)(B) of this section. Alternatively, testing service means service determined for all employees in a reasonable manner that satisfies the requirements of paragraph (d)(1)(iv)(B) of this section. For example, the number of plan years that an employee has benefited under the plan within the meaning of §1.410(b)–3(a) is an acceptable definition of testing service because it determines service in a reasonable manner and satisfies paragraph (d)(1)(iv)(B) of this section. See also §1.401(a)(4)–11(d)(3) (additional limits on service that may be taken into account as testing service).

(B) *Requirements for testing service*—(*1*) *Employees not credited with years of service under the benefit formula*. An employee must be credited with testing service for any year in which the employee benefits under the plan (within the meaning of §1.410(b)–3(a)), unless that year is part of a period of service that may not be taken into account under §1.401(a)(4)–11(d)(3). This rule applies even if the employee does not receive service credit under the benefit formula for that year (e.g., because of a service cap in the benefit formula or because of a transfer out of the group of employees covered by the plan).

(*2*) *Current year testing service*. In the case of a measurement period that is the current plan year, testing service for the plan year equals one (1).

(2) *Rules of application*—(i) *Consistency requirement*. Both normal and most valuable accrual rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same measurement periods must be used, and the rules of this paragraph (d)(2) and any available options described in paragraph (d)(3) of this section must be applied consistently. If plan benefits are not expressed as straight life annuities beginning at employees' testing ages, they must be normalized.

(ii) *Determining plan benefits, service and compensation*—(A) *In general*. Potential plan benefits, testing service, and average annual compensation must be determined in a reasonable manner, reflecting actual or projected service and compensation only through the end of the measurement period. The determination of potential plan benefits is not reasonable if it incorporates an assumption that, in future years, an employee's compensation will increase or the employee will terminate employment before the employee's testing age (other than the assumptions under paragraph (d)(1)(ii) of this section that the employee's service will end in connection with the payment of each potential QJSA in future years).

(B) Section 415 limits. For purposes of determining accrual rates under this paragraph (d), plan benefits are generally determined without regard to whether those benefits are permitted to be paid under section 415. However, plan provisions implementing any of the limits of section 415 may be taken into account in applying this paragraph (d) if the plan does not provide for benefit increases resulting from

section 415(d)(1) adjustments for former employees who were employees in a plan year in which such plan provisions were taken into account in applying this paragraph (d). If the limits of section 415 are taken into account under this paragraph (d)(2)(ii)(B) as of the end of the measurement period, they must also be taken into account as of the beginning of the measurement period. If the limits of section 415 are not taken into account in testing the plan for the current plan year, but were taken into account in testing the plan for the preceding plan year, any resulting increase in the accrued benefits taken into account in testing the plan is treated as an increase in accrued benefits during the current plan year.

(iii) *Requirements for measurement period that includes future years*—(A) *Discriminatory pattern of accruals.* A measurement period that includes future years (as described in paragraph (d)(1)(iii)(C) of this section) may not be used if the pattern of accruals under the plan discriminates in favor of HCEs (i.e., if projected benefits for HCEs are relatively frontloaded when compared to the degree of front loading or backloading for NHCEs). This determination is made based on all of the relevant facts and circumstances.

(B) *Future-period limitation.* Future years beginning after an employee's attainment of the employee's testing age (or after the employee's assumed termination in the case of most valuable accrual rates) may not be included in the measurement period.

(3) *Optional rules*—(i) *Imputation of permitted disparity.* The disparity permitted under section 401(l) may be imputed in accordance with the rules of §1.401(a)(4)–7.

(ii) *Grouping of accrual rates*—(A) *General rule.* An employer may treat all employees who have accrual rates within a specified range above and below a midpoint rate chosen by the employer as having an accrual rate equal to the midpoint rate within that range. Accrual rates within a given range may not be grouped under this paragraph (d)(3)(ii) if the accrual rates of HCEs within the range generally are significantly higher than the accrual rates of NHCEs in the range. The specified ranges within which all employees are treated as having the same accrual rate may not overlap and may be no larger than provided in paragraph (d)(3)(ii)(B) of this section. Accrual rates of employees that are not within any of these specified ranges are determined without regard to this paragraph (d)(3)(ii).

(B) *Size of specified ranges.* In the case of normal accrual rates, the lowest and highest accrual rates in the range must be within five percent (not five percentage points) of the midpoint rate. In the case of most valuable accrual rates, the lowest and highest accrual rates in the range must be within 15 percent (not 15 percentage points) of the midpoint rate. If accrual rates are determined as a percentage of average annual compensation, the lowest and highest accrual rates need not be within five percent (or 15 percent) of the midpoint rate, if they are no more than one twentieth of a percentage point above or below the midpoint rate.

(iii) *Fresh-start alternative*—(A) *General rule.* Notwithstanding the definition of measurement period provided in paragraph (d)(1)(iii) of this section, a measurement period for a fresh-start group is permitted to be limited to the period beginning after the fresh-start date with respect to that group if the plan makes a fresh start that satisfies §1.401(a)(4)–13(c) (without regard to §1.401(a)(4)–13(c)(2)(i) and (ii)). If the measurement period is so limited or the measurement period is the plan year (whether or not so limited), any compensation adjustments during the measurement period to the frozen accrued benefit as of the fresh-start date that are permitted under the rules of §1.401(a)(4)–13(d) may be disregarded in determining the increase in accrued benefits during the measurement period, but only if—

(*1*) The plan makes a fresh start as of the fresh-start date that satisfies §1.401(a)(4)–13(c) (without regard to §1.401(a)(4)–13(c)(2)(ii)) in conjunction with a bona fide amendment to the benefit formula or accrual method under the plan; and

(*2*) The amendment provides for adjustments to employees' frozen accrued benefits as of the fresh-start date in accordance with the rules of §1.401(a)(4)–13(d).

(B) *Application of consistency requirements*. Limiting the application of the fresh-start alternative in this paragraph (d)(3)(iii) to a fresh-start group that consists of fewer than all employees does not violate the consistency requirement of paragraph (d)(2)(i) of this section.

(iv) *Floor on most valuable accrual rate*. In lieu of determining an employee's most valuable accrual rate in accordance with the definition in paragraph (d)(1)(ii) of this section, an employer may determine an employee's most valuable accrual rate for the current plan year as the employee's highest most valuable accrual rate determined for any prior plan year. This option may be used only if the employee's normal accrual rate has not changed significantly from the normal accrual rate for the relevant prior plan year and, there have been no plan amendments in the interim period since that prior plan year that affect the determination of most valuable accrual rates.

(4) *Examples*. The following examples illustrate the rules in this paragraph (d):

Example 1. The employees in Plan A have the following normal accrual rates (expressed as percentage of average annual compensation): 0.8 percent, 0.83 percent, 0.9 percent, 1.9 percent, 2.0 percent, and 2.1 percent. Because the first three rates are within a range of no more than one twentieth of a percentage point above or below 0.85 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an accrual rate of 0.85 percent (provided that the accrual rates of HCEs within the range are not significantly higher than the accrual rates for NHCEs within the range). Because the last three rates are within a range of no more than five percent above or below 2.0 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an accrual rate of 2.0 percent (provided that the accrual rates of HCEs within the range are not significantly higher than the accrual rates for NHCEs within the range).

Example 2. Employer X maintains a plan under which headquarters employees accrue a benefit of 1.25 percent of average compensation for the first 10 years of service and 0.75 percent of average compensation for subsequent years of service, while all other employees accrue a benefit of one percent of compensation for all years of service. Assume that the group of headquarters employees does not satisfy section 410(b). Under these facts, the pattern of accruals under the plan discriminates in favor of HCEs, and, therefore, under paragraph (d)(2)(iii)(A) of this section, the measurement period for determining accrual rates under the plan may not include future service.

(e) *Compensation rules*—(1) *In general*. This paragraph (e) provides rules for determining average annual compensation. Safe harbor plans that satisfy paragraph (b) of this section must determine benefits either as a dollar amount unrelated to employees' compensation or as a percentage of each employee's average annual compensation. In contrast, plans that must satisfy the general test of paragraph (c) of this section are not required under this section to determine benefits under any particular definition of compensation or in any particular manner, but the accrual rates used in testing these plans must be expressed either as a dollar amount or determined as a percentage of each employee's average annual compensation.

(2) *Average annual compensation*—(i) *General rule*. An employee's average annual compensation is the average of the employee's annual section 414(s) compensation determined over the averaging period in the employee's compensation history during which the average of the employee's annual section 414(s) compensation is the highest. For this purpose, an averaging period must consist of three or more consecutive 12-month periods, but need not be longer than the employee's period of employment. An employee's compensation history may begin at any time, but must be continuous, be no shorter than the averaging period, and end in the current plan year.

(ii) *Certain permitted modifications to average annual compensation*—(A) *Use of plan year compensation*. If the measurement period for determination of accrual rates is the current plan year, or the plan is an accumulation plan that satisfies paragraph (b) of this section, then plan year compensation may be substituted for average annual compensation.

(B) *Drop-out years*. Any of the following types of 12-month periods in an employee's compensation history may

be disregarded in determining the employee's average annual compensation (including for purposes of the requirement to average section 414(s) compensation over consecutive 12-month periods), but only if the plan disregards the employee's compensation for those periods in determining benefits—

(*1*) The 12-month period in which the employee terminates employment;

(*2*) All 12-month periods in which the employee performs no services; or

(*3*) All 12-month periods in which the employee performs services for less than a specified number of hours or specified period of time in the 12-month period. The specified number of hours or specified period of time may be selected by the employer, but may not exceed three quarters of the time that an employee in the same job category working on a full-time basis would perform services during that 12-month period.

(C) *Drop-out months within 12-month periods*. If a plan determines an employee's average annual compensation using 12-month periods that do not end on a fixed date (e.g., average annual compensation as of a date is defined as the average of the employee's section 414(s) compensation for the 60 consecutive months within the compensation history in which the average is highest), then, for purposes of determining a 12-month period, any of the following type of months may be disregarded (including for purposes of the requirement to average section 414(s) compensation over consecutive 12-month periods), but only if the plan disregards the employee's compensation for those months in determining benefits—

(*1*) The month in which the employee terminates employment;

(*2*) All months in which the employee performs no services; or

(*3*) All months in which the employee performs services for less than a specified number of hours or specified period of time in the month. The specified number of hours or specified period of time may be selected by the employer, but may not exceed three quarters of the time that an employee in the same job category working on a full-time basis would perform services during that month.

(D) *Employees working less than full-time*. In the case of an employee who normally works less than full-time, the rules in paragraphs (e)(2)(ii)(B)(*3*) and (e)(2)(ii)(C)(*3*) of this section may be applied in relation to that employee's normal work schedule (instead of a full- time employee's work schedule) by prorating the specified number of hours or specified period of time, based on the employee's normal work schedule as a fraction of a full-time schedule.

(E) *Exception from consecutive-periods requirement for certain plans*. The requirement that the periods taken into account under paragraph (e)(2)(i) of this section be consecutive does not apply in the case of a plan that is not a section 401(l) plan, provided that it does not take permitted disparity into account under §1.401(a)(4)–7. This paragraph (e)(2)(ii)(E) applies only if the plan does not take into account whether 12-month periods of compensation are consecutive in determining average compensation for purposes of calculating benefits.

(iii) *Consistency requirements*. Average annual compensation must be determined in a consistent manner for all employees.

(3) *Examples*. The following examples illustrate the rules in this paragraph (e):

Example 1. Plan A is a defined benefit plan. Plan A determines benefits on the basis of the average of each employee's annual compensation for the five consecutive plan years (or the employee's period of employment, if shorter) during the employee's compensation history in which the average of the employee's annual compensation is the highest. The compensation history used for this purpose is the last 10 plan years, plus the current plan year. In determining compensation for each plan year in the compensation history, Plan A defines compensation using a single definition that satisfies section 414(s) as a safe harbor definition under §1.414(s)–1(c). Plan A determines benefits on the basis of average annual compensation.

Example 2. Plan B is a defined benefit plan. Plan B determines benefits on the basis of the average of each employee's compensation for the five consecutive 12-month periods (or the employee's period of employment, if shorter) during the employee's compensation history in which the average of the employee's annual compensation is the highest. The compensation history used for this purpose is the 10 consecutive 12-month

periods ending on the employee's termination date. In determining the average, Plan B disregards all months in which the employee performs services for less than 100 hours (60 percent of a full-time work schedule of 173 hours). In the case of an employee whose normal work schedule is less than a full-time schedule, Plan B disregards all months in which that employee performs services for less than 60 percent of the employee's normal work schedule. Plan B defines compensation for each 12-month period using a single definition that satisfies §1.414(s)–1. Plan B determines benefits on the basis of average annual compensation.

Example 3. (a) The facts are the same as in *Example 1*, except that, for plan years prior to 1996, the compensation for a plan year was determined under a rate of pay definition of compensation that satisfies section 414(s), while, for plan years after 1995, the compensation for a plan year is determined using a definition that satisfies section 414(s) as a safe harbor definition under §1.414(s)–1(c).

(b) The underlying definition of compensation for each plan year in the employee's compensation history is section 414(s) compensation, because for each plan year the definition satisfies the requirements for section 414(s) compensation under §1.401(a)(4)–12. Therefore, Plan A determines benefits on the basis of average annual compensation, even though the underlying definition used to measure the amount of compensation for each plan year in an employee's compensation history is not the same for all plan years.

Example 4. The facts are the same as in *Example 1*, except that Plan A determines benefits on the basis of the average of the employee's annual section 414(s) compensation for the five consecutive 12-month periods ending on June 30 during the employee's compensation history in which the average is highest. An employee's compensation history begins when the employee commences participation in the plan and ends in the current plan year. In the case of an employee with less than five consecutive years of plan participation as of June 30, the compensation history is extended prior to the employee's commencement of participation to include the five consecutive 12-month periods ending on June 30 of the current plan year (or the employee's total period of employment, if shorter). Plan A determines benefits on the basis of average annual compensation.

Example 5. The facts are the same as in *Example 4*, except that Plan A determines benefits on the basis of the average of each employee's compensation for the employee's entire compensation history. Plan A determines benefits on the basis of average annual compensation.

(f) *Special rules*—(1) *In general.* The special rules in this paragraph (f) apply for purposes of applying the provisions of this section to a defined benefit plan. Any special rule provided in this paragraph (f) that is optional must, if used, apply uniformly to all employees.

(2) *Certain qualified disability benefits.* In general, qualified disability benefits (within the meaning of section 411(a)(9)) are not taken into account under this section. However, a qualified disability benefit that results from the crediting of compensation or service for a period of disability in the same manner as actual compensation or service is credited under a plan's benefit formula is permitted to be taken into account under this section as an accrued benefit upon the employee's return to service with the employer following the period of disability, provided that the qualified disability benefit is then treated in the same manner as an accrued benefit for all purposes under the plan.

(3) *Accruals after normal retirement age*—(i) *General rule.* An employee's accruals for any plan year after the plan year in which the employee attains normal retirement age are taken into account for purposes of this section. However, any plan provision that provides for increases in an employee's accrued benefit solely because the employee has delayed commencing benefits beyond the normal retirement age applicable to the employee under the plan may be disregarded, but only if—

(A) The same uniform normal retirement age applies to all employees; and

(B) The percentage factor used to increase the employee's accrued benefit is no greater than the largest percentage factor that could be applied to increase actuarially the employee's accrued benefit using any standard mortality table and any standard interest rate.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (f)(3). In each example, it is assumed that the plan satisfies the requirements of paragraph (f)(3)(i)(A) and (B) of this section.

Example 1. Plan A provides a benefit of two percent of average annual compensation per year of service for all employees. In addition, Plan A provides an actuarial increase in an employee's accrued benefit of six percent for

each year that an employee defers commencement of benefits beyond normal retirement age. For employees who continue in service beyond normal retirement age, the employee's two-percent accrual for the current plan year is offset by the six-percent actuarial increase, as permitted under section 411(b)(1)(H)(iii)(II). For purposes of this section, the actuarial increase (and hence the offset) may be disregarded, and thus all employees may be treated as if they were accruing at the rate of two percent of average annual compensation per year.

Example 2. The facts are the same as in *Example 1*, except that the employee's two- percent accrual for the current plan year is not offset by the six-percent actuarial increase. The employer may disregard the actuarial increase and thus may treat all employees as if they were accruing at the rate of two percent of average annual compensation per year.

(4) *Early retirement window benefits*—(i) *General rule.* In applying the requirements of this section, all early retirement benefits, retirement-type subsidies, QSUPPs, and other optional forms of benefit under a plan, and changes in the plan's benefit formula, are taken into account regardless of whether they are permanent features of the plan or are offered only to employees whose employment terminates within a limited period of time. Additional rules and examples relevant to the testing of early retirement window benefits are found in *Example 6* of paragraph (b)(2)(vi) of this section; paragraph (b)(2)(ii)(A)(2), *Example 2* of paragraph (c)(2), paragraph (d)(3), and *Example 3* of paragraph (e)(1)(iii) of § 1.401(a)(4)–4; paragraph (c)(4)(i) and *Example 2* of paragraph (c)(6) of § 1.401(a)(4)–9; and the definition of benefit formula in § 1.401(a)(4)–12.

(ii) Special rules—(A) *Year in which early retirement window benefit taken into account.* Notwithstanding paragraph (f)(4)(i) of this section, an early retirement window benefit is disregarded for purposes of determining whether a plan satisfies this section with respect to an employee for all plan years other than the first plan year in which the benefit is currently available (within the meaning of § 1.401(a)(4)–4(b)(2)) to the employee. For purposes of this paragraph (f)(4)(ii)(A), in determining which plan years the benefit is currently available, an early retirement window benefit that consists of a temporary change in the plan's benefit formula is treated as an optional form of benefit.

(B) *Treatment of early retirement window benefit that consists of temporary change in benefit formula.* An early retirement window benefit is disregarded for purposes of determining an employee's normal accrual rate, even if the early retirement window benefit consists of a temporary change in a plan's benefit formula. However, if an early retirement window benefit consists of a temporary change in a plan's benefit formula, the plan does not satisfy paragraph (b) of this section during the period for which the change is effective unless the plan satisfies paragraph (b) of this section both reflecting the temporary change in the benefit formula and disregarding that change.

(C) *Effect of early retirement window benefit on most valuable accrual rate.* In determining an employee's most valuable optional form of payment of the accrued benefit (which is used in determining the employee's most valuable accrual rate under paragraphs (d)(1)(ii) and (f)(4)(i) of this section), an early retirement window benefit that is currently available to the employee (within the meaning of paragraph (f)(4)(ii)(A) of this section) and that is not disregarded for a plan year under paragraph (f)(4)(ii)(A) of this section is taken into account in that plan year with respect to the employee's accrued benefit as of the earliest of the employee's date of termination, the close of the early retirement window, or the last day of that plan year.

(D) *Effect of early retirement window benefit on average benefit percentage test.* Notwithstanding paragraph (c)(2) of this section, a rate group under a plan that provides an early retirement window benefit is deemed to satisfy the average benefit percentage test of § 1.410(b)–5 if—

(*1*) All rate groups under the plan would satisfy the ratio percentage test of § 1.410(b)–2(b)(2) if the early retirement window benefit were disregarded; and

(*2*) The group of employees to whom the early retirement window benefit is

currently available (within the meaning of paragraph (f)(4)(ii)(A) of this section) satisfies section 410(b) without regard to the average benefit percentage test of §1.410(b)–5.

(iii) *Early retirement window benefit defined.* For purposes of this paragraph (f)(4), an early retirement window benefit is an early retirement benefit, retirement-type subsidy, QSUPP, or other optional form of benefit under a plan that is available, or a change in the plan's benefit formula that is applicable, only to employees who terminate employment within a limited period specified by the plan (not to exceed one year) under circumstances specified by the plan. A benefit does not fail to be described in the preceding sentence merely because the plan contains provisions under which certain employees may receive the benefit even though, for bona fide business reasons, they terminate employment within a reasonable period after the end of the limited period. An amendment to an early retirement window benefit that merely extends the periods in the preceding sentences is not treated as a separate early retirement window benefit, provided that the periods, as extended, satisfy the preceding sentences. However, any other amendment to an early retirement window benefit creates a separate early retirement window benefit.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (f)(4):

Example 1. (a) Plan A provides a benefit of one percent of average annual compensation per year of service and satisfies the requirements of paragraph (b)(2) of this section. Thus, the plan provides the same benefit to all employees with the same years of service under the Plan. Plan A is amended to treat all employees with ten or more years of service who terminate employment after attainment of age 55 and between March 1, 1999, and January 31, 2000, as if they had an additional five years of service under the benefit formula. However, in order to ensure the orderly implementation of the early retirement window, the plan amendment provides that designated employees in the human resources department who would otherwise be eligible for the early retirement window benefit are eligible to be treated as having the additional five years of service only if they terminate between January 1, 2000, and April 30, 2000.

(b) The additional benefits provided under this amendment are tested as benefits provided to employees rather than former employees. The effect of this amendment is temporarily to change the benefit formula for employees who are eligible for the early retirement window benefit because the amendment changes (albeit temporarily) the amount of the benefit payable to those employees at normal retirement age. See the definition of benefit formula in §1.401(a)(4)–12. Assume that the additional years of service credited to employees eligible for the window benefit do not represent past service (within the meaning of §1.401(a)(4)–11(d)(3)(i)(B)) or pre-participation or imputed service (within the meaning of §1.401(a)(4)–11(d)(3)(ii)(A) or (B), respectively) and thus may not be taken into account as years of service. See §1.401(a)(4)–11(d)(3)(i)(A) (regarding years of service that may not be taken into account under §1.401(a)(4)–1(b)(2)). Thus, the window-eligible employees are entitled to a larger benefit (as a percentage of average annual compensation) than other employees with the same number of years of service, and the plan does not satisfy the uniform normal retirement benefit requirement of paragraph (b)(2)(i) of this section.

(c) Plan A is restructured under the provisions of §1.401(a)(4)–9(c) into two component plans: Component Plan A1, consisting of all employees who are not eligible for the early retirement window benefit and all of their accruals and benefits, rights, and features under the plan, and Component Plan A2, consisting of all employees who are eligible for the early retirement window benefit (including the designated employees in the human resource department) and all of their accruals and benefits, rights, and features under the plan.

(d) Component Plan A1 still satisfies paragraph (b) of this section, because there has been no change for the employees in that component plan. Similarly, Component Plan A2 satisfies paragraph (b) of this section disregarding the change in the benefit formula.

(e) Because the early retirement window benefit consists of a temporary change in the benefit formula, paragraph (f)(4)(ii)(B) of this section requires that the plan satisfy the requirements of paragraph (b) of this section reflecting the change in order to remain a safe harbor plan. After reflecting the change, Component Plan A2 still provides the same benefit (albeit higher than under the regular benefit formula) to all employees with the same years of service that may be taken into account in testing the plan, and thus the benefit formula (as temporarily amended) satisfies the requirements of paragraphs (b)(2) (i) and (ii) of this section.

(f) Since Component Plan A2 also satisfies all of the other requirements of paragraph (b)(2) of this section and the safe harbor of paragraph (b)(3) of this section reflecting the

change in the benefit formula, Component Plan A2 satisfies this paragraph (b) both reflecting and disregarding the change in the benefit formula. Thus, Component Plan A2 satisfies paragraph (b) of this section.

Example 2. The facts are the same as in *Example 1*, except that Plan A's benefit formula used the maximum amount of permitted disparity under section 401(l) prior to the amendment. The analysis is the same as in paragraphs (a) through the first sentence of paragraph (e) of *Example 1*. In order to satisfy the requirements of paragraph (b)(2) of this section, a plan that uses permitted disparity must satisfy the requirements of section 401(l) after reflecting the change in the benefit formula. Because, as stated in *Example 1*, the additional five years of service may not be taken into account for purposes of satisfying paragraph (b) of this section, the disparity that results from crediting that service exceeds the maximum permitted disparity under section 401(l). Thus, Component Plan A2 does not satisfy the requirements of paragraph (b) of this section.

Example 3. The facts are the same as in *Example 1*, except that Plan A is tested under the general test in paragraph (c) of this section. The early retirement window benefit is disregarded for purposes of determining the normal accrual rates, but is taken into account in 1999 for purposes of determining the most valuable accrual rates, of employees who were eligible for the early retirement window benefit (regardless of whether they elected to receive it). As stated in *Example 1*, the additional five years of service do not represent past service, pre-participation service, or imputed service, and thus under §1.401(a)(4)–11(d)(3)(i)(A) may not be taken into account as testing service.

(5) *Unpredictable contingent event benefits*—(i) *General rule*. In general, an unpredictable contingent event benefit (within the meaning of section 412(l)(7)(B)(ii)) is not taken into account under this section until the occurrence of the contingent event. Thus, the special rule in §1.401(a)(4)–4(d)(7) (treating the contingent event as having occurred) does not apply for purposes of this section. In the case of an unpredictable contingent event that is expected to result in the termination from employment of certain employees within a period of time consistent with the rules for defining an early retirement window benefit in paragraph (f)(4)(iii) of this section, the unpredictable contingent event benefit available to those employees is permitted to be treated as an early retirement window benefit, thus permitting the rules of paragraph (f)(4) of this section to be applied to it.

(ii) *Example*. The following example illustrates the rules of this paragraph (f)(5):

Example. (a) Employer X operates various manufacturing plants and maintains Plan A, a defined benefit plan that covers all of its nonexcludable employees. Plan A provides an early retirement benefit under which employees who retire after age 55 but before normal retirement age and who have at least 10 years of service receive a benefit equal to their normal retirement benefit reduced by four percent per year for each year prior to normal retirement age. Plan A also provides a plant-closing benefit under which employees who satisfy the conditions for receiving the early retirement benefit and who work at a plant where operations have ceased and whose employment has been terminated will receive an unreduced normal retirement benefit. The plant-closing benefit is an unpredictable contingent event benefit.

(b) During the 1997 plan year, Employer X had no plant closings. Therefore, the plant-closing benefit is not taken into account for the 1997 plan year in determining accrual rates or in applying the safe harbors in paragraph (b) of this section.

(c) During the 1998 plan year, Employer X begins to close one plant. Employees M through Z, who are employees at the plant that is closing, are expected to terminate employment with Employer X during the plan year and will satisfy the conditions for the plant-closing benefit. Therefore, in testing Plan A under this section for the 1998 plan year, the availability of the plant-closing benefit to Employees M through Z must be taken into account in determining their accrual rates or in determining whether the plan satisfies one of the safe harbors under paragraph (b) of this section.

(d) Because the employees eligible for the unpredictable contingent event benefit are expected to terminate employment with Employer X during a period consistent with the rules for defining an early retirement window benefit, in testing Plan A under this section for the 1998 plan year, the special rules in paragraph (f)(4)(ii) of this section may be applied. Thus, for example, normal accrual rates may be determined without reference to the unpredictable contingent event benefit.

(e) Despite the closing of the plant, Employee Q remains an employee into the 1999 plan year. Under paragraph (f)(4)(ii)(A) of this section, the availability of the plant-closing benefit to Employee Q may be disregarded in the 1999 plan year.

(6) *Determination of benefits on other than plan-year basis*. For purposes of

this section, accruals are generally determined based on the plan year. Nevertheless, an employer may determine accruals on the basis of any period ending within the plan year as long as the period is at least 12 months in duration. For example, accruals for all employees may be determined based on accrual computation periods ending within the plan year.

(7) *Adjustments for certain plan distributions.* For purposes of this section, an employee's accrued benefit includes the actuarial equivalent of prior distributions of accrued benefits from the plan to the employee if the years of service taken into account in determining the accrued benefits that were distributed continue to be taken into account under the plan for purposes of determining the employee's current accrued benefit. For purposes of this paragraph (f)(7), actuarial equivalence must be determined in a uniform manner for all employees using reasonable actuarial assumptions. A standard interest rate and a standard mortality table are among the assumptions considered reasonable for this purpose. Thus, for example, if an employee has commenced receipt of benefits in accordance with the minimum distribution requirements of section 401(a)(9), and the plan reduces the employee's accrued benefit to take into account the amount of the distributions, the employee's accrued benefit for purposes of this section is restored to the value it would have had if the distributions had not occurred.

(8) *Adjustment for certain QPSA charges.* For purposes of this section, an employee's accrued benefit includes the cost of a qualified preretirement survivor annuity (QPSA) that reduces the employee's accrued benefit otherwise determined under the plan, as permitted under §1.401(a)–20, Q&A–21. Thus, an employee's accrued benefit for purposes of this section is determined as if the cost of the QPSA had not been charged against the accrued benefit. This paragraph (f)(8) applies only if the QPSA charges apply uniformly to all employees.

(9) *Disregard of certain offsets*—(i) *General rule.* For purposes of this section, an employee's accrued benefit under a plan includes that portion of the benefit that is offset under an offset provision described in §1.401(a)(4)–11(d)(3)(i)(D). The rule in the preceding sentence applies only to the extent that the benefit by which the benefit under the plan being tested is offset is attributable to periods for which the plan being tested credits pre-participation service (within the meaning of §1.401(a)(4)–11(d)(3)(ii)(A)) that satisfies §1.401(a)(4)–11(d)(3)(iii) or past service (within the meaning of §1.401(a)(4)–11(d)(3)(i)(B)), and only if—

(A) The benefit under the plan being tested is offset by either—

(*1*) Benefits under a qualified defined benefit plan or defined contribution plan (whether or not terminated); or

(*2*) Benefits under a foreign plan that are reasonably expected to be paid; and,

(B) If any portion of the benefit that is offset is nonforfeitable (within the meaning of section 411), that portion is offset by a benefit (or portion of a benefit) that is also nonforfeitable (or vested, in the case of a foreign plan).

(ii) *Examples.* The following examples illustrate the rules in this paragraph (f)(9):

Example 1. (a) Employer X maintains two qualified defined benefit plans, Plan A and Plan B. Plan B provides that, whenever an employee transfers to Plan B from Plan A, the service that was credited under Plan A is credited in determining benefits under Plan B. The Plan A service credited under Plan B is pre-participation service that satisfies §1.401(a)(4)–11(d)(3)(iii). Plan B offsets the benefits determined under Plan B by the employee's vested benefits under Plan A. Plan A does not credit additional benefit service or accrual service after employees transfer to Plan B.

(b) The Plan B provision providing for an offset of benefits under Plan A satisfies §1.401(a)(4)–11(d)(3)(i)(D). This is because the provision applies to similarly-situated employees and the benefits under Plan A that are offset against the Plan B benefits are attributable to pre-participation service taken into account under Plan B.

(c) This paragraph (f)(9) applies in determining the benefits that are taken into account under this section for employees in Plan B who are transferred from Plan A. This is because the offset provision is described in §1.401(a)(4)–11(d)(3)(i)(D), the benefits under the other plan by which the benefits under the plan being tested are offset are attributable solely to pre-participation service that satisfies §1.401(a)(4)–11(d)(3)(iii), and

the benefits are offset solely by vested benefits under another qualified plan. Thus, for example, the accrual rates of employees in Plan B are determined as if there were no offset, i.e., by adding back the benefits that are offset to the net benefits under Plan B.

(d) The result would be the same even if Plan A continued to recognize compensation paid after the transfer in the determination of benefits under Plan A. However, if Plan A continued to credit benefit or accrual service after the transfer, then, to the extent that Plan B's offset of benefits under Plan A increased as a result, the additional benefits offset under Plan B would not be added back in determining the benefits under Plan B that are taken into account under this section.

Example 2. The facts are the same as in *Example 1,* except that Plan A is not a plan described in paragraph (f)(9)(i)(A) of this section. None of the benefits under Plan B that are offset by benefits under Plan A may be added back in determining the benefits under Plan B that are taken into account under this section. Thus, benefits under Plan B are tested on a net basis.

(10) *Special rule for multiemployer plans.* For purposes of this section, if a multiemployer plan increases benefits for service prior to a specific date subject to a plan provision requiring employees to complete a specified amount of service (not to exceed five years) after that date, then benefits are permitted to be determined disregarding the service condition, provided that the condition is applicable to all employees in the multiemployer plan (including collectively bargained employees).

[T.D. 8485, 58 FR 46785, Sept. 3, 1993]

§ 1.401(a)(4)–4 Nondiscriminatory availability of benefits, rights, and features.

(a) *Introduction.* This section provides rules for determining whether the benefits, rights, and features provided under a plan (i.e., all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan) are made available in a nondiscriminatory manner. Benefits, rights, and features provided under a plan are made available to employees in a nondiscriminatory manner only if each benefit, right, or feature satisfies the current availability requirement of paragraph (b) of this section and the effective availability requirement of paragraph (c) of this section. Paragraph (d) of this section provides special rules for applying these requirements. Paragraph (e) of this section defines optional form of benefit, ancillary benefit, and other right or feature.

(b) *Current availability*—(1) *General rule.* The current availability requirement of this paragraph (b) is satisfied if the group of employees to whom a benefit, right, or feature is currently available during the plan year satisfies section 410(b) (without regard to the average benefit percentage test of § 1.410(b)–5). In determining whether the group of employees satisfies section 410(b), an employee is treated as benefiting only if the benefit, right, or feature is currently available to the employee.

(2) *Determination of current availability*—(i) *General rule.* Whether a benefit, right, or feature that is subject to specified eligibility conditions is currently available to an employee generally is determined based on the current facts and circumstances with respect to the employee (e.g., current compensation, accrued benefit, position, or net worth).

(ii) *Certain conditions disregarded*—(A) *Certain age and service conditions—(1) General rule.* Notwithstanding paragraph (b)(2)(i) of this section, any specified age or service condition with respect to an optional form of benefit or a social security supplement is disregarded in determining whether the optional form of benefit or the social security supplement is currently available to an employee. Thus, for example, an optional form of benefit that is available to all employees who terminate employment on or after age 55 with at least 10 years of service is treated as currently available to an employee, without regard to the employee's current age or years of service, and without regard to whether the employee could potentially meet the age and service conditions prior to attaining the plan's normal retirement age.

(*2*) *Time-limited age or service conditions not disregarded.* Notwithstanding paragraph (b)(2)(ii)(A)(*1*) of this section, an age or service condition is not disregarded in determining the current availability of an optional form of benefit or social security supplement if

the condition must be satisfied within a limited period of time. However, in determining the current availability of an optional form of benefit or a social security supplement subject to such an age or service condition, the age and service of employees may be projected to the last date by which the age condition or service condition must be satisfied in order to be eligible for the optional form of benefit or social security supplement under the plan. Thus, for example, an optional form of benefit that is available only to employees who terminate employment between July 1, 1995, and December 31, 1995, after attainment of age 55 with at least 10 years of service is treated as currently available to an employee only if the employee could satisfy those age and service conditions by December 31, 1995.

(B) *Certain other conditions.* Specified conditions on the availability of a benefit, right, or feature requiring a specified percentage of the employee's accrued benefit to be nonforfeitable, termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, family status, default on a plan loan secured by a participant's account balance, execution of a covenant not to compete, application for benefits or similar ministerial or mechanical acts, election of a benefit form, execution of a waiver of rights under the Age Discrimination in Employment Act or other federal or state law, or absence from service, are disregarded in determining the employees to whom the benefit, right, or feature is currently available. In addition, if a multiemployer plan includes a reasonable condition that limits eligibility for an ancillary benefit, or other right or feature, to those employees who have recent service under the plan (e.g., a condition on a death benefit that requires an employee to have a minimum number of hours credited during the last two years) and the condition applies to all employees in the multiemployer plan (including the collectively bargained employees) to whom the ancillary benefit, or other right or feature, is otherwise currently available, then the condition is disregarded in determining the employees to whom the ancillary benefit, or other right or feature, is currently available.

(C) *Certain conditions relating to mandatory cash-outs.* In the case of a plan that provides for mandatory cash-outs of all terminated employees who have a vested accrued benefit with an actuarial present value less than or equal to a specified dollar amount (not to exceed the cash-out limit in effect under §1.411(a)–11(c)(3)(ii)) as permitted by sections 411(a)(11) and 417(e), the implicit condition on any benefit, right, or feature (other than the mandatory cash-out) that requires the employee to have a vested accrued benefit with an actuarial present value in excess of the specified dollar amount is disregarded in determining the employees to whom the benefit, right, or feature is currently available.

(D) *Other dollar limits.* A condition that the amount of an employee's vested accrued benefit or the actuarial present value of that benefit be less than or equal to a specified dollar amount is disregarded in determining the employees to whom the benefit, right, or feature is currently available.

(E) *Certain conditions on plan loans.* In the case of an employee's right to a loan from the plan, the condition that an employee must have an account balance sufficient to be eligible to receive a minimum loan amount specified in the plan (not to exceed $1,000) is disregarded in determining the employees to whom the right is currently available.

(3) *Benefits, rights, and features that are eliminated prospectively*—(i) *Special testing rule.* Notwithstanding paragraph (b)(1) of this section, a benefit, right, or feature that is eliminated with respect to benefits accrued after the later of the eliminating amendment's adoption or effective date (the elimination date), but is retained with respect to benefits accrued as of the elimination date, and that satisfies this paragraph (b) as of the elimination date, is treated as satisfying this paragraph (b) for all subsequent periods. This rule does not apply if the terms of the benefit, right, or feature (including the employees to whom it is available) are changed after the elimination date.

(ii) *Elimination of a benefit, right, or feature*—(A) *General rule.* For purposes

of this paragraph (b)(3), a benefit, right, or feature provided to an employee is eliminated with respect to benefits accrued after the elimination date if the amount or value of the benefit, right, or feature depends solely on the amount of the employee's accrued benefit (within the meaning of section 411(a)(7)) as of the elimination date, including subsequent income, expenses, gains, and losses with respect to that benefit in the case of a defined contribution plan.

(B) *Special rule for benefits, rights, and features that are not section 411(d)(6)-protected benefits.* Notwithstanding paragraph (b)(3)(ii)(A) of this section, in the case of a benefit, right, or feature under a defined contribution plan that is not a section 411(d)(6)-protected benefit (within the meaning of §1.411(d)–4, Q&A–1), e.g., the availability of plan loans, for purposes of this paragraph (b)(3)(ii) each employee's accrued benefit as of the elimination date may be treated, on a uniform basis, as consisting exclusively of the dollar amount of the employee's account balance as of the elimination date.

(C) *Special rule for benefits, rights, and features that depend on adjusted accrued benefits.* For purposes of this paragraph (b)(3), a benefit, right, or feature provided to an employee under a plan that has made a fresh start does not fail to be eliminated as of an elimination date that is the fresh-start date merely because it depends solely on the amount of the employee's adjusted accrued benefit (within the meaning of §1.401(a)(4)–13(d)(8)).

(c) *Effective availability*—(1) *General rule.* Based on all of the relevant facts and circumstances, the group of employees to whom a benefit, right, or feature is effectively available must not substantially favor HCEs.

(2) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Employer X maintains Plan A, a defined benefit plan that covers both of its highly compensated nonexcludable employees and nine of its 12 nonhighly compensated nonexcludable employees. Plan A provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65, and an early retirement benefit payable upon termination in the form of an annuity to employees who terminate from service with the employer on or after age 55 with 30 or more years of service. Both HCEs of Employer X currently meet the age and service requirement, or will have 30 years of service by the time they reach age 55. All but two of the nine NHCEs of Employer X who are covered by Plan A were hired on or after age 35 and, thus, cannot qualify for the early retirement benefit. Even though the group of employees to whom the early retirement benefit is currently available satisfies the ratio percentage test of §1.410(b)–2(b)(2) when age and service are disregarded pursuant to paragraph (b)(2)(ii)(A) of this section, absent other facts, the group of employees to whom the early retirement benefit is effectively available substantially favors HCEs.

Example 2. Employer Y maintains Plan B, a defined benefit plan that provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65. By a plan amendment first adopted and effective December 1, 1998, Employer Y amends Plan B to provide an early retirement benefit that is available only to employees who terminate employment by December 15, 1998, and who are at least age 55 with 30 or more years of service. Assume that all employees were hired prior to attaining age 25 and that the group of employees who have, or will have, attained age 55 with 30 years of service by December 15, 1998, satisfies the ratio percentage test of §1.410(b)–2(b)(2). Assume, further, that the employer takes no steps to inform all eligible employees of the early retirement option on a timely basis and that the only employees who terminate from employment with the employer during the two-week period in which the early retirement benefit is available are HCEs. Under these facts, the group of employees to whom this early retirement window benefit is effectively available substantially favors HCEs.

Example 3. Employer Z amends Plan C on June 30, 1999, to provide for a single sum optional form of benefit for employees who terminate from employment with Employer Z after June 30, 1999, and before January 1, 2000. The availability of this single sum optional form of benefit is conditioned on the employee's having a particular disability at the time of termination of employment. The only employee of the employer who meets this disability requirement at the time of the amendment and thereafter through December 31, 1999, is a HCE. Under paragraph (b)(2)(ii)(B) of this section, the disability condition is disregarded in determining the current availability of the single sum optional form of benefit. Nevertheless, under these facts, the group of employees to whom the single sum optional form of benefit is effectively available substantially favors HCEs.

(d) *Special rules*—(1) *Mergers and acquisitions*—(i) *Special testing rule*. A benefit, right, or feature available under a plan solely to an acquired group of employees is treated as satisfying paragraphs (b) and (c) of this section during the period that each of the following requirements is satisfied:

(A) The benefit, right, or feature must satisfy paragraphs (b) and (c) of this section (determined without regard to the special rule in section 410(b)(6)(C)) on the date that is selected by the employer as the latest date by which an employee must be hired or transferred into the acquired trade or business for an employee to be included in the acquired group of employees. This determination is made with reference to the plan of the current employer and its nonexcludable employees.

(B) The benefit, right, or feature must be available under the plan of the current employer after the transaction on the same terms as it was available under the plan of the prior employer before the transaction. This requirement is not violated merely because of a change made to the benefit, right, or feature that is permitted by section 411(d)(6), provided that—

(*1*) The change is a replacement of the benefit, right, or feature with another benefit, right, or feature that is available to the same employees as the original benefit, right, or feature, and the original benefit, right, or feature is of inherently equal or greater value (within the meaning of paragraph (d)(4)(i)(A) of this section) than the benefit, right, or feature that replaces it; or

(*2*) The change is made before January 12, 1993.

(ii) *Scope of special testing rule*. This paragraph (d)(1) applies only to benefits, rights, and features with respect to benefits accruing under the plan of the current employer, and not to benefits, rights, and features with respect to benefits accrued under the plan of the prior employer (unless, pursuant to the transaction, the plan of the prior employer becomes the plan of the current employer, or the assets and liabilities with respect to the acquired group of employees under the plan of the prior employer are transferred to the plan of the current employer in a plan merger, consolidation, or other transfer described in section 414(l)).

(iii) *Example*. The following example illustrates the rules of this paragraph (d)(1):

Example. Employer X maintains Plan A, a defined benefit plan with a single sum optional form of benefit for all employees. Employer Y acquires Employer X and merges Plan A into Plan B, a defined benefit plan maintained by Employer Y that does not otherwise provide a single sum optional form of benefit. Employer Y continues to provide the single sum optional form of benefit under Plan B on the same terms as it was offered under Plan A to all employees who were acquired in the transaction with Employer X (and to no other employees). The optional form of benefit satisfies paragraphs (b) and (c) of this section immediately following the transaction (determined without taking into account section 410(b)(6)(C)) when tested with reference to Plan B and Employer Y's nonexcludable employees. Under these facts, Plan B is treated as satisfying this section with respect to the single sum optional form of benefit for the plan year of the transaction and all subsequent plan years.

(2) *Frozen participants*. A plan must satisfy the nondiscriminatory availability requirement of this section not only with respect to benefits, rights, and features provided to employees who are currently benefiting under the plan, but also separately with respect to benefits, rights, and features provided to nonexcludable employees with accrued benefits who are not currently benefiting under the plan (frozen participants). Thus, each benefit, right, and feature available to any frozen participant under the plan is separately subject to the requirements of this section. A plan satisfies paragraphs (b) and (c) of this section with respect to a benefit, right, or feature available to any frozen participant under the plan only if one or more of the following requirements is satisfied:

(i) The benefit, right, or feature must be one that would satisfy paragraphs (b) and (c) of this section if it were not available to any employee currently benefiting under the plan.

(ii) The benefit, right, or feature must be one that would satisfy paragraphs (b) and (c) of this section if all frozen participants were treated as employees currently benefiting under the plan.

(iii) No change in the availability of the benefit, right, or feature may have been made that is first effective in the current plan year with respect to a frozen participant.

(iv) Any change in the availability of the benefit, right, or feature that is first effective in the current plan year with respect to a frozen participant must be made in a nondiscriminatory manner. Thus, any expansion in the availability of the benefit, right, or feature to any highly compensated frozen participant must be applied on a consistent basis to all nonhighly compensated frozen participants. Similarly, any contraction in the availability of the benefit, right, or feature that affects any nonhighly compensated frozen participant must be applied on a consistent basis to all highly compensated frozen participants.

(3) *Early retirement window benefits.* If a benefit, right, or feature meets the definition of an early retirement window benefit in §1.401(a)(4)–3(f)(4)(iii) (or would meet that definition if the definition applied to all benefits, rights, and features), the benefit, right, or feature is disregarded for purposes of applying this section with respect to an employee for all plan years other than the first plan year in which the benefit is currently available to the employee.

(4) *Permissive aggregation of certain benefits, rights, or features*—(i) *General rule.* An optional form of benefit, ancillary benefit, or other right or feature may be aggregated with another optional form of benefit, ancillary benefit, or other right or feature, respectively, and the two may be treated as a single optional form of benefit, ancillary benefit, or other right or feature, if both of the following requirements are satisfied:

(A) One of the two optional forms of benefit, ancillary benefit, or other rights or features must in all cases be of inherently equal or greater value than the other. For this purpose, one benefit, right, or feature is of inherently equal or greater value than another benefit, right, or feature only if, at any time and under any conditions, it is impossible for any employee to receive a smaller amount or a less valuable right under the first benefit, right, or feature than under the second benefit, right, or feature.

(B) The optional form of benefit, ancillary benefit, or other right or feature of inherently equal or greater value must separately satisfy paragraphs (b) and (c) of this section (without regard to this paragraph (d)(4)).

(ii) *Aggregation may be applied more than once.* The aggregation rule in this paragraph (d)(4) may be applied more than once. Thus, for example, an optional form of benefit may be aggregated with another optional form of benefit that itself constitutes two separate optional forms of benefit that are aggregated and treated as a single optional form of benefit under this paragraph (d)(4).

(iii) *Examples.* The following examples illustrate the rules in this paragraph (d)(4):

Example 1. Plan A is a defined benefit plan that provides a single sum optional form of benefit to all employees. The single sum optional form of benefit is available on the same terms to all employees, except that, for employees in Division S, a five-percent discount factor is applied and, for employees of Division T, a seven-percent discount factor is applied. Under paragraph (e)(1) of this section, the single sum optional form of benefit constitutes two separate optional forms of benefit. Assume that the single sum optional form of benefit available to employees of Division S separately satisfies paragraphs (b) and (c) of this section without taking into account this paragraph (d)(4). Because a lower discount factor is applied in determining the single sum optional form of benefit available to employees of Division S than is applied in determining the single sum optional form of benefit available to employees of Division T, the first single sum optional form of benefit is of inherently greater value than the second single sum optional form of benefit. Under these facts, these two single sum optional forms of benefit may be aggregated and treated as a single optional form of benefit for purposes of this section.

Example 2. The facts are the same as in *Example 1,* except that, in order to receive the single sum optional form of benefit, employees of Division S (but not employees of Division T) must have completed at least 20 years of service. The single sum optional form of benefit available to employees of Division S is not of inherently equal or greater value than the single sum optional form of benefit available to employees of Division T, because an employee of Division S who terminates employment with less than 20 years

of service would receive a smaller single sum amount (i.e., zero) than a similarly-situated employee of Division T who terminates employment with less than 20 years of service. Under these facts, the two single sum optional forms of benefit may not be aggregated and treated as a single optional form of benefit for purposes of this section.

(5) *Certain spousal benefits.* In the case of a plan that includes two or more plans that have been permissively aggregated under §1.410(b)–7(d), the aggregated plan satisfies this section with respect to the availability of any nonsubsidized qualified joint and survivor annuities, qualified preretirement survivor annuities, or spousal death benefits described in section 401(a)(11), if each plan that is part of the aggregated plan satisfies section 401(a)(11). Whether a benefit is considered subsidized for this purpose may be determined using any reasonable actuarial assumptions. For purposes of this paragraph (d)(5), a qualified joint and survivor annuity, qualified preretirement survivor annuity, or spousal death benefit is deemed to be nonsubsidized if it is provided under a defined contribution plan.

(6) *Special ESOP rules.* An ESOP does not fail to satisfy paragraphs (b) and (c) of this section merely because it makes an investment diversification right or feature or a distribution option available solely to all qualified participants (within the meaning of section 401(a)(28)(B)(iii)), or merely because the restrictions of section 409(n) apply to certain individuals.

(7) *Special testing rule for unpredictable contingent event benefits.* A benefit, right, or feature that is contingent on the occurrence of an unpredictable contingent event (within the meaning of section 412(l)(7)(B)(ii)) is tested under this section as if the event had occurred. Thus, the current availability of a benefit that becomes an optional form of benefit upon the occurrence of an unpredictable contingent event is tested by deeming the event to have occurred and by disregarding age and service conditions on the eligibility for that benefit to the extent permitted for optional forms of benefit under paragraph (b)(2) of this section.

(e) *Definitions*—(1) *Optional form of benefit*—(i) *General rule.* The term optional form of benefit means a distribution alternative (including the normal form of benefit) that is available under a plan with respect to benefits described in section 411(d)(6)(A) or a distribution alternative that is an early retirement benefit or retirement-type subsidy described in section 411(d)(6)(B)(i), including a QSUPP. Except as provided in paragraph (e)(1)(ii) of this section, different optional forms of benefit exist if a distribution alternative is not payable on substantially the same terms as another distribution alternative. The relevant terms include all terms affecting the value of the optional form, such as the method of benefit calculation and the actuarial assumptions used to determine the amount distributed. Thus, for example, different optional forms of benefit may result from differences in terms relating to the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in kind), election rights, differences in eligibility requirements, or the portion of the benefit to which the distribution alternative applies.

(ii) *Exceptions*—(A) *Differences in benefit formula or accrual method.* A distribution alternative available under a defined benefit plan does not fail to be a single optional form of benefit merely because the benefit formulas, accrual methods, or other factors (including service-computation methods and definitions of compensation) underlying, or the manner in which employees vest in, the accrued benefit that is paid in the form of the distribution alternative are different for different employees to whom the distribution alternative is available. Notwithstanding the foregoing, differences in the normal retirement ages of employees or in the form in which the accrued benefit of employees is payable at normal retirement age under a plan are taken into account in determining whether a distribution alternative constitutes one or more optional forms of benefit.

(B) *Differences in allocation formula.* A distribution alternative available under a defined contribution plan does not fail to be a single optional form of benefit merely because the allocation formula or other factors (including service-computation methods, definitions of compensation, and the manner

in which amounts described in § 1.401(a)(4)–2(c)(2)(iii) are allocated) underlying, or the manner in which employees vest in, the accrued benefit that is paid in the form of the distribution alternative are different for different employees to whom the distribution alternative is available.

(C) *Distributions subject to section 417(e).* A distribution alternative available under a defined benefit plan does not fail to be a single optional form of benefit merely because, in determining the amount of a distribution, the plan applies a lower interest rate to determine the distribution for employees with a vested accrued benefit having an actuarial present value not in excess of $25,000, as required by section 417(e)(3) and § 1.417(e)–1.

(D) *Differences attributable to uniform normal retirement age.* A distribution alternative available under a defined benefit plan does not fail to be a single optional form of benefit, to the extent that the differences are attributable to differences in normal retirement dates among employees, provided that the differences do not prevent the employees from having the same uniform normal retirement age under the definition of uniform normal retirement age in § 1.401(a)(4)–12.

(iii) *Examples.* The following examples illustrate the rules in this paragraph (e)(1):

Example 1. Plan A is a defined benefit plan that benefits all employees of Divisions S and T. The plan offers a qualified joint and 50-percent survivor annuity at normal retirement age, calculated by multiplying an employee's single life annuity payment by a factor. For an employee of Division S whose benefit commences at age 65, the plan provides a factor of 0.90, but for a similarly-situated employee of Division T the plan provides a factor of 0.85. The qualified joint and survivor annuity is not available to employees of Divisions S and T on substantially the same terms, and thus it constitutes two separate optional forms of benefit.

Example 2. Plan B is a defined benefit plan that benefits all employees of Divisions U and V. The plan offers a single sum distribution alternative available on the same terms and determined using the same actuarial assumptions, to all employees. However, different benefit formulas apply to employees of each division. Under the exception provided in paragraph (e)(1)(ii)(A) of this section, the single sum optional form of benefit available to employees of Division U is not a separate optional form of benefit from the single sum optional form of benefit available to employees of Division V.

Example 3. Defined benefit Plan C provides an early retirement benefit based on a schedule of early retirement factors that is a single optional form of benefit. Plan C is amended to provide an early retirement window benefit that consists of a temporary change in the plan's benefit formula (e.g., the addition of five years of service to an employee's actual service under the benefit formula) applicable in determining the benefits for certain employees who terminate employment within a limited period of time. Under the exception provided in paragraph (e)(1)(ii)(A) of this section, the early retirement optional form of benefit available to window-eligible employees is not a separate optional form of benefit from the early retirement optional form of benefit available to the other employees.

(2) *Ancillary benefit.* The term ancillary benefit means social security supplements (other than QSUPPs), disability benefits not in excess of a qualified disability benefit described in section 411(a)(9), ancillary life insurance and health insurance benefits, death benefits under a defined contribution plan, preretirement death benefits under a defined benefit plan, shut-down benefits not protected under section 411(d)(6), and other similar benefits. Different ancillary benefits exist if an ancillary benefit is not available on substantially the same terms as another ancillary benefit. Principles similar to those in paragraph (e)(1)(ii) of this section apply in making this determination.

(3) *Other right or feature*—(i) *General rule.* The term other right or feature generally means any right or feature applicable to employees under the plan. Different rights or features exist if a right or feature is not available on substantially the same terms as another right or feature.

(ii) *Exceptions to definition of other right or feature.* Notwithstanding paragraph (e)(3)(i) of this section, a right or feature is not considered an other right or feature if it—

(A) Is an optional form of benefit or an ancillary benefit under the plan;

(B) Is one of the terms that are taken into account in determining whether separate optional forms of benefit or ancillary benefits exist, or that would

be taken into account but for paragraph (e)(1)(ii) of this section (e.g., benefit formulas or the manner in which benefits vest); or

(C) Cannot reasonably be expected to be of meaningful value to an employee (e.g., administrative details).

(iii) *Examples.* Other rights and features include, but are not limited to—

(A) Plan loan provisions (other than those relating to a distribution of an employee's accrued benefit upon default under a loan);

(B) The right to direct investments;

(C) The right to a particular form of investment, including, for example, a particular class or type of employer securities (taking into account, in determining whether different forms of investment exist, any differences in conversion, dividend, voting, liquidation preference, or other rights conferred under the security);

(D) The right to make each rate of elective contributions described in §1.401(k)–1(g)(3) (determining the rate based on the plan's definition of the compensation out of which the elective contributions are made (regardless of whether that definition satisfies section 414(s)), but also treating different rates as existing if they are based on definitions of compensation or other requirements or formulas that are not substantially the same);

(E) The right to make after-tax employee contributions to a defined benefit plan that are not allocated to separate accounts;

(F) The right to make each rate of after-tax employee contributions described in §1.401(m)–1(f)(6) (determining the rate based on the plan's definition of the compensation out of which the after-tax employee contributions are made (regardless of whether that definition satisfies section 414(s)), but also treating different rates as existing if they are based on definitions of compensation or other requirements or formulas that are not substantially the same);

(G) The right to each rate of allocation of matching contributions described in §1.401(m)–1(f)(12) (determining the rate using the amount of matching, elective, and after-tax employee contributions determined after any corrections under §§1.401(k)–1(f)(1)(i), 1.401(m)–1(e)(1)(i), and 1.401(m)–2(c), but also treating different rates as existing if they are based on definitions of compensation or other requirements or formulas that are not substantially the same);

(H) The right to purchase additional retirement or ancillary benefits under the plan; and

(I) The right to make rollover contributions and transfers to and from the plan.

[T.D. 8485, 58 FR 46796, Sept. 3, 1993, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8891, 65 FR 44682, July 19, 2000]

§ 1.401(a)(4)–5 Plan amendments and plan terminations.

(a) *Introduction*—(1) *Overview.* This paragraph (a) provides rules for determining whether the timing of a plan amendment or series of amendments has the effect of discriminating significantly in favor of HCEs or former HCEs. For purposes of this section, a plan amendment includes, for example, the establishment or termination of the plan, and any change in the benefits, rights, or features, benefit formulas, or allocation formulas under the plan. Paragraph (b) of this section sets forth additional requirements that must be satisfied in the case of a plan termination.

(2) *Facts-and-circumstances determination.* Whether the timing of a plan amendment or series of plan amendments has the effect of discriminating significantly in favor of HCEs or former HCEs is determined at the time the plan amendment first becomes effective for purposes of section 401(a), based on all of the relevant facts and circumstances. These include, for example, the relative numbers of current and former HCEs and NHCEs affected by the plan amendment, the relative length of service of current and former HCEs and NHCEs, the length of time the plan or plan provision being amended has been in effect, and the turnover of employees prior to the plan amendment. In addition, the relevant facts and circumstances include the relative accrued benefits of current and former HCEs and NHCEs before and after the plan amendment and any additional benefits provided to current and former HCEs and NHCEs under

other plans (including plans of other employers, if relevant). In the case of a plan amendment that provides additional benefits based on an employee's service prior to the amendment, the relevant facts and circumstances also include the benefits that employees and former employees who do not benefit under the amendment would have received had the plan, as amended, been in effect throughout the period on which the additional benefits are based.

(3) *Safe harbor for certain grants of benefits for past periods.* The timing of a plan amendment that credits (or increases benefits attributable to) years of service for a period in the past is deemed not to have the effect of discriminating significantly in favor of HCEs or former HCEs if the period for which the service credit (or benefit increase) is granted does not exceed the five years immediately preceding the year in which the amendment first becomes effective, the service credit (or benefit increase) is granted on a reasonably uniform basis to all employees, benefits attributable to the period are determined by applying the current plan formula, and the service credited is service (including pre-participation or imputed service) with the employer or a previous employer that may be taken into account under §1.401(a)(4)–11(d)(3) (without regard to §1.401(a)(4)–11(d)(3)(i)(B)). However, this safe harbor is not available if the plan amendment granting the service credit (or increasing benefits) is part of a pattern of amendments that has the effect of discriminating significantly in favor of HCEs or former HCEs.

(4) *Examples.* The following examples illustrate the rules in this paragraph (a):

Example 1. Plan A is a defined benefit plan that covered both HCEs and NHCEs for most of its existence. The employer decides to wind up its business. In the process of ceasing operations, but at a time when the plan covers only HCEs, Plan A is amended to increase benefits and thereafter is terminated. The timing of this plan amendment has the effect of discriminating significantly in favor of HCEs.

Example 2. Plan B is a defined benefit plan that provides a social security supplement that is not a QSUPP. After substantially all of the HCEs of the employer have benefited from the supplement, but before a substantial number of NHCEs have become eligible for the supplement, Plan B is amended to reduce significantly the amount of the supplement. The timing of this plan amendment has the effect of discriminating significantly in favor of HCEs.

Example 3. Plan C is a defined benefit plan that contains an ancillary life insurance benefit available to all employees. The plan is amended to eliminate this benefit at a time when life insurance payments have been made only to beneficiaries of HCEs. Because all employees received the benefit of life insurance coverage before Plan C was amended, the timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 4. Plan D provides for a benefit of one percent of average annual compensation per year of service. Ten years after Plan D is adopted, it is amended to provide a benefit of two percent of average annual compensation per year of service, including years of service prior to the amendment. The amendment is effective only for employees currently employed at the time of the amendment. The ratio of HCEs to former HCEs is significantly higher than the ratio of NHCEs to former NHCEs. In the absence of any additional factors, the timing of this plan amendment has the effect of discriminating significantly in favor of HCEs.

Example 5. The facts are the same as in *Example 4*, except that, in addition, the years of prior service are equivalent between HCEs and NHCEs who are current employees, and the group of current employees with prior service would satisfy the nondiscriminatory classification test of §1.410(b)–4 in the current and all prior plan years for which past service credit is granted. The timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 6. Employer V maintains Plan E, an accumulation plan. In 1994, Employer V amends Plan E to provide that the compensation used to determine an employee's benefit for all preceding plan years shall not be less than the employee's average annual compensation as of the close of the 1994 plan year. The years of service and percentage increases in compensation for HCEs are reasonably comparable to those of NHCEs. In addition, the ratio of HCEs to former HCEs is reasonably comparable to the ratio of NHCEs to former NHCEs. The timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 7. Employer W currently has six nonexcludable employees, two of whom, H1 and H2, are HCEs, and the remaining four of whom, N1 through N4, are NHCEs. The ratio of HCEs to former HCEs is significantly higher than the ratio of NHCEs to former

NHCEs. Employer W establishes Plan F, a defined benefit plan providing a benefit of one percent of average annual compensation per year of service, including years of service prior to the establishment of the plan. H1 and H2 each have 15 years of prior service, N1 has nine years of past service, N2 has five years, N3 has three years, and N4 has one year. The timing of this plan establishment has the effect of discriminating significantly in favor of HCEs.

Example 8. Assume the same facts as in *Example 7,* except that N1 through N4 were hired in the current year, and Employer W never employed any NHCEs prior to the current year. Thus, no NHCEs would have received additional benefits had Plan F been in existence during the preceding 15 years. The timing of this plan establishment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 9. The facts are the same as in *Example 7,* except that Plan F limits the grant of past service credit to five years, and the grant of past service otherwise satisfies the safe harbor in paragraph (a)(3) of this section. The timing of this plan establishment is deemed not to have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 10. The facts are the same as in *Example 9,* except that, five years after the establishment of Plan F, Employer W amends the plan to provide a benefit equal to two percent of average annual compensation per year of service, taking into account all years of service since the establishment of the plan. The ratio of HCEs to former HCEs who terminated employment during the five-year period since the establishment of the plan is significantly higher than the ratio of NHCEs to former NHCEs who terminated employment during the five-year period since the establishment of the plan. Although the amendment described in this example might separately satisfy the safe harbor in paragraph (a)(3) of this section, the safe harbor is not available with respect to the amendment because, under these facts, the amendment is part of a pattern of amendments that has the effect of discriminating significantly in favor of HCEs.

Example 11. Employer Y maintains Plan G, a defined benefit plan, covering all its employees. In 1995, Employer Y acquires Division S from Employer Z. Some of the employees of Division S had been covered under a defined benefit plan maintained by Employer Z. Soon after the acquisition, Employer Y amends Plan G to cover all employees of Division S and to credit those who were in Division S's defined benefit plan with years of service for years of employment with Employer Z. Because the timing of the plan amendment was determined by the timing of the transaction, the timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs. See also §1.401(a)(4)–11(d)(3) for other rules regarding the crediting of preparticipation service.

Example 12. Plan H is an insurance contract plan within the meaning of section 412(i). For all plan years before 1999, Plan H purchases insurance contracts from Insurance Company J. In 1999, Plan H shifts future purchases of insurance contracts to Insurance Company K. The shift in insurance companies is a plan amendment subject to this paragraph (a).

(b) *Pre-termination restrictions*—(1) *Required provisions in defined benefit plans.* A defined benefit plan has the effect of discriminating significantly in favor of HCEs or former HCEs unless it incorporates provisions restricting benefits and distributions as described in paragraph (b)(2) and (3) of this section at the time the plan is established or, if later, as of the first plan year to which §§1.401(a)(4)–1 through 1.401(a)(4)–13 apply to the plan under §1.401(a)(4)–13(a) or (b). This paragraph (b) does not apply if the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of an early termination of the plan. The restrictions in this paragraph (b) apply to a plan within the meaning of §1.410(b)–7(b) (i.e., a section 414(l) plan). Any plan containing a provision described in this paragraph (b) satisfies section 411(d)(2) and does not fail to satisfy section 411(a) or (d)(3) merely because of the provision.

(2) *Restriction of benefits upon plan termination.* A plan must provide that, in the event of plan termination, the benefit of any HCE (and any former HCE) is limited to a benefit that is nondiscriminatory under section 401(a)(4).

(3) *Restrictions on distributions*—(i) *General rule.* A plan must provide that, in any year, the payment of benefits to or on behalf of a restricted employee shall not exceed an amount equal to the payments that would be made to or on behalf of the restricted employee in that year under—

(A) A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the restricted employee is entitled under the plan (other than a social security supplement); and

(B) A social security supplement, if any, that the restricted employee is entitled to receive.

(ii) *Restricted employee defined.* For purposes of this paragraph (b), the term restricted employee generally means any HCE or former HCE. However, an HCE or former HCE need not be treated as a restricted employee in the current year if the HCE or former HCE is not one of the 25 (or a larger number chosen by the employer) nonexcludable employees and former employees of the employer with the largest amount of compensation in the current or any prior year. Plan provisions defining or altering this group can be amended at any time without violating section 411(d)(6).

(iii) *Benefit defined.* For purposes of this paragraph (b), the term benefit includes, among other benefits, loans in excess of the amounts set forth in section 72(p)(2)(A), any periodic income, any withdrawal values payable to a living employee or former employee, and any death benefits not provided for by insurance on the employee's or former employee's life.

(iv) *Nonapplicability in certain cases.* The restrictions in this paragraph (b)(3) do not apply, however, if any one of the following requirements is satisfied:

(A) After taking into account payment to or on behalf of the restricted employee of all benefits payable to or on behalf of that restricted employee under the plan, the value of plan assets must equal or exceed 110 percent of the value of current liabilities, as defined in section 412(l)(7).

(B) The value of the benefits payable to or on behalf of the restricted employee must be less than one percent of the value of current liabilities before distribution.

(C) The value of the benefits payable to or on behalf of the restricted employee must not exceed the amount described in section 411(a)(11)(A) (restrictions on certain mandatory distributions).

(v) *Determination of current liabilities.* For purposes of this paragraph (b), any reasonable and consistent method may be used for determining the value of current liabilities and the value of plan assets.

(4) *Operational restrictions on certain money purchase pension plans.* A money purchase pension plan that has an accumulated funding deficiency, within the meaning of section 412(a), or an unamortized funding waiver, within the meaning of section 412(d), must comply in operation with the restrictions on benefits and distributions as described in paragraphs (b)(2) and (b)(3) of this section. Such a plan does not fail to satisfy section 411(d)(6) merely because of restrictions imposed by the requirements of this paragraph (b)(4).

[T.D. 8485, 58 FR 46800, Sept. 3, 1993]

§ 1.401(a)(4)–6 Contributory defined benefit plans.

(a) *Introduction.* This section provides rules necessary for determining whether a contributory DB plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2). Paragraph (b) of this section provides rules for determining the amount of benefits derived from employer contributions (employer-provided benefits) under a contributory DB plan for purposes of determining whether the plan satisfies § 1.401(a)(4)–1(b)(2) with respect to such amounts. Paragraph (c) of this section provides the exclusive rules for determining whether a contributory DB plan satisfies § 1.401(a)(4)–1(b)(2) with respect to the amount of benefits derived from employee contributions not allocated to separate accounts (employee-provided benefits). See § 1.401(a)(4)–1(b)(2)(ii)(B) for the exclusive tests applicable to employee contributions allocated to separate accounts under a section 401(m) plan.

(b) *Determination of employer-provided benefit*—(1) *General rule.* An employee's employer-provided benefit under a contributory DB plan for purposes of section 401(a)(4) equals the difference between the employee's total benefit and the employee's employee-provided benefit under the plan. The rules of section 411(c) generally must be used to determine the employee's employer-provided benefit for this purpose. However, paragraphs (b)(2) through (b)(6) of this section provide alternative methods for determining the employee's employer-provided benefit.

(2) *Composition-of-workforce method*—(i) *General rule.* A contributory DB plan

that satisfies paragraph (b)(2)(ii) (A) and (B) of this section may determine employees' employer-provided benefit rates under the rules of paragraph (b)(2)(iii) of this section.

(ii) *Eligibility requirements*—(A) *Uniform rate of employee contributions.* A contributory DB plan satisfies this paragraph (b)(2)(ii)(A) if all employees make employee contributions at the same rate, expressed as a percentage of plan year compensation (the employee contribution rate). A plan does not fail to satisfy this paragraph (b)(2)(ii)(A) merely because it eliminates employee contributions for all employees with plan year compensation below a specified contribution breakpoint that is either a stated dollar amount or a stated percentage of covered compensation (within the meaning of § 1.401(l)–1(c)(7)); or merely because all employees make employee contributions at the same rate (expressed as a percentage of plan year compensation) with respect to plan year compensation up to the contribution breakpoint (base employee contribution rate) and at a higher rate (expressed as a percentage of plan year compensation) that is the same for all employees with respect to plan year compensation above the contribution breakpoint (excess employee contribution rate). A plan described in paragraph (c)(4)(i) of this section that satisfies paragraph (c)(4)(iii) of this section is deemed to satisfy this paragraph.

(B) *Demographic requirements*—(*1*) *In general.* A contributory DB plan satisfies this paragraph (b)(2)(ii)(B) if it satisfies either of the demographic tests in paragraph (b)(2)(ii)(B) (*2*) or (*3*) of this section.

(*2*) *Minimum percentage test.* This test is satisfied only if more than 40 percent of the NHCEs in the plan have attained ages at least equal to the plan's target age, and more than 20 percent of the NHCEs in the plan have attained ages at least equal to the average attained age of the HCEs in the plan. For this purpose, a plan's target age is the lower of age 50 or the average attained age of the HCEs in the plan minus X years, where X equals 20 minus the product of five times the employee contribution rate under the plan. In no case, however, may X years be fewer than zero (0) years. Thus, for example, if the average attained age of the HCEs in the plan is 53 and the employee contribution rate is two percent of plan year compensation, the plan's target age is 43 years (i.e., $53 - (20 - (5 \times 2))$).

(*3*) *Ratio test.* This test is satisfied only if the percentage of all nonhighly compensated nonexcludable employees, who are in the plan and who have attained ages at least equal to the average attained age of the HCEs in the plan, is at least 70 percent of the percentage of all highly compensated nonexcludable employees, who are in the plan and who have attained ages at least equal to the average attained age of the HCEs in the plan. Attained ages must be determined as of the beginning of the plan year. In lieu of determining the actual distribution of the attained ages of the HCEs, an employer may assume that 50 percent of all HCEs have attained ages at least equal to the average attained age of the HCEs.

(iii) *Determination of employer-provided benefit*—(A) *Safe harbor plans other than section 401(l) plans.* For purposes of applying the exception to the safe harbor in § 1.401(a)(4)–3(b)(6)(viii) with respect to employer-provided benefits under a plan other than a section 401(l) plan, the employee's entire accrued benefit is treated as employer-provided.

(B) *Section 401(l) plans*—(*1*) *General rule.* For purposes of applying the exception to the safe harbor in § 1.401(a)(4)–3(b)(6)(viii) with respect to employer-provided benefits under a section 401(l) plan, an employee's base benefit percentage and excess benefit percentage are reduced, or an employee's gross benefit percentage is reduced, by subtracting the product of the employee contribution rate and the factor determined under paragraph (b)(2)(iv) of this section from the respective percentages for the plan year. For this purpose, the employee contribution rate is the highest rate of employee contributions applicable to any potential level of plan year compensation for that plan year under the plan.

(*2*) *Excess plans with varying contribution rates.* In the case of a defined benefit excess plan described in the second sentence of paragraph (b)(2)(ii)(A) of

this section, solely for purposes of reducing an employee's base benefit percentage as required under paragraph (b)(2)(iii)(B)(*1*) of this section, it may be assumed that the employee's employee contribution rate equals the weighted average of the base employee contribution rate and the excess employee contribution rate. In determining this weighted average, the weight of the base employee contribution rate is equal to a fraction, the numerator of which is the lesser of the integration level and the contribution breakpoint and the denominator of which is the integration level. The weight of the excess employee contribution rate is equal to the difference between one and the weight of the base employee contribution rate.

(*3*) *Offset plans with varying contribution rates.* In the case of an offset plan described in the second sentence of paragraph (b)(2)(ii)(A) of this section, an equivalent adjustment to the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section may be made to the offset percentage.

(C) *Employer-provided benefits under the general test.* For purposes of applying the general test of §1.401(a)(4)–3(c) with respect to employer-provided benefits, an employee's normal and most valuable accrual rates otherwise determined under §1.401(a)(4)–3(d) (without applying any of the options under §1.401(a)(4)–3(d)(3) other than the fresh-start alternative of §1.401(a)(4)–3(d)(3)(iii)) are each reduced by subtracting the product of the employee's contributions (expressed as a percentage of plan year compensation) and the factor determined under paragraph (b)(2)(iv) of this section from the respective accrual rates. A plan may then apply the optional rules in §1.401(a)(4)–3(d)(3) (i) and (ii) to this resulting accrual rate.

(D) *Additional limitation.* A plan may not use the composition-of-workforce method provided in this paragraph (b)(2) to determine an employee's base benefit percentage, excess benefit percentage, gross benefit percentage, offset percentage, or accrual rates unless employee contributions have been made at the same rate (or rates) throughout the period after the fresh-start date or throughout the measurement period used to determine accrual rates.

(iv) *Determination of plan factor.* The factor for a plan is determined under the following table based on the average entry age of the employees in the plan and on whether the plan determines benefits based on average compensation. For this purpose, average entry age equals the average attained age of all employees in the plan, minus the average years of participation of all employees in the plan. A plan is treated as determining benefits based on average compensation if it determines benefits based on compensation averaged over a specified period not exceeding five consecutive years (or the employee's entire period of employment with the employer, if shorter).

TABLE OF FACTORS

Average entry age	Factors	
	Average compensation benefit formula	Other formulas
Less than 30	0.5	0.75
30 to 40	0.4	0.6
Over 40	0.2	0.3

(v) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1. Plan A is a contributory DB plan that is a defined benefit excess plan providing a benefit equal to 2.0 percent of employees' average annual compensation at or below covered compensation, plus 2.5 percent of average annual compensation above covered compensation, times years of service up to 35. Under the plan, average annual compensation is determined using a five-consecutive-year period for purposes of §1.401(a)(4)–3(e)(2). The plan requires employee contributions at a rate of four percent of plan year compensation for all employees. Assume that the plan satisfies the demographic requirements of paragraph (b)(2)(ii)(B) of this section. Under these facts, the plan satisfies the eligibility requirements of paragraph (b)(2)(ii) of this section. Assume, further, that the average attained age for all employees in the plan is 55, and that the average years of participation of all employees in the plan is 10. The average entry age for the plan is therefore 45, and, accordingly, the appropriate factor under the table is 0.2. Thus, in applying the safe harbor requirements of §1.401(a)(4)–3(b) to this plan for the plan year (including the requirements of §1.401(l)–3), the employee's base benefit

percentage and excess benefit percentage are each reduced by 0.8 percent (4 percent × 0.2) and equal 1.2 percent and 1.7 percent, respectively.

Example 2. The facts are the same as in *Example 1*, except that the employee contribution rate is two percent of plan year compensation up to the covered compensation level, and four percent for plan year compensation at or above that contribution breakpoint. The employer elects to apply the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section to determine the reduction in the base benefit percentage. Because the contribution breakpoint is equal to the integration level, the weight of the employee contribution rate below the contribution breakpoint is 100 percent, and the weight of the employee contribution rate above the contribution breakpoint is zero. Thus, the weighted average of employee contribution rates is two percent. Under the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section, the reduction in the employee's base benefit percentage is 0.4. In applying the safe harbor requirements of § 1.401(a)(4)–3(b) to this plan (including the requirements of § 1.401(l)–3), the employee's base benefit percentage is 1.6 percent, and the employee's excess benefit percentage is 1.7.

Example 3. The facts are the same as in *Example 1*, except that the employee contribution rate is two percent of plan year compensation up to 50 percent of the covered compensation level, and four percent for plan year compensation at or above that contribution breakpoint. Because the contribution breakpoint is equal to 50 percent of the integration level, the weight of the employee contribution rate below the contribution breakpoint is 50 percent, and the weight of the employee contribution rate above the contribution breakpoint is 50 percent. Thus, the weighted average of employee contribution rates is three percent. Under the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section, the reduction in the employee's base benefit percentage is 0.6. In applying the safe harbor requirements of § 1.401(a)(4)–3(b) to this plan (including the requirements of § 1.401(l)–3), the employee's base benefit percentage is 1.4 percent, and the employee's excess benefit percentage is 1.7.

Example 4. The facts are the same as in *Example 1*, except that the plan is tested using the general test in § 1.401(a)(4)–3(c). Assume Employee M benefits under Plan A and has a normal accrual rate for the plan year (calculated with respect to Employee M's total accrued benefit) of 2.2 percent of average annual compensation. In applying the general test in § 1.401(a)(4)–3(c) with respect to employer-provided benefits, this rate is reduced by 0.8 to yield a normal accrual rate of 1.4 percent. This rate may then be adjusted using either of the optional rules in § 1.401(a)(4)–3(d)(3)(i) or (ii).

(3) *Minimum-benefit method*—(i) *Application of uniform factors*. A contributory DB plan that satisfies the uniform rate requirement of paragraph (b)(2)(ii)(A) of this section and the minimum benefit requirement of paragraph (b)(3)(ii) of this section may apply the adjustments provided in paragraph (b)(2)(iii) of this section as if the average entry age of employees in the plan were within the range of 30 to 40, without regard to the actual demographics of the employees in the plan.

(ii) *Minimum benefit requirement*. This requirement is satisfied if the plan provides that, in plan years beginning on or after the effective date of these regulations, as set forth in § 1.401(a)(4)–13(a) and (b), each employee will accrue a benefit that equals or exceeds the sum of—

(A) The accrued benefit derived from employee contributions made for plan years beginning on or after the effective date of these regulations, determined in accordance with section 411(c); and

(B) Fifty percent of the total benefit accrued in plan years beginning on or after the effective date of these regulations, as determined under the plan benefit formula without regard to that portion of the formula designed to satisfy the minimum benefit requirement of this paragraph (b)(3)(ii).

(iii) *Example*. The following example illustrates the minimum-benefit method of this paragraph (b)(3):

Example. Plan A is contributory DB plan. For the plan year beginning in 1994, Employee M participates in Plan A and accrues a benefit under the terms of the plan (without regard to the minimum benefit requirement of paragraph (b)(3)(ii) of this section) of $3,000. The portion of Employee M's benefit accrual for the plan year beginning in 1994 derived from employee contributions is $2,000, determined by applying the rules of section 411(c) to such contributions. The requirement of paragraph (b)(3)(ii) of this section is not satisfied for the plan year beginning in 1994 unless the plan provides that Employee M's benefit accrual for the plan year beginning in 1994 is equal to $3,500 ($2,000 + (50 percent × $3,000)).

(4) *Grandfather rule for plans in existence on May 14, 1990*. A contributory DB plan that satisfies paragraph (c)(4) of

this section may determine an employee's employer-provided benefit by subtracting from the employee's total benefit the employee-provided benefits determined using any reasonable method set forth in the plan, provided that it is the same method used in determining whether the plan satisfies paragraph (c)(4)(ii)(D) of this section.

(5) *Government-plan method.* A contributory DB plan that is established and maintained for its employees by the government of any state or political subdivision or by any agency or instrumentality thereof may treat an employee's total benefit as entirely employer-provided.

(6) *Cessation of employee contributions.* If a contributory DB plan provides that no employee contributions may be made to the plan after the last day of the first plan year beginning on or after the effective date of these regulations, as set forth in §1.401(a)(4)–13 (a) and (b), the plan may treat an employee's total benefit as entirely employer-provided.

(c) *Rules applicable in determining whether employee-provided benefits are nondiscriminatory in amount*—(1) *In general.* A contributory DB plan satisfies §1.401(a)(4)–1(b)(2) with respect to the amount of employee-provided benefits for a plan year only if the plan satisfies the requirements of paragraph (c)(2), (c)(3), or (c)(4) of this section for the plan year. This requirement applies regardless of the method used to determine the amount of employer-provided benefits under paragraph (b) of this section.

(2) *Same rate of contributions.* This requirement is satisfied for a plan year if the employee contribution rate (within the meaning of paragraph (b)(2)(ii)(A) of this section) is the same for all employees for the plan year.

(3) *Total-benefits method.* This requirement is satisfied for a plan year if—

(i) The total benefits (i.e., the sum of employer-provided and employee-provided benefits) under the plan would satisfy §1.401(a)(4)–3 if all benefits were treated as employer-provided benefits; and

(ii) The plan's contribution requirements satisfy paragraph (b)(2)(ii)(A) of this section.

(4) *Grandfather rules for plans in existence on May 14, 1990*—(i) *In general.* This requirement is satisfied for a plan year if the plan contained provisions as of May 14, 1990, that meet the requirements of paragraph (c)(4)(ii) or (c)(4)(iii) of this section.

(ii) *Graded contribution rates.* The plan's provisions meet the requirements of this paragraph (c)(4)(ii) if all the following requirements are met:

(A) The provisions require employee contributions at a greater rate (expressed as a percentage of compensation) at higher levels of compensation than at lower levels of compensation.

(B) The required rate of employee contributions is not increased after May 14, 1990, although the level of compensation at which employee contributions are required may be increased or decreased.

(C) All employees are permitted to make employee contributions under the plan at a uniform rate with respect to all compensation, beginning no later than the last day of the first plan year to which these regulations apply, as set forth in §1.401(a)(4)–13 (a) and (b).

(D) The benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided on account of employee contributions at higher levels of compensation.

(iii) *Prior year compensation.* The plan's provisions meet the requirements of this paragraph (c)(4)(iii) if they are part of a plan maintained by more than one employer that requires employee contributions and the rate of required employee contributions, expressed as a percentage of compensation for the last calendar year ending before the beginning of the plan year, is the same for all employees.

[T.D. 8485, 58 FR 46802, Sept. 3, 1993]

§1.401(a)(4)–7 Imputation of permitted disparity.

(a) *Introduction.* In determining whether a plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits, section 401(a)(5)(C) allows the disparities permitted under section 401(l) to be taken into account. For purposes of satisfying the safe harbors of §§1.401(a)(4)–2(b)(2) and 1.401(a)(4)–3(b), permitted

disparity may be taken into account only by satisfying section 401(l) in form in accordance with §1.401(l)–2 or 1.401(l)–3, respectively. For purposes of the general tests of §§1.401(a)(4)–2(c) and 1.401(a)(4)–3(c), permitted disparity may be taken into account only in accordance with the rules of this section. In general, this section allows permitted disparity to be arithmetically imputed with respect to employer-provided contributions or benefits by determining an adjusted allocation or accrual rate that appropriately accounts for the permitted disparity with respect to each employee. Paragraph (b) of this section provides rules for imputing permitted disparity with respect to employer-provided contributions by adjusting each employee's unadjusted allocation rate. Paragraph (c) of this section provides rules for imputing permitted disparity with respect to employer-provided benefits by adjusting each employee's unadjusted accrual rate. Paragraph (d) of this section provides rules of general application.

(b) *Adjusting allocation rates*—(1) *In general*. The rules in this paragraph (b) produce an adjusted allocation rate for each employee by determining the excess contribution percentage under the hypothetical formula that would yield the allocation actually received by the employee, if the plan took into account the full disparity permitted under section 401(l)(2) and used the taxable wage base as the integration level. This adjusted allocation rate is used to determine whether the amount of contributions under the plan satisfies the general test of §1.401(a)(4)–2(c) and to apply the average benefit percentage test on the basis of contributions under §1.410(b)–5(d). Paragraphs (b)(2) and (b)(3) of this section apply to employees whose plan year compensation does not exceed and does exceed, respectively, the taxable wage base, and paragraph (b)(4) of this section provides definitions.

(2) *Employees whose plan year compensation does not exceed taxable wage base*. If an employee's plan year compensation does not exceed the taxable wage base, the employee's adjusted allocation rate is the lesser of the A rate and the B rate determined under the formulas below, where the permitted disparity rate and the unadjusted allocation rate are determined under paragraph (b)(4) (ii) and (iv) of this section, respectively.

A Rate = 2×unadjusted allocation rate

B Rate = unadjusted allocation rate + permitted disparity rate

(3) *Employees whose plan year compensation exceeds taxable wage base*. If an employee's plan year compensation exceeds the taxable wage base, the employee's adjusted allocation rate is the lesser of the C rate and the D rate determined under the formulas below, where allocations and the permitted disparity rate are determined under paragraph (b)(4) (i) and (ii) of this section, respectively.

$$\text{C Rate} = \frac{\text{allocations}}{\text{plan year compensation} - \frac{1}{2}\ \text{taxable wage base}}$$

$$\text{D Rate} = \frac{\text{allocations} + (\text{permitted disparity rate} \times \text{taxable wage base})}{\text{plan year compensation}}$$

(4) *Definitions*. In applying this paragraph (b), the following definitions govern—

(i) *Allocations*. Allocations means the amount determined by multiplying the employee's plan year compensation by the employee's unadjusted allocation rate.

(ii) *Permitted disparity rate*—(A) *General rule*. Permitted disparity rate means the rate in effect as of the beginning of the plan year under section 401(l)(2)(A)(ii) (e.g., 5.7 percent for plan years beginning in 1990).

(B) *Cumulative permitted disparity limit*. Notwithstanding paragraph

(b)(4)(ii)(A) of this section, the permitted disparity rate is zero for an employee who has benefited under a defined benefit plan taken into account under §1.401(l)–5(a)(3) for a plan year that begins on or after one year from the first day of the first plan year to which these regulations apply, as set forth in §1.401(a)(4)–13 (a) and (b), if imputing permitted disparity would result in a cumulative disparity fraction for the employee, as defined in §1.401(l)–5(c)(2), that exceeds 35. See §1.401(l)–5(c)(1) for special rules for determining whether an employee has benefited under a defined benefit plan for this purpose.

(iii) *Taxable wage base*. Taxable wage base means the taxable wage base, as defined in §1.401(l)–1(c)(32), in effect as of the beginning of the plan year.

(iv) *Unadjusted allocation rate*. Unadjusted allocation rate means the employee's allocation rate determined under §1.401(a)(4)–2(c)(2)(i) for the plan year (expressed as a percentage of plan year compensation), without imputing permitted disparity under this section.

(5) *Example*. The following example illustrates the rules in this paragraph (b):

Example. (a) Employees M and N participate in a defined contribution plan maintained by Employer X. Employee M has plan year compensation of $30,000 in the 1990 plan year and has an unadjusted allocation rate of five percent. Employee N has plan year compensation of $100,000 in the 1990 plan year and has an unadjusted allocation rate of eight percent. The taxable wage base in 1990 is $51,300.

(b) Because Employee M's plan year compensation does not exceed the taxable wage base, Employee M's A rate is 10 percent (2×5 percent), and Employee M's B rate is 10.7 percent (5 percent+5.7 percent). Thus, Employee M's adjusted allocation rate is 10 percent, the lesser of the A rate and the B rate.

(c) Employee N's allocations are $8,000 (8 percent×$100,000). Because Employee N's plan year compensation exceeds the taxable wage base, Employee N's C rate is 10.76 percent ($8,000 divided by ($100,000 − (½×$51,300))), and Employee N's D rate is 10.92 percent (($8,000+(5.7 percent×$51,300)) divided by $100,000). Thus, Employee N's adjusted allocation rate is 10.76 percent, the lesser of the C rate and the D rate.

(c) *Adjusting accrual rates*—(1) *In general*. The rules in this paragraph (c) produce an adjusted accrual rate for each employee by determining the excess benefit percentage under the hypothetical plan formula that would yield the employer-provided accrual actually received by the employee, if the plan took into account the full permitted disparity under section 401(l)(3)(A) in each of the first 35 years of an employee's testing service under the plan and used the employee's covered compensation as the integration level. This adjusted accrual rate is used to determine whether the amount of employer-provided benefits under the plan satisfies the alternative safe harbor for flat benefit plans under §1.401(a)(4)–3(b)(4)(i)(C)(*3*) or the general test of §1.401(a)(4)–3(c), and to apply the average benefit percentage test on the basis of benefits under §1.410(b)–5. Paragraphs (c)(2) and (c)(3) of this section apply to employees whose average annual compensation does not exceed and does exceed, respectively, covered compensation, and paragraph (c)(4) of this section provides definitions. Paragraph (c)(5) of this section provides a special rule for employees with negative unadjusted accrual rates.

(2) *Employees whose average annual compensation does not exceed covered compensation*. If an employee's average annual compensation does not exceed the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the A rate and the B rate determined under the formulas below, where the permitted disparity factor and the unadjusted accrual rate are determined under paragraph (c)(4)(iii) and (v) of this section, respectively.

$$\text{A Rate} = 2 \times \text{unadjusted accrual rate}$$

$$\text{B Rate} = \text{unadjusted accrual rate} + \text{permitted disparity factor}$$

(3) *Employees whose average annual compensation exceeds covered compensation.* If an employee's average annual compensation exceeds the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the C rate and D rate determined under the formulas below, where the employer-provided accrual and the permitted disparity factor are determined under paragraph (c)(4)(ii) and (iii) of this section, respectively.

$$\text{C Rate} = \frac{\text{employer-provided accrual}}{\text{average annual compensation} - \frac{1}{2}\ \text{covered compensation}}$$

$$\text{D Rate} = \frac{\text{employer-provided accrual} + (\text{permitted disparity factor} \times \text{covered compensation})}{\text{average annual compensation}}$$

(4) *Definitions.* For purposes of this paragraph (c), the following definitions apply.

(i) *Covered compensation.* Covered compensation means covered compensation as defined in §1.401(l)–1(c)(7). Notwithstanding §1.401(l)–1(c)(7)(iii), an employee's covered compensation must be automatically adjusted each plan year for purposes of applying this paragraph (c).

(ii) *Employer-provided accrual.* Employer-provided accrual means the amount determined by multiplying the employee's average annual compensation by the employee's unadjusted accrual rate.

(iii) *Permitted disparity factor*—(A) *General rule.* Permitted disparity factor for an employee means the sum of the employee's annual permitted disparity factors determined under paragraph (c)(4)(iii)(B) of this section for each of the years in the measurement period used for determining the employee's accrual rate in §1.401(a)(4)–3(d)(1), divided by the employee's testing service during that measurement period.

(B) *Annual permitted disparity factor*—(*1*) *Definition.* An employee's annual permitted disparity factor is generally 0.75 percent adjusted, pursuant to §1.401(l)–3(e), using as the age at which benefits commence the lesser of age 65 or the employee's testing age. No adjustments are made in the annual permitted disparity factor unless an employee's testing age is different from the employee's social security retirement age. An annual permitted disparity factor that is less than the annual permitted disparity factor described in the first sentence of this paragraph (c)(4)(iii)(B)(*1*) may be used if it is a uniform percentage of that factor (e.g., 50 percent of the annual permitted disparity factor) or a fixed percentage (e.g., 0.65 percent) for all employees.

(*2*) *Annual permitted disparity factor after 35 years.* For purposes of determining the sum described in paragraph (c)(4)(iii)(A) of this section, the annual permitted disparity factor for each of the employee's first 35 years of testing service is the amount described in paragraph (c)(4)(iii)(B)(*1*) of this section, and the annual permitted disparity factor in any subsequent year equals zero. This rule applies regardless of whether the end of the measurement period extends beyond an employee's first 35 years of testing service. Thus, for example, if the measurement period is the current plan year and the employee completed 35 years of testing service prior to the beginning of the current plan year, under this paragraph (c)(4)(iii)(B)(*2*) the annual permitted disparity factor in the current plan year (and hence the sum of the annual permitted disparity factors for each year in the measurement period) is zero.

(*3*) *Cumulative permitted disparity limit.* The 35 years used in paragraph (c)(4)(iii)(B)(*2*) of this section must be reduced by the employee's cumulative disparity fraction, as defined in §1.401(l)–5(c)(2), but determined solely with respect to the employee's total years of service under all plans taken into account under §1.401(l)–5(a)(3) during the measurement period, other than the plan being tested.

(iv) *Social security retirement age*. Social security retirement age means social security retirement age as defined in section 415(b)(8).

(v) *Unadjusted accrual rate*. Unadjusted accrual rate means the normal or most valuable accrual rate, whichever is being determined for the employee under § 1.401(a)(4)–3(d), expressed as a percentage of average annual compensation, without imputing permitted disparity under this section.

(5) *Employees with negative unadjusted accrual rates*. Notwithstanding the formulas in paragraph (c)(2) and (c)(3) of this section, if an employee's unadjusted accrual rate is less than zero, the employee's adjusted accrual rate is deemed to be the employee's unadjusted accrual rate.

(6) *Example*. The following example illustrates the rules in this paragraph (c):

Example. (a) Employees M and N participate in a defined benefit plan that uses a normal retirement age of 65. The plan is being tested for the plan year under § 1.401(a)(4)–3(c), using unadjusted accrual rates determined using a plan year measurement period under § 1.401(a)(4)–3(d)(1)(iii)(A). Employee M has an unadjusted normal accrual rate of 1.48 percent, average annual compensation of $21,000, and an employer-provided accrual of $311 (1.48 percent×$21,000). Employee N has an unadjusted normal accrual rate of 1.7 percent, average annual compensation of $106,000, and an employer-provided accrual of $1,802 (1.7 percent×$106,000). The covered compensation of both Employees M and N is $25,000, and social security retirement age for both employees is 65. Neither employee has testing service of more than 35 years and neither has ever participated in another plan.

(b) Because Employee M's average annual compensation does not exceed covered compensation, Employee M's A rate is 2.96 percent (2.0×1.48 percent), and Employee M's B rate is 2.23 percent (1.48 percent+0.75 percent). Thus, Employee M's adjusted accrual rate is 2.23 percent, the lesser of the A rate and the B rate.

(c) Because Employee N's average annual compensation exceeds covered compensation, Employee N's C rate is 1.93 percent ($1,802/($106,000 – (0.5×$25,000))), and Employee N's D rate is 1.88 percent (($1,802+(0.75 percent×$25,000))/$106,000). Thus, Employee N's adjusted accrual rate is 1.88 percent, the lesser of the C rate and the D rate.

(d) *Rules of general application*—(1) *Eligible plans*. The rules in this section may be used only for those plans to which the permitted disparity rules of section 401(l) are available. See § 1.401(l)–1(a)(3).

(2) *Exceptions from consistency requirements*. A plan does not fail to satisfy the consistency requirements of § 1.401(a)(4)–2(c)(2)(vi) or § 1.401(a)(4)–3(d)(2)(i) merely because the plan does not impute disparity for some employees to the extent required to comply with paragraph (d)(3) of this section, or because the plan does not impute disparity for any employees (including self-employed individuals within the meaning of section 401(c)(1)) who are not covered by any of the taxes under section 3111(a), section 3221, or section 1401.

(3) *Overall permitted disparity*. The annual overall permitted disparity limits of § 1.401(l)–5(b) apply to the employer-provided contributions and benefits for an employee under all plans taken into account under § 1.401(l)–5(a)(3). Thus, if an employee who benefits under the plan for the current plan year also benefits under a section 401(l) plan for the plan year ending with or within the current plan year, permitted disparity may not be imputed for that employee for the plan year. See § 1.401(l)–5(b)(9), *Example 4*. Similarly, if an employee who benefits under the plan for the current plan year also benefits under another plan of the employer for the plan year ending with or within the current plan year, disparity may be imputed for that employee under only one of the plans.

[T.D. 8485, 58 FR 46804, Sept. 3, 1993]

§ 1.401(a)(4)–8 Cross-testing.

(a) *Introduction*. This section provides rules for testing defined benefit plans on the basis of equivalent employer-provided contributions and defined contribution plans on the basis of equivalent employer-provided benefits under § 1.401(a)(4)–1(b)(2). Paragraphs (b)(1) and (c)(1) of this section provide general tests for nondiscrimination based on individual equivalent accrual or allocation rates determined under paragraphs (b)(2) and (c)(2) of this section, respectively. Paragraphs (b)(3), (c)(3), and (d) of this section provide additional safe-harbor testing methods for target benefit plans, cash balance

plans, and defined benefit plans that are part of floor-offset arrangements, respectively, that generally may be satisfied on a design basis.

(b) *Nondiscrimination in amount of benefits provided under a defined contribution plan*—(1) *General rule and gateway*—(i) *General rule.* Equivalent benefits under a defined contribution plan (other than an ESOP) are nondiscriminatory in amount for a plan year if—

(A) The plan would satisfy §1.401(a)(4)–2(c)(1) for the plan year if an equivalent accrual rate, as determined under paragraph (b)(2) of this section, were substituted for each employee's allocation rate in the determination of rate groups; and

(B) For plan years beginning on or after January 1, 2002, the plan satisfies one of the following conditions—

(*1*) The plan has broadly available allocation rates (within the meaning of paragraph (b)(1)(iii) of this section) for the plan year;

(*2*) The plan has age-based allocation rates that are based on either a gradual age or service schedule (within the meaning of paragraph (b)(1)(iv) of this section) or a uniform target benefit allocation (within the meaning of paragraph (b)(1)(v) of this section) for the plan year; or

(*3*) The plan satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section for the plan year.

(ii) *Allocations after testing age.* A plan does not fail to satisfy paragraph (b)(1)(i)(A) of this section merely because allocations are made at the same rate for employees who are older than their testing age (determined without regard to the current-age rule in paragraph (4) of the definition of *testing age* in §1.401(a)(4)–12) as they are made for employees who are at that age.

(iii) *Broadly available allocation rates*—(A) *In general.* A plan has broadly available allocation rates for the plan year if each allocation rate under the plan is currently available during the plan year (within the meaning of §1.401(a)(4)–4(b)(2)), to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test of §1.410(b)–5). For this purpose, if two allocation rates could be permissively aggregated under §1.401(a)(4)–4(d)(4), assuming the allocation rates were treated as benefits, rights or features, they may be aggregated and treated as a single allocation rate. In addition, the disregard of age and service conditions described in §1.401(a)(4)–4(b)(2)(ii)(A) does not apply for purposes of this paragraph (b)(1)(iii)(A).

(B) *Certain transition allocations.* In determining whether a plan has broadly available allocation rates for the plan year within the meaning of paragraph (b)(1)(iii)(A) of this section, an employee's allocation may be disregarded to the extent that the allocation is a transition allocation for the plan year. In order for an allocation to be a transition allocation, the allocation must comply with the requirements of paragraph (b)(1)(iii)(C) of this section and must be either—

(*1*) A defined benefit replacement allocation within the meaning of paragraph (b)(1)(iii)(D) of this section; or

(*2*) A pre-existing replacement allocation or pre-existing merger and acquisition allocation, within the meaning of paragraph (b)(1)(iii)(E) of this section.

(C) *Plan provisions relating to transition allocations*—(*1*) *In general.* Plan provisions providing for transition allocations for the plan year must specify both the group of employees who are eligible for the transition allocations and the amount of the transition allocations.

(*2*) *Limited plan amendments.* Allocations are not transition allocations within the meaning of paragraph (b)(1)(iii)(B) of this section for the plan year if the plan provisions relating to the allocations are amended after the date those plan provisions are both adopted and effective. The preceding sentence in this paragraph (b)(1)(iii)(C)(*2*) does not apply to a plan amendment that reduces transition allocations to HCEs, makes de minimis changes in the calculation of the transition allocations (such as a change in the definition of compensation to include section 132(f) elective reductions), or adds or removes a provision permitted under paragraph (b)(1)(iii)(C)(*3*) of this section.

(*3*) *Certain permitted plan provisions.* An allocation does not fail to be a transition allocation within the meaning of paragraph (b)(1)(iii)(B) of this section merely because the plan provides that each employee who is eligible for a transition allocation receives the greater of such allocation and the allocation for which the employee would otherwise be eligible under the plan. In a plan that contains such a provision, for purposes of determining whether the plan has broadly available allocation rates within the meaning of paragraph (b)(1)(iii)(A) of this section, the allocation for which an employee would otherwise be eligible is considered currently available to the employee, even if the employee's transition allocation is greater.

(D) *Defined benefit replacement allocation.* An allocation is a defined benefit replacement allocation for the plan year if it is provided in accordance with guidance prescribed by the Commissioner published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) and satisfies the following conditions—

(*1*) The allocations are provided to a group of employees who formerly benefitted under an established nondiscriminatory defined benefit plan of the employer or of a prior employer that provided age-based equivalent allocation rates;

(*2*) The allocations for each employee in the group were reasonably calculated, in a consistent manner, to replace the retirement benefits that the employee would have been provided under the defined benefit plan if the employee had continued to benefit under the defined benefit plan;

(*3*) Except as provided in paragraph (b)(1)(iii)(C) of this section, no employee who receives the allocation receives any other allocations under the plan for the plan year; and

(*4*) The composition of the group of employees who receive the allocations is nondiscriminatory.

(E) *Pre-existing transition allocations—(1) Pre-existing replacement allocations.* An allocation is a pre-existing replacement allocation for the plan year if the allocation satisfies the following conditions—

(*i*) The allocations are provided pursuant to a plan provision adopted before June 29, 2001;

(*ii*) The allocations are provided to employees who formerly benefitted under a defined benefit plan of the employer; and

(*iii*) The allocations for each employee in the group are reasonably calculated, in a consistent manner, to replace some or all of the retirement benefits that the employee would have received under the defined benefit plan and any other plan or arrangement of the employer if the employee had continued to benefit under such defined benefit plan and such other plan or arrangement.

(*2*) *Pre-existing merger and acquisition allocations.* An allocation is a pre-existing merger and acquisition allocation for the plan year if the allocation satisfies the following conditions—

(*i*) The allocations are provided solely to employees of a trade or business that has been acquired by the employer in a stock or asset acquisition, merger, or other similar transaction occurring prior to August 28, 2001, involving a change in the employer of the employees of the trade or business;

(*ii*) The allocations are provided only to employees who were employed by the acquired trade or business before a specified date that is no later than two years after the transaction (or January 1, 2002, if earlier);

(*iii*) The allocations are provided pursuant a plan provision adopted no later than the specified date; and

(*iv*) The allocations for each employee in the group are reasonably calculated, in a consistent manner, to replace some or all of the retirement benefits that the employee would have received under any plan of the employer if the new employer had continued to provide the retirement benefits that the prior employer was providing for employees of the trade or business.

(F) *Successor employers.* An employer that accepts a transfer of assets (within the meaning of section 414(l)) from the plan of a prior employer may continue to treat any transition allocations provided under that plan as transition allocations under paragraph (b)(1)(iii)(B) of this section, provided that the successor employer continues

to satisfy the applicable requirements set forth in paragraphs (b)(1)(iii)(C) through (E) of this section for the plan year.

(iv) *Gradual age or service schedule*—(A) *In general.* A plan has a gradual age or service schedule for the plan year if the allocation formula for all employees under the plan provides for a single schedule of allocation rates under which—

(*1*) The schedule defines a series of bands based solely on age, years of service, or the number of points representing the sum of age and years of service (age and service points), under which the same allocation rate applies to all employees whose age, years of service, or age and service points are within each band; and

(*2*) The allocation rates under the schedule increase smoothly at regular intervals, within the meaning of paragraphs (b)(1)(iv)(B) and (C) of this section.

(B) *Smoothly increasing schedule of allocation rates.* A schedule of allocation rates increases smoothly if the allocation rate for each band within the schedule is greater than the allocation rate for the immediately preceding band (i.e., the band with the next lower number of years of age, years of service, or age and service points) but by no more than 5 percentage points. However, a schedule of allocation rates will not be treated as increasing smoothly if the ratio of the allocation rate for any band to the rate for the immediately preceding band is more than 2.0 or if it exceeds the ratio of allocation rates between the two immediately preceding bands.

(C) *Regular intervals.* A schedule of allocation rates has regular intervals of age, years of service or age and service points, if each band, other than the band associated with the highest age, years of service, or age and service points, is the same length. For this purpose, if the schedule is based on age, the first band is deemed to be of the same length as the other bands if it ends at or before age 25. If the first age band ends after age 25, then, in determining whether the length of the first band is the same as the length of other bands, the starting age for the first age band is permitted to be treated as age 25 or any age earlier than 25. For a schedule of allocation rates based on age and service points, the rules of the preceding two sentences are applied by substituting 25 age and service points for age 25. For a schedule of allocation rates based on service, the starting service for the first service band is permitted to be treated as one year of service or any lesser amount of service.

(D) *Minimum allocation rates permitted.* A schedule of allocation rates under a plan does not fail to increase smoothly at regular intervals, within the meaning of paragraphs (b)(1)(iv)(B) and (C) of this section, merely because a minimum uniform allocation rate is provided for all employees or the minimum benefit described in section 416(c)(2) is provided for all non-key employees (either because the plan is top heavy or without regard to whether the plan is top heavy) if the schedule satisfies one of the following conditions—

(*1*) The allocation rates under the plan that are greater than the minimum allocation rate can be included in a hypothetical schedule of allocation rates that increases smoothly at regular intervals, within the meaning of paragraphs (b)(1)(iv)(B) and (C) of this section, where the hypothetical schedule has a lowest allocation rate no lower than 1% of plan year compensation; or

(*2*) For a plan using a schedule of allocation rates based on age, for each age band in the schedule that provides an allocation rate greater than the minimum allocation rate, there could be an employee in that age band with an equivalent accrual rate that is less than or equal to the equivalent accrual rate that would apply to an employee whose age is the highest age for which the allocation rate equals the minimum allocation rate.

(v) *Uniform target benefit allocations.* A plan has allocation rates that are based on a uniform target benefit allocation for the plan year if the plan fails to satisfy the requirements for the safe harbor testing method in paragraph (b)(3) of this section merely because the determination of the allocations under the plan differs from the allocations determined under that safe harbor testing method for any of the following reasons—

(A) The interest rate used for determining the actuarial present value of the stated plan benefit and the theoretical reserve is lower than a standard interest rate;

(B) The stated benefit is calculated assuming compensation increases at a specified rate; or

(C) The plan computes the current year contribution using the actual account balance instead of the theoretical reserve.

(vi) *Minimum allocation gateway*—(A) *General rule*. A plan satisfies the minimum allocation gateway of this paragraph (b)(1)(vi) if each NHCE has an allocation rate that is at least one third of the allocation rate of the HCE with the highest allocation rate.

(B) *Deemed satisfaction*. A plan is deemed to satisfy the minimum allocation gateway of this paragraph (b)(1)(vi) if each NHCE receives an allocation of at least 5% of the NHCE's compensation within the meaning of section 415(c)(3), measured over a period of time permitted under the definition of plan year compensation.

(vii) *Determination of allocation rate*. For purposes of paragraph (b)(1)(i)(B) of this section, allocations and allocation rates are determined under § 1.401(a)(4)–2(c)(2), but without taking into account the imputation of permitted disparity under § 1.401(a)(4)–7. However, in determining whether the plan has broadly available allocation rates as provided in paragraph (b)(1)(iii) of this section, differences in allocation rates attributable solely to the use of permitted disparity described in § 1.401(l)–2 are disregarded.

(viii) *Examples*. The following examples illustrate the rules in this paragraph (b)(1):

Example 1. (i) Plan M, a defined contribution plan without a minimum service requirement, provides an allocation formula under which allocations are provided to all employees according to the following schedule:

Completed years of service	Allocation rate (in percent)	Ratio of allocation rate for band to allocation rate for immediately preceding band
0–5	3.0	(1)
6–10	4.5	1.50
11–15	6.5	1.44
16–20	8.5	1.31
21–25	10.0	1.18
26 or more	11.5	1.15

[1] Not applicable.

(ii) Plan M provides that allocation rates for all employees are determined using a single schedule based solely on service, as described in paragraph (b)(1)(iv)(A)(*1*) of this section. Therefore, if the allocation rates under the schedule increase smoothly at regular intervals as described in paragraph (b)(1)(iv)(A)(*2*) of this section, then the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

(iii) The schedule of allocation rates under Plan M does not increase by more than 5 percentage points between adjacent bands and the ratio of the allocation rate for any band to the allocation rate for the immediately preceding band is never more than 2.0 and does not increase. Therefore, the allocation rates increase smoothly as described in paragraph (b)(1)(iv)(B) of this section. In addition, the bands (other than the highest band) are all 5 years long, so the increases occur at regular intervals as described in paragraph (b)(1)(iv)(C) of this section. Thus, the allocation rates under the plan's schedule increase smoothly at regular intervals as described in paragraph (b)(1)(iv)(A)(*2*) of this section. Accordingly, the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

(iv) Under paragraph (b)(1)(i) of this section, Plan M satisfies the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section, regardless of whether it satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section.

Example 2. (i) The facts are the same as in *Example 1*, except that the 4.5% allocation rate applies for all employees with 10 years of service or less.

(ii) Plan M provides that allocation rates for all employees are determined using a single schedule based solely on service, as described in paragraph (b)(1)(iv)(A)(*1*) of this section. Therefore, if the allocation rates under the schedule increase smoothly at regular intervals as described in paragraph (b)(1)(iv)(A)(*2*) of this section, then the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

(iii) The bands (other than the highest band) in the schedule are not all the same length, since the first band is 10 years long

while other bands are 5 years long. Thus, the schedule does not have regular intervals as described in paragraph (b)(1)(iv)(C) of this section. However, under paragraph (b)(1)(iv)(D) of this section, the schedule of allocation rates does not fail to increase smoothly at regular intervals merely because the minimum allocation rate of 4.5% results in a first band that is longer than the other bands, if either of the conditions of paragraph (b)(1)(iv)(D)(*1*) or (*2*) of this section is satisfied.

(iv) In this case, the schedule of allocation rates satisfies the condition in paragraph (b)(1)(iv)(D)(*1*) of this section because the allocation rates under the plan that are greater than the 4.5% minimum allocation rate can be included in the following hypothetical schedule of allocation rates that increases smoothly at regular intervals and has a lowest allocation rate of at least 1% of plan year compensation:

Completed years of service	Allocation rate (in percent)	Ratio of allocation rate for band to allocation rate for immediately preceding band
0–5	2.5	(1)
6–10	4.5	1.80
11–15	6.5	1.44
16–20	8.5	1.31
21–25	10.0	1.18
26 or more	11.5	1.15

[1] Not applicable.

(v) Accordingly, the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section. Under paragraph (b)(1)(i) of this section, Plan M satisfies the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section, regardless of whether it satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section.

Example 3. (i) Plan N, a defined contribution plan, provides an allocation formula under which allocations are provided to all employees according to the following schedule:

Age	Allocation rate (in percent)	Ratio of allocation rate for band to allocation rate for immediately preceding band
Under 25	3.0	(1)
25–34	6.0	2.00
35–44	9.0	1.50
45–54	12.0	1.33
55–64	16.0	1.33
65 or older	21.0	1.31

[1] Not applicable.

(ii) Plan N provides that allocation rates for all employees are determined using a single schedule based solely on age, as described in paragraph (b)(1)(iv)(A)(*1*) of this section. Therefore, if the allocation rates under the schedule increase smoothly at regular intervals as described in paragraph (b)(1)(iv)(A)(*2*) of this section, then the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

(iii) The schedule of allocation rates under Plan N does not increase by more than 5 percentage points between adjacent bands and the ratio of the allocation rate for any band to the allocation rate for the immediately preceding band is never more than 2.0 and does not increase. Therefore, the allocation rates increase smoothly as described in paragraph (b)(1)(iv)(B) of this section. In addition, the bands (other than the highest band and the first band, which is deemed to be the same length as the other bands because it ends prior to age 25) are all 5 years long, so the increases occur at regular intervals as described in paragraph (b)(1)(iv)(C) of this section. Thus, the allocation rates under the plan's schedule increase smoothly at regular intervals as described in paragraph (b)(1)(iv)(A)(*2*) of this section. Accordingly, the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

(iv) Under paragraph (b)(1)(i) of this section, Plan N satisfies the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section, regardless of whether it satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section.

Example 4. (i) Plan O, a defined contribution plan, provides an allocation formula under which allocations are provided to all employees according to the following schedule:

Age	Allocation rate (in percent)	Ratio of allocation rate for band to allocation rate for immediately preceding band
Under 40	3	(1)
40–44	6	2.00
45–49	9	1.50

Age	Allocation rate (in percent)	Ratio of allocation rate for band to allocation rate for immediately preceding band
50–54	12	1.33
55–59	16	1.33
60–64	20	1.25
65 or older	25	1.25

[1] Not applicable.

(ii) Plan O provides that allocation rates for all employees are determined using a single schedule based solely on age, as described in paragraph (b)(1)(iv)(A)(*1*) of this section. Therefore, if the allocation rates under the schedule increase smoothly at regular intervals as described in paragraph (b)(1)(iv)(A)(*2*) of this section, then the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

(iii) The bands (other than the highest band) in the schedule are not all the same length, since the first band is treated as 15 years long while other bands are 5 years long. Thus, the schedule does not have regular intervals as described in paragraph (b)(1)(iv)(C) of this section. However, under paragraph (b)(1)(iv)(D) of this section, the schedule of allocation rates does not fail to increase smoothly at regular intervals merely because the minimum allocation rate of 3% results in a first band that is longer than the other bands, if either of the conditions of paragraph (b)(1)(iv)(D)(*1*) or (*2*) of this section is satisfied.

(iv) In this case, in order to define a hypothetical schedule that could include the allocation rates in the actual schedule of allocation rates, each of the bands below age 40 would have to be 5 years long (or be treated as 5 years long). Accordingly, the hypothetical schedule would have to provide for a band for employees under age 30, a band for employees in the range 30–34 and a band for employees age 35–39.

(v) The ratio of the allocation rate for the age 40–44 band to the next lower band is 2.0. Accordingly, in order for the applicable allocations rates under this hypothetical schedule to increase smoothly, the ratio of the allocation rate for each band in the hypothetical schedule below age 40 to the allocation rate for the immediately preceding band would have to be 2.0. Thus, the allocation rate for the hypothetical band applicable for employees under age 30 would be .75%, the allocation rate for the hypothetical band for employees in the range 30–34 would be 1.5% and the allocation rate for employees in the range 35–39 would be 3%.

(vi) Because the lowest allocation rate under any possible hypothetical schedule is less than 1% of plan year compensation, Plan O will be treated as satisfying the requirements of paragraphs (b)(1)(iv)(B) and (C) of this section only if the schedule of allocation rates satisfies the steepness condition described in paragraph (b)(1)(iv)(D)(*2*) of this section. In this case, the steepness condition is not satisfied because the equivalent accrual rate for an employee age 39 is 2.81%, but there is no hypothetical employee in the band for ages 40–44 with an equal or lower equivalent accrual rate (since the lowest equivalent accrual rate for hypothetical employees within this band is 3.74% at age 44).

(vii) Since the schedule of allocation rates under the plan does not increase smoothly at regular intervals, Plan O's schedule of allocation rates is not a gradual age or service schedule. Further, Plan O does not provide uniform target benefit allocations. Therefore, under paragraph (b)(1)(i) of this section, Plan O cannot satisfy the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) for the plan year on the basis of benefits unless either Plan O provides for broadly available allocation rates for the plan year as described in paragraph (b)(1)(iii) of this section (i.e., the allocation rate at each age is provided to a group of employees that satisfies section 410(b) without regard to the average benefit percentage test), or Plan O satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section for the plan year.

Example 5. (i) Plan P is a profit-sharing plan maintained by Employer A that covers all of Employer A's employees, consisting of two HCEs, X and Y, and 7 NHCEs. Employee X's compensation is $170,000 and Employee Y's compensation is $150,000. The allocation for Employees X and Y is $30,000 each, resulting in an allocation rate of 17.65% for Employee X and 20% for Employee Y. Under Plan P, each NHCE receives an allocation of 5% of compensation within the meaning of section 415(c)(3), measured over a period of time permitted under the definition of plan year compensation.

(ii) Because the allocation rate for X is not currently available to any NHCE, Plan P does not have broadly available allocation rates within the meaning of paragraph (b)(1)(iii) of this section. Furthermore, Plan P does not provide for age based-allocation rates within the meaning of paragraph (b)(1)(iv) or (v) of this section. Thus, under paragraph (b)(1)(i) of this section, Plan P can satisfy the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) for the plan year on the basis of benefits only if Plan P satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section for the plan year.

(iii) The highest allocation rate for any HCE under Plan P is 20%. Accordingly, Plan P would satisfy the minimum allocation gateway of paragraph (b)(1)(vi) of this section if all NHCEs have an allocation rate of

at least 6.67%, or if all NHCEs receive an allocation of at least 5% of compensation within the meaning of section 415(c)(3) (measured over a period of time permitted under the definition of plan year compensation).

(iv) Under Plan P, each NHCE receives an allocation of 5% of compensation within the meaning of section 415(c)(3) (measured over a period of time permitted under the definition of plan year compensation). Accordingly, Plan P satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section.

(v) Under paragraph (b)(1)(i) of this section, Plan P satisfies the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section.

(2) *Determination of equivalent accrual rates*—(i) *Basic definition*. An employee's equivalent accrual rate for a plan year is the annual benefit that is the result of normalizing the increase in the employee's account balance during the measurement period, divided by the number of years in which the employee benefited under the plan during the measurement period, and expressed either as a dollar amount or as a percentage of the employee's average annual compensation. A measurement period that includes future years may not be used for this purpose.

(ii) *Rules of application*—(A) *Determination of account balance*. The increase in the account balance during the measurement period taken into account under paragraph (b)(2)(i) of this section does not include income, expenses, gains, or losses allocated during the measurement period that are attributable to the account balance as of the beginning of the measurement period, but does include any additional amounts that would have been included in the increase in the account balance but for the fact that they were previously distributed (including a reasonable adjustment for interest). In the case of a measurement period that is the current plan year, an employer may also elect to disregard the income, expenses, gains, and losses allocated during the current plan year that are attributable to the increase in account balance since the beginning of the year, and thus, determine the increase in account balance during the plan year taking into account only the allocations described in §1.401(a)(4)–2(c)(2)(ii). In addition, an employer may disregard distributions made to a NHCE as well as distributions made to any employee in plan years beginning before a selected date no later than January 1, 1986.

(B) *Normalization*. The account balances determined under paragraph (b)(2)(ii)(A) of this section are normalized by treating them as single-sum benefits that are immediately and unconditionally payable to the employee. A standard interest rate, and a straight life annuity factor that is based on the same or a different standard interest rate and on a standard mortality table, must be used in normalizing these benefits. In addition, no mortality may be assumed prior to the employee's testing age.

(iii) *Options*. Any of the optional rules in §1.401(a)(4)–3(d)(3) (e.g., imputation of permitted disparity) may be applied in determining an employee's equivalent accrual rate by substituting the employee's equivalent accrual rate (determined without regard to the option) for the employee's normal accrual rate (i.e., not most valuable accrual rate) in that section where appropriate. For this purpose, however, the last sentence of the fresh-start alternative in §1.401(a)(4)–3(d)(3)(iii)(A) (dealing with compensation adjustments to the frozen accrued benefit) is not applicable. No other options are available in determining an employee's equivalent accrual rate except those (e.g., selection of alternative measurement periods) specifically provided in this paragraph (b)(2). Thus, for example, none of the optional special rules in §1.401(a)(4)–3(f) (e.g., determination of benefits on other than a plan year basis under §1.401(a)(4)–3(f)(6)) is available.

(iv) *Consistency rule*. Equivalent accrual rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same measurement periods and standard interest rates must be used, and any available options must be applied consistently if at all.

(3) *Safe-harbor testing method for target benefit plans*—(i) *General rule*. A target benefit plan is a money purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary

to fund the employee's stated benefit under the plan. Whether a target benefit plan satisfies section 401(a)(4) with respect to an equivalent amount of benefits is generally determined under paragraphs (b)(1) and (b)(2) of this section. A target benefit plan is deemed to satisfy section 401(a)(4) with respect to an equivalent amount of benefits, however, if each of the following requirements is satisfied:

(A) *Stated benefit formula*. Each employee's stated benefit must be determined as the straight life annuity commencing at the employee's normal retirement age under a formula that would satisfy the requirements of §1.401(a)(4)–3(b)(4)(i)(C) (*1*) or (*2*), and that would satisfy each of the uniformity requirements in §1.401(a)(4)–3(b)(2) (taking into account the relevant exceptions provided in §1.401(a)(4)–3(b)(6)), if the plan were a defined benefit plan with the same benefit formula. In determining whether these requirements are satisfied, the rules of §1.401(a)(4)–3(f) do not apply, and, in addition, except as provided in paragraph (b)(3)(vii) of this section, an employee's stated benefit at normal retirement age under the stated benefit formula is deemed to accrue ratably over the period ending with the plan year in which the employee is projected to reach normal retirement age and beginning with the latest of: the first plan year in which the employee benefited under the plan, the first plan year taken into account in the stated benefit formula, and any plan year immediately following a plan year in which the plan did not satisfy this paragraph (b)(3). Thus, except as provided in paragraph (b)(3)(vii) of this section, under §1.401(a)(4)–3(b)(2)(v) an employee's stated benefit may not take into account service in years prior to the first plan year that the employee benefited under the plan, and an employee's stated benefit may not take into account service in plan years prior to the current plan year unless the plan satisfied this paragraph (b)(3) in all of those prior plan years.

(B) *Employer and employee contributions*. Employer contributions with respect to each employee must be based exclusively on the employee's stated benefit using the method provided in paragraph (b)(3)(iv) of this section, and forfeitures and any other amounts under the plan taken into account under §1.401(a)(4)–2(c)(2)(ii) (other than employer contributions) are used exclusively to reduce employer contributions. Employee contributions (if any) may not be used to fund the stated benefit.

(C) *Permitted disparity*. If permitted disparity is taken into account, the stated benefit formula must satisfy §1.401(l)–3. For this purpose, the 0.75-percent factor in the maximum excess or offset allowance in §1.401(l)–3(b)(2)(i) or (b)(3)(i), respectively, as adjusted in accordance with §1.401(l)–3(d)(9) (and, if the employee's normal retirement age is not the employee's social security retirement age, §1.401(l)–3(e)), is further reduced by multiplying the factor by 0.80.

(ii) *Changes in stated benefit formula*. A plan does not fail to satisfy paragraph (b)(3)(i) of this section merely because the plan determines each employee's stated benefit in the current plan year under a stated benefit formula that differs from the stated benefit formula used to determine the employee's stated benefit in prior plan years.

(iii) *Stated benefits after normal retirement age*. A target benefit plan may limit increases in the stated benefit after normal retirement age consistent with the requirements applicable to defined benefit plans under section 411(b)(1)(H) (without regard to section 411(b)(1)(H)(iii)), provided that the limitation applies on the same terms to all employees. Thus, post-normal retirement benefits required under §1.401(a)(4)–3(b)(2)(ii) must be provided under the stated benefit formula, subject to any uniformly applicable service cap under the formula.

(iv) *Method for determining required employer contributions*—(A) *General rule*. An employer's required contribution to the account of an employee for a plan year is determined based on the employee's stated benefit and the amount of the employee's theoretical reserve as of the date the employer's required contribution is determined for the plan

year (the determination date). Paragraph (b)(3)(iv)(B) of this section provides rules for determining an employee's theoretical reserve. Paragraph (b)(3)(iv) (C) and (D) of this section provides rules for determining an employer's required contributions.

(B) *Theoretical reserve—(1) Initial theoretical reserve.* An employee's theoretical reserve as of the determination date for the first plan year in which the employee benefits under the plan, the first plan year taken into account under the stated benefit formula (if that is the current plan year), or the first plan year immediately following any plan year in which the plan did not satisfy this paragraph (b)(3), is zero.

(*2*) *Theoretical reserve in subsequent plan years.* An employee's theoretical reserve as of the determination date for a plan year (other than a plan year described in paragraph (b)(3)(iv)(B)(*1*) of this section) is the employee's theoretical reserve as of the determination date for the prior plan year, plus the employer's required contribution for the prior plan year (as limited by section 415, but without regard to the additional contributions described in paragraph (b)(3)(v) of this section) both increased by interest from the determination date for the prior plan year through the determination date for the current plan year, but not beyond the determination date for the plan year that includes the employee's normal retirement date. (Thus, an employee's theoretical reserve as of the determination date for a plan year does not include the amount of the employer's required contribution for the plan year.) The interest rate for determining employer contributions that was in effect on the determination date in the prior plan year must be applied to determine the required interest adjustment for this period. For plan years beginning after the effective date applicable to the plan under §1.401(a)(4)–13(a) or (b), a standard interest rate must be used, and may not be changed except on the determination date for a plan year.

(C) *Required contributions for employees under normal retirement age.* The required employer contributions with respect to an employee whose attained age is less than the employee's normal retirement age must be determined for each plan year as follows:

(*1*) Determine the employee's fractional rule benefit (within the meaning of §1.411(b)–1(b)(3)(ii)(A)) under the plan's stated benefit formula as if the plan were a defined benefit plan with the same benefit formula.

(*2*) Determine the actuarial present value of the fractional rule benefit determined in paragraph (b)(3)(iv)(C)(*1*) of this section as of the determination date for the current plan year, using a standard interest rate and a standard mortality table that are set forth in the plan and that are the same for all employees, and assuming no mortality before the employee's normal retirement age.

(*3*) Determine the excess, if any, of the amount determined in paragraph (b)(3)(iv)(C)(*2*) of this section over the employee's theoretical reserve for the current plan year determined under paragraph (b)(3)(iv)(B) of this section.

(*4*) Determine the required employer contribution for the current plan year by amortizing on a level annual basis, using the same interest rate used for paragraph (b)(3)(iv)(C)(*2*) of this section, the result in paragraph (b)(3)(iv)(C)(*3*) of this section over the period beginning with the determination date for the current plan year and ending with the determination date for the plan year in which the employee is projected to reach normal retirement age.

(D) *Required contributions for employees over normal retirement age.* The required employer contributions with respect to an employee whose attained age equals or exceeds the employee's normal retirement age is the excess, if any, of the actuarial present value, as of the determination date for the current plan year, of the employee's stated benefit for the current plan year (determined using an immediate straight life annuity factor based on a standard interest rate and a standard mortality table, for an employee whose attained age equals the employee's normal retirement age) over the employee's theoretical reserve as of the determination date.

(v) *Effect of section 415 and 416 requirements.* A target benefit plan does not fail to satisfy this paragraph (b)(3)

merely because required contributions under the plan are limited by section 415 in a plan year. Similarly, a target benefit plan does not fail to satisfy this paragraph (b)(3) merely because additional contributions are made consistent with the requirements of section 416(c)(2) (regardless of whether the plan is top-heavy).

(vi) *Certain conditions on allocations.* A target benefit plan does not fail to satisfy this paragraph (b)(3) merely because required contributions under the plan are subject to the conditions on allocations permitted under §1.401(a)(4)–2(b)(4)(iii).

(vii) *Special rules for target benefit plans qualified under prior law*—(A) S*ervice taken into account prior to satisfaction of this paragraph.* For purposes of determining whether the stated benefit formula satisfies paragraph (b)(3)(i)(A) of this section (e.g., whether the period over which an employee's stated benefit is deemed to accrue is the same as the period taken into account under the stated benefit formula as required by paragraph (b)(3)(i)(A) of this section), a target benefit plan that was adopted and in effect on September 19, 1991, is deemed to have satisfied this paragraph (b)(3), and an employee is treated as benefiting under the plan, in any year prior to the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b) that was taken into account in the stated benefit formula under the plan on September 19, 1991, if the plan satisfied the applicable nondiscrimination requirements for target benefit plans for that prior year.

(B) *Initial theoretical reserve.* Notwithstanding paragraph (b)(3)(iv)(B)(1) of this section, a target benefit plan under which the stated benefit formula takes into account service for an employee for plan years prior to the first plan year in which the plan satisfied this paragraph (b)(3), as permitted under paragraph (b)(3)(vii)(A) of this section, must determine an initial theoretical reserve for the employee as of the determination date for the last plan year beginning before such plan year under the rules of §1.401(a)(4)–13(e).

(C) *Satisfaction of prior law.* In determining whether a plan satisfied the applicable nondiscrimination requirements for target benefit plans for any period prior to the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b), no amendments after September 19, 1991, other than amendments necessary to satisfy section 401(l), are taken into account.

(viii) *Examples.* The following examples illustrate the rules in this paragraph (b)(3):

Example 1. (a) Employer X maintains a target benefit plan with a calendar plan year that bases contributions on a stated benefit equal to 40 percent of each employee's average annual compensation, reduced pro rata for years of participation less than 25, payable annually as a straight life annuity commencing at normal retirement age. The UP–84 mortality table and an interest rate of 7.5 percent are used to calculate the contributions necessary to fund the stated benefit. Required contributions are determined on the last day of each plan year. The normal retirement age under the plan is 65. Employee M is 39 years old in 1994, has participated in the plan for six years, and has average annual compensation equal to $60,000 for the 1994 plan year. Assume that Employee M's theoretical reserve as of the last day of the 1993 plan year is $13,909, determined under §1.401(a)(4)–13(e), and that required employer contributions for 1993 were determined using an interest rate of six percent.

(b) Under these facts, Employer X's 1994 required contribution to fund Employee M's stated benefit is $1,318, calculated as follows:

(1) Employee M's fractional rule benefit is $24,000 (40 percent of Employee M's average annual compensation of $60,000).

(2) The actuarial present value of Employee M's fractional rule benefit as of the last day of the 1994 plan year is $30,960 (Employee M's fractional rule benefit of $24,000 multiplied by 1.290, the actuarial present value factor for an annual straight life annuity commencing at age 65 applicable to a 39-year-old employee, determined using the stated interest rate of 7.5 percent and the UP–84 mortality table, and assuming no mortality before normal retirement age).

(3) The actuarial present value of Employee M's fractional rule benefit ($30,960) is reduced by Employee M's theoretical reserve as of the last day of the 1994 plan year. The theoretical reserve on that day is $14,744—the $13,909 theoretical reserve as of the last day of the 1993 plan year, increased by interest for one year at the rate of six percent. Because the required contribution for the 1993 plan year is taken into account under §1.401(a)(4)–13(e)(2) in determining the theoretical reserve as of the last day of the 1993 plan year, it is not added to the theoretical reserve again in this paragraph (b)(3) of this

Example 1. The resulting difference is $16,216 ($30,960 – $14,744).

(4) The $16,216 excess of the actuarial present value of Employee M's fractional rule benefit over Employee M's theoretical reserve is multiplied by 0.0813, the amortization factor applicable to a 39-year-old employee determined using the stated interest rate of 7.5 percent. The product of $1,318 is the amount of the required employer contribution for Employee M for the 1994 plan year.

Example 2. (a) The facts are the same as in *Example 1,* except that as of January 1, 1995, the plan's stated benefit formula is amended to provide for a stated benefit equal to 45 percent of average annual compensation, reduced pro rata for years of participation less than 25, payable annually as a straight life annuity commencing at normal retirement age. For the 1995 plan year, Employee M's average annual compensation continues to be $60,000. The mortality table used for the calculation of the employer's required contributions remains the same as in the prior plan year, but the plan's stated interest rate is changed to 8.0 percent effective as of December 31, 1995.

(b) Under these facts, Employer X's required contribution for Employee M is $1,290, calculated as follows:

(1) Employee M's fractional rule benefit is $27,000 (45 percent of $60,000).

(2) The actuarial present value of Employee M's fractional rule benefit as of the last day of the 1995 plan year is $32,319 ($27,000 multiplied by 1.197, the actuarial present value factor for an annuity commencing at age 65 applicable to a 40-year-old employee, determined using the stated interest rate of 8.0 percent and the UP–84 mortality table, and assuming no mortality before normal retirement age).

(3) The actuarial present value of Employee M's fractional rule benefit ($32,319) is reduced by Employee M's theoretical reserve as of the last day of the 1995 plan year. The theoretical reserve as of that day is $17,267—the $14,744 theoretical reserve as of the last day of the 1994 plan year plus the $1,318 required contribution for the 1994 plan year, both increased by interest for one year at the rate of 7.5 percent. The resulting difference is $15,052 ($32,319 – $17,267).

(4) The result in paragraph (b)(3) of this *Example 2* is multiplied by 0.0857, the amortization factor applicable to a 40-year-old employee determined using the stated interest rate of 8.0 percent. The product, $1,290, is the amount of the required employer contribution for Employee M for the 1995 plan year.

(c) *Nondiscrimination in amount of contributions under a defined benefit plan*—(1) *General rule.* Equivalent allocations under a defined benefit plan are nondiscriminatory in amount for a plan year if the plan would satisfy §1.401(a)(4)–3(c)(1) (taking into account §1.401(a)(4)–3(c)(3)) for the plan year if an equivalent normal and most valuable allocation rate, as determined under paragraph (c)(2) of this section, were substituted for each employee's normal and most valuable accrual rate, respectively, in the determination of rate groups.

(2) *Determination of equivalent allocation rates*—(i) *Basic definitions.* An employee's equivalent normal and most valuable allocation rates for a plan year are, respectively, the actuarial present value of the increase over the plan year in the benefit that would be taken into account in determining the employee's normal and most valuable accrual rates for the plan year, expressed either as a dollar amount or as a percentage of the employee's plan year compensation. In the case of a contributory DB plan, the rules in §1.401(a)(4)–6(b)(1), (b)(5), or (b)(6) must be used to determine the amount of each employee's employer-provided benefit that would be taken into account for this purpose.

(ii) *Rules for determining actuarial present value.* The actuarial present value of the increase in an employee's benefit must be determined using a standard interest rate and a standard mortality table, and no mortality may be assumed prior to the employee's testing age.

(iii) *Options.* The optional rules in §1.401(a)(4)–2(c)(2)(iv) (imputation of permitted disparity) and (v) (grouping of rates) may be applied to determine an employee's equivalent normal and most valuable allocation rates by substituting those rates (determined without regard to the option) for the employee's allocation rate in that section where appropriate. In addition, the limitations under section 415 may be taken into account under §1.401(a)(4)–3(d)(2)(ii)(B), and qualified disability benefits may be taken into account as accrued benefits under §1.401(a)(4)–3(f)(2), in determining the increase in an employee's accrued benefit during a plan year for purposes of paragraph (c)(2)(i) of this section, if those rules would otherwise be available. No other options are available in determining an employee's equivalent normal and

most valuable allocations rate except those (e.g., selection of alternative standard interest rates) specifically provided in this paragraph (c)(2). Thus, while all of the mandatory rules in §1.401(a)(4)–3(d) and (f) for determining the amount of benefits used to determine an employee's normal and most valuable accrual rates (e.g., the treatment of early retirement window benefits in §1.401(a)(4)–3(f)(4)) are applicable in determining an employee's equivalent normal and most valuable allocation rates, none of the optional rules under §1.401(a)(4)–3 is available (except the options relating to the section 415 limits and qualified disability benefits noted above).

(iv) *Consistency rule*. Equivalent allocation rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same standard interest rates must be used, and any available options must be applied consistently if at all.

(3) *Safe harbor testing method for cash balance plans*—(i) *General rule*. A cash balance plan is a defined benefit plan that defines benefits for each employee by reference to the employee's hypothetical account. An employee's hypothetical account is determined by reference to hypothetical allocations and interest adjustments that are analogous to actual allocations of contributions and earnings to an employee's account under a defined contribution plan. Because a cash balance plan is a defined benefit plan, whether it satisfies section 401(a)(4) with respect to the equivalent amount of contributions is generally determined under paragraphs (c)(1) and (c)(2) of this section. However, a cash balance plan that satisfies each of the requirements in paragraphs (c)(3)(ii) through (xi) of this section is deemed to satisfy section 401(a)(4) with respect to an equivalent amount of contributions.

(ii) *Plan requirements in general*. The plan must be an accumulation plan. The benefit formula under the plan must provide for hypothetical allocations for each employee in the plan that satisfy paragraph (c)(3)(iii) of this section, and interest adjustments to these hypothetical allocations that satisfy paragraph (c)(3)(iv) of this section. The benefit formula under the plan must provide that these hypothetical allocations and interest adjustments are accumulated as a hypothetical account for each employee, determined in accordance with paragraph (c)(3)(v) of this section. The plan must provide that an employee's accrued benefit under the plan as of any date is an annuity that is the actuarial equivalent of the employee's projected hypothetical account as of normal retirement age, determined in accordance with paragraph (c)(3)(vi) of this section. In addition, the plan must satisfy paragraphs (c)(3)(vii) through (xi) of this section (to the extent applicable) regarding optional forms of benefit, past service credits, post-normal retirement age benefits, certain uniformity requirements, and changes in the plan's benefit formula, respectively.

(iii) *Hypothetical allocations*—(A) *In general*. The hypothetical allocations provided under the plan's benefit formula must satisfy either paragraph (c)(3)(iii)(B) or (C) of this section. Paragraph (c)(3)(iii)(B) of this section provides a design-based safe harbor that does not require the annual comparison of hypothetical allocations under the plan. Paragraph (c)(3)(iii)(C) of this section requires the annual comparison of hypothetical allocations.

(B) *Uniform hypothetical allocation formula*. To satisfy this paragraph (c)(3)(iii)(B), the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for all plan years of amounts that would satisfy §1.401(a)(4)–2(b)(3) for each such plan year if the hypothetical allocations were the only allocations under a defined contribution plan for the employees for those plan years. Thus, the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for all plan years that are the same percentage of plan year compensation or the same dollar amount. In determining whether the hypothetical allocations satisfy §1.401(a)(4)–2(b)(3), the only provisions of §1.401(a)(4)–2(b)(5) that apply are §1.401(a)(4)–2(b)(5)(ii) (section 401(l) permitted disparity, (iii) (entry dates), (vi) (certain limits on allocations), and (vii) (dollar allocation per uniform unit of service). Thus, for example, the

plan's benefit formula may take permitted disparity into account in a manner allowed under §1.401(l)–2 for defined contribution plans.

(C) *Modified general test*. To satisfy this paragraph (c)(3)(iii)(C), the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for the plan year that would satisfy the general test in §1.401(a)(4)–2(c) for the plan year, if the hypothetical allocations were the only allocations for the employees taken into account under §1.401(a)(4)–2(c)(2)(ii) under a defined contribution plan for the plan year. In determining whether the hypothetical allocations satisfy §1.401(a)(4)–2(c), the provisions of §1.401(a)(4)–2(c)(2)(iii) through (v) apply. Thus, for example, permitted disparity may be imputed under §1.401(a)(4)–2(c)(2)(iv) in accordance with the rules of §1.401(a)(4)–7(b) applicable to defined contribution plans.

(iv) *Interest adjustments to hypothetical allocations*—(A) *General rule*. The plan benefit formula must provide that the dollar amount of the hypothetical allocation for each employee for a plan year is automatically adjusted using an interest rate that satisfies paragraph (c)(3)(iv)(B) of this section, compounded no less frequently than annually, for the period that begins with a date in the plan year and that ends at normal retirement age. This requirement is not satisfied if any portion of the interest adjustments to a hypothetical allocation are contingent on the employee's satisfaction of any requirement. Thus, for example, the interest adjustments to a hypothetical allocation must be provided through normal retirement age, even though the employee terminates employment or commences benefits before that age.

(B) *Requirements with respect to interest rates*. The interest rate must be a single interest rate specified in the plan that is the same for all employees in the plan for all plan years. The interest rate must be either a standard interest rate or a variable interest rate. If the interest rate is a variable interest rate, it must satisfy paragraph (c)(3)(iv)(C) of this section.

(C) *Variable interest rates*—(*1*) *General rule*. The plan must specify the variable interest rate, the method for determining the current value of the variable interest rate, and the period (not to exceed 1 year) for which the current value of the variable interest rate applies. Permissible variable interest rates are listed in paragraph (c)(3)(iv)(C)(*2*) of this section. Permissible methods for determining the current value of the variable interest rate are provided in paragraph (c)(3)(iv)(C)(*3*) of this section.

(*2*) *Permissible variable interest rates*. The variable interest rate specified in the plan must be one of the following—

(*i*) The rate on 3-month Treasury Bills,

(*ii*) The rate on 6-month Treasury Bills,

(*iii*) The rate on 1-year Treasury Bills,

(*iv*) The yield on 1-year Treasury Constant Maturities,

(*v*) The yield on 2-year Treasury Constant Maturities,

(*vi*) The yield on 5-year Treasury Constant Maturities,

(*vii*) The yield on 10-year Treasury Constant Maturities,

(*viii*) The yield on 30-year Treasury Constant Maturities, or

(*ix*) The single interest rate such that, as of a single age specified in the plan, the actuarial present value of a deferred straight life annuity of an amount commencing at the normal retirement age under the plan, calculated using that interest rate and a standard mortality table but assuming no mortality before normal retirement age, is equal to the actuarial present value, as of the single age specified in the plan, of the same annuity calculated using the section 417(e) rates applicable to distributions in excess of $25,000 (determined under §1.417(e)–1(d)), and the same mortality assumptions.

(*3*) *Current value of variable interest rate*. The current value of the variable interest rate that applies for a period must be either the value of the variable interest rate determined as of a specified date in the period or the immediately preceding period, or the average of the values of the variable interest rate as of two or more specified dates during the current period or the immediately preceding period. The value as of a date of the rate on a Treasury Bill is the average auction

rate for the week or month in which the date falls, as reported in the Federal Reserve Bulletin. The value as of a date of the yield on a Treasury Constant Maturity is the average yield for the week, month, or year in which the date falls, as reported in the Federal Reserve Bulletin. (The Federal Reserve Bulletin is published by the Board of Governors of the Federal Reserve System and is available from Publication Services, Mail Stop 138, Board of Governors of the Federal Reserve System, Washington DC 20551.) The plan may limit the current value of the variable interest rate to a maximum (not less than the highest standard interest rate), or a minimum (not more than the lowest standard interest rate), or both.

(v) *Hypothetical account*—(A) *Current value of hypothetical account.* As of any date, the current value of an employee's hypothetical account must equal the sum of all hypothetical allocations and the respective interest adjustments to each such hypothetical allocation provided through that date for the employee under the plan's benefit formula (without regard to any interest adjustments provided under the plan's benefit formula for periods after that date).

(B) *Value of hypothetical account as of normal retirement age.* Under paragraph (c)(3)(vi) of this section, the value of an employee's hypothetical account must be determined as of normal retirement age in order to determine the employee's accrued benefit as of any date at or before normal retirement age. As of any date at or before normal retirement age, the value of an employee's hypothetical account as of normal retirement age must equal the sum of each hypothetical allocation provided through that date for the employee under the plan's benefit formula, plus the interest adjustments provided through normal retirement age on each of those hypothetical allocations for the employee under the plan's benefit formula (without regard to any hypothetical allocations that might be provided after that date under the plan's benefit formula). If the interest rate specified in the plan is a variable interest rate, the plan must specify that the determination in the preceding sentence is made by assuming that the current value of the variable interest rate for all future periods is either the current value of the variable interest rate for the current period or the average of the current values of the variable interest rate for the current period and one or more periods immediately preceding the current period (not to exceed 5 years in the aggregate).

(vi) *Determination of accrued benefit*—(A) *Definition of accrued benefit.* The plan must provide that at any date at or before normal retirement age the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) of each employee in the plan is an annuity commencing at normal retirement age that is the actuarial equivalent of the employee's hypothetical account as of normal retirement age (as determined under paragraph (c)(3)(v)(B) of this section). The separate benefit that each employee accrues for a plan year is an annuity that is the actuarial equivalent of the employee's hypothetical allocation for that plan year, including the automatic adjustments for interest through normal retirement age required under paragraph (c)(3)(iv) of this section.

(B) *Normal form of benefit.* The annuity specified in paragraph (c)(3)(vi)(A) of this section must provide an annual benefit payable in the same form at the same uniform normal retirement age for all employees in the plan. The annual benefit must be the normal retirement benefit under the plan (within the meaning of section 411(a)(9)) under the plan.

(C) *Determination of actuarial equivalence.* For purposes of this paragraph (c)(3)(vi) and paragraph (c)(3)(ix) of this section, actuarial equivalence must be determined using a standard mortality table and either a standard interest rate or the interest rate specified in the plan for making interest adjustments to hypothetical allocations. If the interest rate used is the interest rate specified in the plan, and that rate is a variable interest rate, the assumed value of the variable interest rate for all future periods must be the same value that would be assumed for purposes of paragraph (c)(3)(v)(B) of this

section. The same actuarial assumptions must be used for all employees in the plan.

(D) *Effect of section 415 and 416 requirements.* A plan does not fail to satisfy this paragraph (c)(3)(vi) merely because the accrued benefits under the plan are limited by section 415, or merely because the accrued benefits under the plan are the greater of the accrued benefits otherwise determined under the plan and the minimum benefit described in section 416(c)(1) (regardless of whether the plan is top-heavy).

(vii) *Optional forms of benefit*—(A) *In general.* The plan must satisfy the uniform subsidies requirement of §1.401(a)(4)–3(b)(2)(iv) with respect to all subsidized optional forms of benefit.

(B) *Limitation on subsidies.* Unless hypothetical allocations are determined under a uniform hypothetical allocation formula that satisfies paragraph (c)(3)(iii)(B) of this section, the actuarial present value of any QJSA provided under the plan must not be greater than the single sum distribution to the employee that would satisfy paragraph (c)(3)(vii)(C) of this section assuming that it was distributed to the employee on the date of commencement of the QJSA.

(C) *Distributions subject to section 417(e).* Except as otherwise required under section 415(b), if the plan provides for a distribution alternative that is subject to the interest rate restrictions under section 417(e), the actuarial present value of the benefit paid to an employee under the distribution alternative must equal the nonforfeitable percentage (determined under the plan's vesting schedule) of the greater of the following two amounts—

(*1*) The current value of the employee's hypothetical account as of the date the distribution commences, calculated in accordance with paragraph (c)(3)(v)(A) of this section.

(*2*) The actuarial present value (calculated in accordance with §1.417(e)–1(d)) of the employee's accrued benefit.

(D) *Determination of actuarial present value.* For purposes of this paragraph (c)(3)(vii), actuarial present value must be determined using a reasonable interest rate and mortality table. A standard interest rate and a standard mortality table are considered reasonable for this purpose.

(viii) *Past service credit.* The benefit formula under the plan may not provide for hypothetical allocations in the curent plan year that are attributable to years of service before the current plan year, unless each of the following requirements is satisfied—

(A) The years of past service credit are granted on a uniform basis to all current employees in the plan.

(B) Hypothetical allocations for the current plan year are determined under a uniform hypothetical allocation formula that satisfies paragraph (c)(3)(iii)(B) of this section.

(C) The hypothetical allocations attributable to the years of past service would have satisfied the uniform hypothetical allocation formula requirement of paragraph (c)(3)(iii)(B) of this section, and the interest adjustments to those hypothetical allocations would have satisfied paragraph (c)(3)(iv)(A) of this section, if the plan provision granting past service had been in effect for the entire period for which years of past service are granted to any employee. In order to satisfy this requirement, the hypothetical allocation attributable to a year of past service must be adjusted for interest in accordance with paragraph (c)(3)(iv) of this section for the period (including the retroactive period) beginning with the year of past service to which the hypothetical allocation is attributable and ending at normal retirement age. If the interest rate specified in the plan is a variable interest rate, the interest adjustments for the period prior to the current plan year either must be based on the current value of the variable interest rate for the period in which the grant of past service first becomes effective or must be reconstructed based on the then current value of the variable interest rate that would have applied during each prior period.

(ix) *Employees beyond normal retirement age.* In the case of an employee who commences receipt of benefits after normal retirement age, the plan must provide that interest adjustments continue to be made to an employee's hypothetical account until the employee's benefit commencement date. In the case of an employee described in

the previous sentence, the employee's accrued benefit is defined as an annuity that is the actuarial equivalent of the employee's hypothetical account determined in accordance with paragraph (c)(3)(v)(A) of this section as of the date of benefit commencement.

(x) *Additional uniformity requirements.* In addition to any uniformity requirements provided elsewhere in this paragraph (c)(3), the plan must satisfy the uniformity requirements in §1.401(a)(4)–3(b)(2)(v) (uniform vesting and service requirements) and (vi) (no employee contributions). A plan does not fail to satisfy the uniformity requirements of this paragraph (c)(3)(x) or any other uniformity requirement provided in this paragraph (c)(3) merely because the plan contains one or more of the provisions described in §1.401(a)(4)–3(b)(8)(iv) (prior vesting schedules), (v) (certain conditions on accruals), or (xi) (multiple definitions of service).

(xi) *Changes in benefit formula, allocation formula, or interest rates.* A plan does not fail to satisfy this paragraph (c)(3) merely because the plan is amended to change the benefit formula, hypothetical allocation formula, or the interest rate used to adjust hypothetical allocations for plan years after a fresh-start date, provided that the accrued benefits for plan years beginning after the fresh-start date are determined in accordance with §1.401(a)(4)–13(c), as modified by §1.401(a)(4)–13(f).

(d) *Safe-harbor testing method for defined benefit plans that are part of a floor-offset arrangement*—(1) *General rule.* A defined benefit plan that is part of a floor-offset arrangement is deemed to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)–1(b)(2) if all of the following requirements are satisfied:

(i) Under the floor-offset arrangement, the accrued benefit (as defined in section 411(a)(7)(A)(i)) that would otherwise be provided to an employee under the defined benefit plan must be reduced solely by the actuarial equivalent of all or part of the employee's account balance attributable to employer contributions under a defined contribution plan maintained by the same employer (plus the actuarial equivalent of all or part of any prior distributions from that portion of the account balance). If any portion of the benefit that is being offset is nonforfeitable, that portion may be offset only by a benefit (or portion of a benefit) that is also nonforfeitable. In determining the actuarial equivalent of amounts provided under the defined contribution plan, an interest rate no higher than the highest standard interest rate must be used, and no mortality may be assumed in determining the actuarial equivalent of any prior distributions from the defined contribution plan or for periods prior to the benefit commencement date under the defined benefit plan.

(ii) The defined benefit plan may not be a contributory DB plan (unless it satisfies §1.401(a)(4)–6(b)(6)), and benefits under the defined benefit plan may not be reduced by any portion of the employee's account balance under the defined contribution plan (or prior distributions from that account) that are attributable to employee contributions.

(iii) The defined benefit plan and the defined contribution plan must benefit the same employees.

(iv) The offset under the defined benefit plan must be applied to all employees on the same terms.

(v) All employees must have available to them under the defined contribution plan the same investment options and the same options with respect to the timing of preretirement distributions.

(vi) The defined benefit plan must satisfy the uniformity requirements of §1.401(a)(4)–3(b)(2) and the unit credit safe harbor in §1.401(a)(4)–3(b)(3) without taking into account the offset described in paragraph (d)(1)(i) of this section (i.e., on a gross-benefit basis), and the defined contribution plan must satisfy any of the tests in §1.401(a)(4)–2(b) or (c). Alternatively, the defined benefit plan must satisfy any of the tests in §1.401(a)(4)–3(b) or (c) without taking into account the offset described in paragraph (d)(1)(i) of this section, and the defined contribution plan must satisfy the uniform allocation safe harbor in §1.401(a)(4)–2(b)(2).

(vii) The defined contribution plan may not be a section 401(k) plan or a section 401(m) plan.

(2) *Application of safe-harbor testing method to qualified offset arrangements.* A defined benefit plan that is part of a qualified offset arrangement as defined in section 1116(f)(5) of the Tax Reform Act of 1986, Public Law No. 99–514, is deemed to satisfy the requirements of paragraph (d)(1)(vi) and (vii) of this section, if the only defined contribution plans included in the qualified offset arrangement are section 401(k) plans, section 401(m) plans, or both, and the defined benefit plan would satisfy the requirements of paragraph (d)(1)(vi) of this section assuming the elective contributions for each employee under the defined contribution plan were the same (either as a dollar amount or as a percentage of compensation) for all plan years since the establishment of the plan.

[T.D. 8360, 56 FR 47580, Sept. 19, 1991; 57 FR 4720, Feb. 7, 1992; 57 FR 10952, 10953, Mar. 31, 1992, as amended by T.D. 8485, 58 FR 46807, Sept. 3, 1993; T.D. 8954, 66 FR 34540, June 29, 2001]

§ 1.401(a)(4)–9 Plan aggregation and restructuring.

(a) *Introduction.* Two or more plans that are permissively aggregated and treated as a single plan under §§ 1.410(b)–7(d) must also be treated as a single plan for purposes of section 401(a)(4). See § 1.401(a)(4)–12 (definition of plan). An aggregated plan is generally tested under the same rules applicable to single plans. Paragraph (b) of this section, however, provides special rules for determining whether a plan that consists of one or more defined contribution plans and one or more defined benefit plans (a DB/DC plan) satisfies section 401(a)(4) with respect to the amount of employer-provided benefits and the availability of benefits, rights, and features. Paragraph (c) of this section provides rules allowing a plan to be treated as consisting of separate component plans and allowing the component plans to be tested separately under section 401(a)(4).

(b) *Application of nondiscrimination requirements to DB/DC plans*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, whether a DB/DC plan satisfies section 401(a)(4) is determined using the same rules applicable to a single plan. In addition, paragraph (b)(3) of this section provides an optional rule for demonstrating nondiscrimination in availability of benefits, rights, and features provided under a DB/DC plan.

(2) *Special rules for demonstrating nondiscrimination in amount of contributions or benefits*—(i) *Application of general tests.* A DB/DC plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits for a plan year if it would satisfy § 1.401(a)(4)–3(c)(1) (without regard to the special rule in § 1.401(a)(4)–3(c)(3)) for the plan year if an employee's aggregate normal and most valuable allocation rates, as determined under paragraph (b)(2)(ii)(A) of this section, or an employee's aggregate normal and most valuable accrual rates, as determined under paragraph (b)(2)(ii)(B) of this section, were substituted for each employee's normal and most valuable accrual rates, respectively, in the determination of rate groups.

(ii) *Determination of aggregate rates*—(A) *Aggregate allocation rates.* An employee's aggregate normal and most valuable allocation rates are determined by treating all defined contribution plans that are part of the DB/DC plan as a single plan, and all defined benefit plans that are part of the DB/DC plan as a separate single plan; and determining an allocation rate and equivalent normal and most valuable allocation rates for the employee under each plan under §§ 1.401(a)(4)–2(c)(2) and 1.401(a)(4)–8(c)(2), respectively. The employee's aggregate normal allocation rate is the sum of the employee's allocation rate and equivalent normal allocation rate determined in this manner, and the employee's aggregate most valuable allocation rate is the sum of the employee's allocation rate and equivalent most valuable allocation rate determined in this manner.

(B) *Aggregate accrual rates.* An employee's aggregate normal and most valuable accrual rates are determined by treating all defined contribution plans that are part of the DB/DC plan as a single plan, and all defined benefit plans that are part of the DB/DC plan as a separate single plan; and determining an equivalent accrual rate and normal and most valuable accrual

rates for the employee under each plan under §§1.401(a)(4)–8(b)(2) and 1.401(a)(4)–3(d), respectively. The employee's aggregate normal accrual rate is the sum of the employee's equivalent accrual rate and the normal accrual rate determined in this manner, and the employee's aggregate most valuable accrual rate is the sum of the employee's equivalent accrual rate and most valuable accrual rate determined in this manner.

(iii) *Options applied on an aggregate basis.* The optional rules in §1.401(a)(4)–2(c)(2)(iv) (imputation of permitted disparity) and (v) (grouping of rates) may not be used to determine an employee's allocation or equivalent allocation rate, but may be applied to determine an employee's aggregate normal and most valuable allocation rates by substituting those rates (determined without regard to the option) for the employee's allocation rate in that section where appropriate. The optional rules in §1.401(a)(4)–3(d)(3) (e.g., imputation of permitted disparity) may not be used to determine an employee's accrual or equivalent accrual rate, but may be applied to determine an employee's aggregate normal and most valuable accrual rate by substituting those rates (determined without regard to the option) for the employee's normal and most valuable accrual rates, respectively, in that section where appropriate.

(iv) *Consistency rule*—(A) *General rule.* Aggregate normal and most valuable allocation rates and aggregate normal and most valuable accrual rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same measurement periods and interest rates must be used, and any available options must be applied consistently, if at all, for the entire DB/DC plan. Consequently, options that are not permitted to be used under §1.401(a)(4)–8 in cross-testing a defined contribution plan or a defined benefit plan (such as measurement periods that include future periods, non-standard interest rates, the option to disregard compensation adjustments described in §1.401(a)(4)–13(d), or the option to disregard plan provisions providing for actuarial increases after normal retirement age under §1.401(a)(4)–3(f)(3)) may not be used in testing a DB/DC plan on either a benefits or contributions basis, because their use would inevitably result in inconsistent determinations under the defined contribution and defined benefit portions of the plan.

(B) *Exception for section 415 alternative.* A DB/DC plan does not fail to satisfy the consistency rule in paragraph (b)(2)(iv)(A) of this section merely because the limitations under section 415 are not taken into account, or may not be taken into account, under §1.401(a)(4)–3(d)(2)(ii)(B) in determining employees' accrual or equivalent allocation rates under the defined benefit portion of the plan, even though those limitations are applied in determining employees' allocation and equivalent accrual rates under the defined contribution portion of the plan.

(v) *Eligibility for testing on a benefits basis*—(A) *General rule.* For plan years beginning on or after January 1, 2002, unless, for the plan year, a DB/DC plan is primarily defined benefit in character (within the meaning of paragraph (b)(2)(v)(B) of this section) or consists of broadly available separate plans (within the meaning of paragraph (b)(2)(v)(C) of this section), the DB/DC plan must satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section for the plan year in order to be permitted to demonstrate satisfaction of the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits.

(B) *Primarily defined benefit in character.* A DB/DC plan is primarily defined benefit in character if, for more than 50% of the NHCEs benefitting under the plan, the normal accrual rate for the NHCE attributable to benefits provided under defined benefit plans that are part of the DB/DC plan exceeds the equivalent accrual rate for the NHCE attributable to contributions under defined contribution plans that are part of the DB/DC plan.

(C) *Broadly available separate plans.* A DB/DC plan consists of broadly available separate plans if the defined contribution plan and the defined benefit plan that are part of the DB/DC plan each would satisfy the requirements of

section 410(b) and the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) if each plan were tested separately and assuming that the average benefit percentage test of §1.410(b)–5 were satisfied. For this purpose, all defined contribution plans that are part of the DB/DC plan are treated as a single defined contribution plan and all defined benefit plans that are part of the DB/DC plan are treated as a single defined benefit plan. In addition, if permitted disparity is used for an employee for purposes of satisfying the separate testing requirement of this paragraph (b)(2)(v)(C) for plans of one type, it may not be used in satisfying the separate testing requirement for plans of the other type for the employee.

(D) *Minimum aggregate allocation gateway—(1) General rule.* A DB/DC plan satisfies the minimum aggregate allocation gateway if each NHCE has an aggregate normal allocation rate that is at least one third of the aggregate normal allocation rate of the HCE with the highest such rate (HCE rate), or, if less, 5% of the NHCE's compensation, provided that the HCE rate does not exceed 25% of compensation. If the HCE rate exceeds 25% of compensation, then the aggregate normal allocation rate for each NHCE must be at least 5% increased by one percentage point for each 5-percentage-point increment (or portion thereof) by which the HCE rate exceeds 25% (e.g., the NHCE minimum is 6% for an HCE rate that exceeds 25% but not 30%, and 7% for an HCE rate that exceeds 30% but not 35%).

(*2*) *Deemed satisfaction.* A plan is deemed to satisfy the minimum aggregate allocation gateway of this paragraph (b)(2)(v)(D) if the aggregate normal allocation rate for each NHCE is at least 7½% of the NHCE's compensation within the meaning of section 415(c)(3), measured over a period of time permitted under the definition of plan year compensation.

(*3*) *Averaging of equivalent allocation rates for NHCEs.* For purposes of this paragraph (b)(2)(v)(D), a plan is permitted to treat each NHCE who benefits under the defined benefit plan as having an equivalent normal allocation rate equal to the average of the equivalent normal allocation rates under the defined benefit plan for all NHCEs benefitting under that plan.

(E) *Determination of rates.* For purposes of this paragraph (b)(2)(v), the normal accrual rate and the equivalent normal allocation rate attributable to defined benefit plans, the equivalent accrual rate attributable to defined contribution plans, and the aggregate normal allocation rate are determined under paragraph (b)(2)(ii) of this section, but without taking into account the imputation of permitted disparity under §1.401(a)(4)–7, except as otherwise permitted under paragraph (b)(2)(v)(C) of this section.

(F) *Examples.* The following examples illustrate the application of this paragraph (b)(2)(v):

Example 1. (i) Employer A maintains Plan M, a defined benefit plan, and Plan N, a defined contribution plan. All HCEs of Employer A are covered by Plan M (at a 1% accrual rate), but are not covered by Plan N. All NHCEs of Employer A are covered by Plan N (at a 3% allocation rate), but are not covered by Plan M. Because Plan M does not satisfy section 410(b) standing alone, Plans M and N are aggregated for purposes of satisfying sections 410(b) and 401(a)(4).

(ii) Because none of the NHCEs participate in the defined benefit plan, the aggregated DB/DC plan is not primarily defined benefit in character within the meaning of paragraph (b)(2)(v)(B) of this section nor does it consist of broadly available separate plans within the meaning of paragraph (b)(2)(v)(C) of this section. Accordingly, the aggregated Plan M and Plan N must satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section in order be permitted to demonstrate satisfaction of the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits.

Example 2. (i) Employer B maintains Plan O, a defined benefit plan, and Plan P, a defined contribution plan. All of the six employees of Employer B are covered under both Plan O and Plan P. Under Plan O, all employees have a uniform normal accrual rate of 1% of compensation. Under Plan P, Employees A and B, who are HCEs, receive an allocation rate of 15%, and participants C, D, E and F, who are NHCEs, receive an allocation rate of 3%. Employer B aggregates Plans O and P for purposes of satisfying sections 410(b) and 401(a)(4). The equivalent normal allocation and normal accrual rates under Plans O and P are as follows:

Employee	Equivalent normal allocation rates for the 1% accural under plan O (defined benefit plan) (in percent)	Equivalent normal accural rates for the 15%/3% allocation under plan P (defined contribution plan) (in percent)
HCE A (age 55)	3.93	3.82
HCE B (age 50)	2.61	5.74
C (age 60)	5.91	.51
D (age 45)	1.74	1.73
E (age 35)	.77	3.90
F (age 25)	.34	8.82

(ii) Although all of the NHCEs benefit under Plan O (the defined benefit plan), the aggregated DB/DC plan is not primarily defined benefit in character because the normal accrual rate attributable to defined benefit plans (which is 1% for each of the NHCEs) is greater than the equivalent accrual rate under defined contribution plans only for Employee C. In addition, because the 15% allocation rate is available only to HCEs, the defined contribution plan cannot satisfy the requirements of §1.401(a)(4)–2 and does not have broadly available allocation rates within the meaning of §1.401(a)(4)–8(b)(1)(iii). Further, the defined contribution plan does not satisfy the minimum allocation gateway of §1.401(a)(4)–8(b)(1)(vi) (3% is less than 1/3 of the 15% HCE rate). Therefore, the defined contribution plan within the DB/DC plan cannot separately satisfy §1.401(a)(4)–1(b)(2) and does not constitute a broadly available separate plan within the meaning of paragraph (b)(2)(v)(C) of this section. Accordingly, the aggregated plans are permitted to demonstrate satisfaction of the nondiscrimination in amounts requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits only if the aggregated plans satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section.

(iii) Employee A has an aggregate normal allocation rate of 18.93% under the aggregated plans (3.93% from Plan O plus 15% from Plan P), which is the highest aggregate normal allocation rate for any HCE under the plans. Employee F has an aggregate normal allocation rate of 3.34% under the aggregated plans (.34% from Plan O plus 3% from Plan P) which is less than the 5% aggregate normal allocation rate that Employee F would be required to have to satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section.

(iv) However, for purposes of satisfying the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section, Employer B is permitted to treat each NHCE who benefits under Plan O (the defined benefit plan) as having an equivalent allocation rate equal to the average of the equivalent allocation rates under Plan O for all NHCEs benefitting under that plan. The average of the equivalent allocation rates for all of the NHCEs under Plan O is 2.19% (the sum of 5.91%, 1.74%, .77%, and .34%, divided by 4). Accordingly, Employer B is permitted to treat all of the NHCEs as having an equivalent allocation rate attributable to Plan O equal to 2.19%. Thus, all of the NHCEs can be treated as having an aggregate normal allocation rate of 5.19% for this purpose (3% from the defined contribution plan and 2.19% from the defined benefit plan) and the aggregated DB/DC plan satisfies the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section.

(3) *Optional rules for demonstrating nondiscrimination in availability of certain benefits, rights, and features*—(i) *Current availability*. A DB/DC plan is deemed to satisfy §1.401(a)(4)–4(b)(1) with respect to the current availability of a benefit, right, or feature other than a single sum benefit, loan, ancillary benefit, or benefit commencement date (including the availability of in-service withdrawals), that is provided under only one type of plan (defined benefit or defined contribution) included in the DB/DC plan, if the benefit, right, or feature is currently available to all NHCEs in all plans of the same type as the plan under which it is provided.

(ii) *Effective availability*. The fact that it may be difficult or impossible to provide a benefit, right, or feature described in paragraph (b)(3)(i) of this section under a plan of a different type than the plan or plans under which it is provided is one of the factors taken into account in determining whether the plan satisfies the effective availability requirement of §1.401(a)(4)–4(c)(1).

(c) *Plan restructuring*—(1) *General rule*. A plan may be treated, in accordance with this paragraph (c), as consisting of two or more component plans for purposes of determining whether the plan satisfies section 401(a)(4). If each of the component plans of a plan satisfies all of the requirements of sections 401(a)(4) and 410(b) as if it were a separate plan, then the plan is treated as satisfying section 401(a)(4).

(2) *Identification of component plans*. A plan may be restructured into component plans, each consisting of all the allocations, accruals, and other benefits, rights, and features provided to a

selected group of employees. The employer may select the group of employees used for this purpose in any manner, and the composition of the groups may be changed from plan year to plan year. Every employee must be included in one and only one component plan under the same plan for a plan year.

(3) *Satisfaction of section 401(a)(4) by a component plan*—(i) *General rule*. The rules applicable in determining whether a component plan satisfies section 401(a)(4) are the same as those applicable to a plan. Thus, for this purpose, any reference to a plan in section 401(a)(4) and the regulations thereunder (other than this paragraph (c)) is interpreted as a reference to a component plan. As is true for a plan, whether a component plan satisfies the uniformity and other requirements applicable to safe harbor plans under §§1.401(a)(4)–2(b) and 1.401(a)(4)–3(b) is determined on a design basis. Thus, for example, plan provisions are not disregarded merely because they do not currently apply to employees in the component plan if they will apply to those employees as a result of the mere passage of time.

(ii) *Restructuring not available for certain testing purposes*. The safe harbor in §1.401(a)(4)–2(b)(3) for plans with uniform points allocation formulas is not available in testing (and thus cannot be satisfied by) contributions under a component plan. Similarly, component plans cannot be used for purposes of determining whether a plan provides broadly available allocation rates (as defined in §1.401(a)(4)–8(b)(1)(iii)), determining whether a plan has a gradual age or service schedule (as defined in §1.401(a)(4)–8(b)(1)(iv)), determining whether a plan has allocation rates that are based on a uniform target benefit allocation (as defined in §1.401(a)(4)–8(b)(1)(v)), or determining whether a plan is primarily defined benefit in character or consists of broadly available separate plans (as defined in paragraphs (b)(2)(v)(B) and (C) of this section). In addition, the minimum allocation gateway of §1.401(a)(4)–8(b)(1)(vi) and the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section cannot be satisfied on the basis of component plans. See §§1.401(k)–1(b)(3)(iii) and 1.401(m)–1(b)(3)(iii) for rules regarding the inapplicability of restructuring to section 401(k) plans and section 401(m) plans.

(4) *Satisfaction of section 410(b) by a component plan*—(i) *General rule*. The rules applicable in determining whether a component plan satisfies section 410(b) are generally the same as those applicable to a plan. However, a component plan is deemed to satisfy the average benefit percentage test of §1.410(b)–5 if the plan of which it is a part satisfies §1.410(b)–5 (without regard to §1.410(b)–5(f)). In the case of a component plan that is part of a plan that relies on §1.410(b)–5(f) to satisfy the average benefit percentage test, the component plan is deemed to satisfy the average benefit percentage test only if the component plan separately satisfies §1.410(b)–5(f). In addition, all component plans of a plan are deemed to satisfy the average benefit percentage test if the plan makes an early retirement window benefit (within the meaning of §1.401(a)(4)–3(f)(4)(iii)) currently available (within the meaning of §1.401(a)(4)–3(f)(4)(ii)(A)) to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test), and if it would not be necessary for the plan or any rate group or component plan of the plan to satisfy that test in order for the plan to satisfy sections 401(a)(4) and 410(b) in the absence of the early retirement window benefit.

(ii) *Relationship to satisfaction of section 410(b) by the plan*. Satisfaction of section 410(b) by a component plan is relevant solely for purposes of determining whether the plan of which it is a part satisfies section 401(a)(4), and not for purposes of determining whether the plan satisfies section 410(b) itself. The plan must still independently satisfy section 410(b) in order to be a qualified plan. Similarly, satisfaction of section 410(b) by a plan is relevant solely for purposes of determining whether the plan, and not the component plan, satisfies section 410(b). Thus, for example, a component plan that does not satisfy the ratio percentage test of §1.410(b)–2(b)(2) must still satisfy the average benefit test of §1.410(b)–2(b)(3), even though the plan

of which it is a part satisfies the ratio percentage test.

(5) *Effect of restructuring under other sections.* The restructuring rules provided in this paragraph (c) apply solely for purposes of sections 401(a)(4) and 401(l), and those portions of sections 410(b), 414(s), and any other provisions that are specifically applicable in determining whether the requirements of section 401(a)(4) are satisfied. Thus, for example, a component plan is not treated as a separate plan under section 401(a)(26).

(6) *Examples.* The following examples illustrate the rules in this paragraph (c):

Example 1. Employer X maintains a defined benefit plan. The plan provides a normal retirement benefit equal to 1.0 percent of average annual compensation times years of service to employees at Plant S, and 1.5 percent of average annual compensation times years of service to employees at Plant T. Under paragraph (c)(2) of this section, the plan may be treated as consisting of two component defined benefit plans, one providing retirement benefits equal to 1.0 percent of average annual compensation times years of service to the employees at Plant S, and another providing benefits equal to 1.5 percent of average annual compensation times years of service to employees at Plant T. If each component plan satisfies sections 401(a)(4) and 410(b) as if it were a separate plan under the rules of this paragraph (c), then the entire plan satisfies section 401(a)(4).

Example 2. (a) Employer Y maintains Plan A, a defined benefit plan, for its Employees M, N, O, P, Q, and R. Plan A provides benefits under a uniform formula that satisfies the requirements of §1.401(a)(4)–3 (b)(2) and (b)(3) before it is amended on February 14, 1994. The amendment provides an early retirement window benefit that is a subsidized optional form of benefit under §1.401(a)(4)–3(b)(2)(iii) and that is available on the same terms to all employees who satisfy the eligibility requirements for the window. The early retirement window benefit is available only to employees who retire between June 1, 1994, and November 30, 1994.

(b) Assume that Employees M, N, and O will be eligible to receive the window benefit by the end of the window period and Employees P, Q, and R will not. Because substantially all employees will not satisfy the eligibility requirements for the early retirement window benefit by the close of the early retirement window benefit period, Plan A fails to satisfy the uniform subsidies requirement of §1.401(a)(4)–3(b)(2)(iii). See §1.401(a)(4)–3(b)(2)(vi), *Example 6*.

(c) Under paragraph (c)(2) of this section, Employees M, N, O, P, Q, and R may be grouped into two component plans, one consisting of Employees M, N, and O, and all their accruals and other benefits, rights, and features under the plan (including the early retirement window benefit), and another consisting of Employees P, Q, and R, and all their accruals and other benefits, rights, and features under the plan. Each of the component plans identified in this manner satisfies the uniform subsidies requirement of §1.401(a)(4)–3(b)(2)(iii), and thus satisfies §1.401(a)(4)–3(b). The entire plan satisfies section 401(a)(4) under the rules of this paragraph (c), if each of these component plans also satisfies section 410(b) as if it were a separate plan (including, if applicable, the reasonable classification requirement of §1.410(b)–4(b), and taking into account the special rule of paragraph (c)(4)(i) of this section that forgives the average benefit percentage test in certain situations in which the average benefit percentage test would be required solely as a result of the early retirement window benefit).

Example 3. (a) Employer Z maintains Plan B, a defined benefit plan with a benefit formula that provides two percent of average annual compensation for each year of service up to 20 to each employee. Assume that Plan B would satisfy the fractional accrual rule safe harbor in §1.401(a)(4)–3(b)(4), except that some employees accrue a portion of their normal retirement benefit in the current plan year that is more than one-third larger than the portion of the same benefit accrued by other employees for the current plan year, and the plan therefore fails to satisfy the one-third-larger requirement of §1.401(a)(4)–3(b)(4)(i)(C)(*1*).

(b) Employer Z restructures Plan B into two plans, one covering employees with 30 years or less of service at normal retirement age, and the other covering all other employees. Each component plan would separately satisfy the one-third-larger requirement of §1.401(a)(4)–3(b)(4)(i)(C)(*1*) if the only employees taken into account were those employees included in the component plan in the current plan year. Under paragraph (c)(3)(i) of this section and §1.401(a)(4)–3(b)(4)(i)(C)(*1*), however, the component plans do not satisfy the one-third-larger requirement because the safe harbor determination is made taking into account the effect of the plan benefit formula on any potential employee in the component plan (other than employees with more than 33 years of service at normal retirement age), and not just those employees included in the component plan in the current plan year.

[T.D. 8485, 58 FR 46810, Sept. 3, 1993, as amended by T.D. 8954, 66 FR 34544, June 29, 2001]

§ 1.401(a)(4)–10 Testing of former employees.

(a) *Introduction.* This section provides rules for determining whether a plan satisfies the nondiscriminatory amount and nondiscriminatory availability requirements of § 1.401(a)(4)–1(b)(2) and (3), respectively, with respect to former employees. Generally, this section is relevant only in the case of benefits provided through an amendment to the plan effective in the current plan year. See the definitions of employee and former employee in § 1.401(a)(4)–12.

(b) *Nondiscrimination in amount of contributions or benefits*—(1) *General rule.* A plan satisfies § 1.401(a)(4)–1(b)(2) with respect to the amount of contributions or benefits provided to former employees if, under all of the relevant facts and circumstances, the amount of contributions or benefits provided to former employees does not discriminate significantly in favor of former HCEs. For this purpose, contributions or benefits provided to former employees includes all contributions or benefits provided to former employees or, at the employer's option, only those contributions or benefits arising out of the amendment providing the contributions or benefits. A plan under which no former employee currently benefits (within the meaning of § 1.410(b)–3(b)) is deemed to satisfy this paragraph (b).

(2) *Permitted disparity.* Section 401(l) and § 1.401(a)(4)–7 generally apply to benefits provided to former employees in the same manner as those provisions apply to employees. Thus, for example, for purposes of determining a former employee's cumulative permitted disparity limit, the sum of the former employee's total annual disparity fractions (within the meaning of § 1.401(l)–5) as an employee continues to be taken into account. However, the permitted disparity rate applicable to a former employee is determined under § 1.401(l)–3(e) as of the age the former employee commenced receipt of benefits, not as of the date the employee receives the accrual for the current plan year.

(3) *Examples.* The following examples illustrate the rules in this paragraph (b):

Example 1. Employer X maintains a section 401(l) plan, Plan A, that uses maximum permitted disparity. Plan A is amended to increase the benefits of all former employees in pay status. The percentage increase for each former employee is reasonably comparable to the adjustment in social security benefits under section 215(i)(2)(A) of the Social Security Act since the former employee commenced receipt of benefits. Plan A does not fail to satisfy this paragraph (b) merely because of the amendment.

Example 2. The facts are the same as in *Example 1,* except that the amendment provides an across-the-board 20 percent increase in benefits for all former employees in pay status. The cost of living has increased at an average rate of three percent in the two years preceding the amendment, and some HCEs have retired and become former HCEs during that period. Because this amendment increases the disparity in the plan formula beyond the maximum permitted disparity adjusted for any reasonable approximation of the increase in the cost of living since the HCEs retired, Plan A discriminates significantly in favor of former HCEs, and thus does not satisfy this paragraph (b).

Example 3. The facts are the same as in *Example 1,* except that Plan A is only amended to increase the benefits of former employees in pay status who terminated employment with Employer X after attaining early retirement age. The determination of whether the amendment causes Plan A to fail to satisfy this paragraph (b) must take into account the relative numbers of former HCEs and former NHCEs who have terminated employment with Employer X after attaining early retirement age.

(c) *Nondiscrimination in availability of benefits, rights, or features.* A plan satisfies section 401(a)(4) with respect to the availability of benefits, rights, and features provided to former employees if any change in the availability of any benefit, right, or feature to any former employee is applied in a manner that, under all of the relevant facts and circumstances, does not discriminate significantly in favor of former HCEs. For purposes of demonstrating that a plan satisfies section 401(a)(4) with respect to the availability of loans provided to former employees, an employer may treat former employees who are parties in interest within the meaning of section 3(14) of the Employee Retirement Income Security Act of 1974 as employees.

[T.D. 8485, 58 FR 46812, Sept. 3, 1993]

§ 1.401(a)(4)–11 Additional rules.

(a) *Introduction.* This section provides additional rules for determining whether a plan satisfies section 401(a)(4). Paragraph (b) of this section provides rules for the treatment of the portion of an employee's accrued benefit or account balance that is attributable to rollovers, transfers between plans, and employee buybacks. Paragraph (c) of this section provides rules regarding vesting. Paragraph (d) of this section provides rules regarding service crediting. Paragraph (e) of this section, regarding family aggregation, and paragraph (f) of this section, regarding governmental plans, are reserved. Paragraph (g) of this section provides rules regarding the extent to which corrective amendments may be made for purposes of section 401(a).

(b) *Rollovers, transfers, and buybacks*—(1) *Rollovers and elective transfers.* The portion of an employee's accrued benefit or account balance under a plan that is attributable to rollover (including direct rollover) contributions to the plan that are described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 408(d)(3), or elective transfers to the plan that are described in § 1.411(d)–4, Q&A–3(b), is not taken into account in determining whether the plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2).

(2) *Other transfers.* [Reserved]

(3) *Employee buybacks*—(i) *Rehired employee buyback of previous service.* An employee's repayment to a plan of a prior distribution from the plan (including reasonable interest from the time of the distribution) that results in the restoration of the employee's accrued benefit under the plan (or the service associated with that accrued benefit) that would otherwise be disregarded in determining the employee's accrued benefit in accordance with section 411 on account of the distribution is not treated as an employee contribution for purposes of §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

(ii) *Make-up of missed employee contributions.* If a contributory DB plan gives all employees who did not make employee contributions for a prior period the right to make the missed contributions at a later date (including reasonable interest from the time of the missed contributions) and, once the contributions have been made, determines benefits under the plan by treating the employee contributions (excluding the interest) as if they were actually made during that prior period, then those contributions must satisfy § 1.401(a)(4)–6(c) as if they were employee contributions actually made during that prior period. Thus, for example, § 1.401(a)(4)–6(c)(2) is not satisfied for the current plan year if the employee contribution rate (within the meaning of § 1.401(a)(4)–6(b)(2)(ii)(A) but determined without regard to the interest) for the employees making up missed contributions is different than the employee contribution rate applicable to other employees during the prior period. The rule in this paragraph (b)(3)(ii) may be extended to employees who did not make employee contributions for a period of service that is or would otherwise have been credited under the plan and that preceded their participation in the plan.

(c) *Vesting*—(1) *General rule.* A plan satisfies this paragraph (c) if the manner in which employees vest in their accrued benefits under the plan does not discriminate in favor of HCEs. Whether the manner in which employees vest in their accrued benefits under a plan discriminates in favor of HCEs is determined under this paragraph (c) based on all of the relevant facts and circumstances, taking into account any relevant provisions of sections 401(a)(5)(E), 411(a)(10), 411(d)(1), 411(d)(2), 411(d)(3), 411(e), and 420(c)(2), and taking into account any plan provisions that affect the nonforfeitability of employees' accrued benefits (e.g., plan provisions regarding suspension of benefits permitted under section 411(a)(3)(B)), other than the method of crediting years of service for purposes of applying the vesting schedule provided in the plan.

(2) *Deemed equivalence of statutory vesting schedules.* For purposes of this paragraph (c), the manner in which employees vest in their accrued benefits under the vesting schedules in section 411(a)(2) (A) and (B) are treated as equivalent to one another, and the manner in which employees vest in their accrued benefits under the vesting schedules in section 416(b)(1) (A)

and (B) are treated as equivalent to one another.

(3) *Safe harbor for vesting schedules.* The manner in which employees vest in their accrued benefits under a plan is deemed not to discriminate in favor of HCEs if each combination of plan provisions that affect the nonforfeitability of any employee's accrued benefit would satisfy the nondiscriminatory availability requirements of §1.401(a)(4)–4 if that combination were an other right or feature.

(4) *Examples.* The following examples illustrate the rules in this paragraph (c):

Example 1. Plan A provides the six-year graded vesting schedule described in section 416(b)(1)(B). In 1996, Plan A is amended to provide the five-year vesting schedule described in section 411(a)(2)(A). To comply with section 411(a)(10)(B), the plan amendment also provides that all employees with at least three years of service may elect to retain the prior vesting schedule. The manner in which employees vest in their accrued benefits under Plan A does not discriminate in favor of HCEs merely because the prior vesting schedule continues to apply to the accrued benefits of electing employees, even if, at the time of the election or in future years, the prior vesting schedule applies only to a group of employees that does not satisfy section 410(b).

Example 2. The facts are the same as in *Example 1*, except that, for administrative convenience in complying with section 411(a)(10)(B), the plan amendment automatically provides all employees employed on the date of the amendment with the higher of the nonforfeitable percentages determined under either schedule. The manner in which employees vest in their accrued benefits under Plan A does not discriminate in favor of HCEs merely because, for administrative convenience in complying with section 411(a)(10), the amendment exceeds the requirements of section 411(a)(10). The result would be the same if the plan amendment automatically provided the higher of the nonforfeitable percentages only to those employees with at least three years of service.

Example 3. (a) Employer Y maintains Plan B covering all of its employees. On January 1, 1996, Employer Y sells Division M to Employer Z, and all of the employees in Division M become employees of Employer Z. Employer Y obtains a determination letter that the resulting cessation of participation by these employees in Plan B constitutes a partial termination. Therefore, in order to satisfy section 411(d)(3), Plan B fully vests the accrued benefit of each of the employees of Division M whose participation in Plan B ceased as a result of the sale on January 1, 1996.

(b) The manner in which employees vest in their accrued benefits under Plan B does not discriminate in favor of HCEs merely because, in order to satisfy section 411(d)(3), the accrued benefits of all employees affected by the partial termination become fully vested. This is true even if the affected group of employees does not satisfy section 410(b).

Example 4. (a) The facts are the same as in *Example 3*, except that Employer Y does not obtain a determination letter that the sale of Division M to Employer Z will cause a partial termination. Instead, based on its reasonable belief that the sale will cause a partial termination, and in order to ensure that Plan B will satisfy section 411(d)(3), Employer Y amends Plan B to vest fully the accrued benefit on January 1, 1996 of each of the employees it reasonably believes to be an affected employee.

(b) The manner in which employees vest in their accrued benefits under Plan B does not discriminate in favor of HCEs merely because, based on Employer Y's reasonable belief that the sale will cause a partial termination, Plan B is amended to vest fully the accrued benefits of each of the employees it reasonably believes to be an affected employee.

(d) *Service-crediting rules*—(1) *Overview*—(i) *In general.* A defined benefit plan or a defined contribution plan does not satisfy this paragraph (d) with respect to the manner in which service is credited under the plan unless the plan satisfies paragraph (d)(2) of this section. Paragraph (d)(3) of this section provides rules for determining whether service other than actual service with the employer may be taken into account in determining whether a defined benefit plan or a defined contribution plan satisfies §1.401(a)(4)–1 (b)(2) or (b)(3). (However, for purposes of cross-testing a defined contribution plan, only years in which the employee benefited under the plan may be taken into account in determining equivalent accrual rates. See §1.401(a)(4)–8(b)(2)(i).) The rules of this paragraph (d) apply separately to service credited under a plan for each different purpose under the plan, including, but not limited to: application of the benefit formula (benefit service), application of the accrual method (accrual service), application of the vesting schedule (vesting service), entitlement to benefits, rights,

and features (entitlement service), application of the requirements for eligibility to participate in the plan (eligibility service).

(ii) *Special rule for pre-effective date service.* A plan is deemed to satisfy this paragraph (d) with respect to service credited for periods prior to the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b) under a plan provision adopted and in effect as of February 11, 1993 (and any such service may be taken into account for purposes of satisfying §1.401(a)(4)–1 (b)(2) or (b)(3)), if the plan satisfied the applicable nondiscrimination requirements with respect to the service that were in effect for all relevant periods prior to the applicable effective date.

(2) *Manner of crediting service*—(i) *General rule.* A plan satisfies this paragraph (d)(2) if, on the basis of all of the relevant facts and circumstances, the manner in which employees' service is credited for all purposes under the plan does not discriminate in favor of HCEs.

(ii) *Equivalent service-crediting methods.* For purposes of this paragraph (d)(2), a service-crediting method used for a specified purpose that is based on hours of service, as provided in 29 CFR 2530.200b–2, and a service-crediting method used for the same purpose that is based on one of the equivalencies set forth in 29 CFR 2530.200b–3, are treated as equivalent if the service-crediting methods are otherwise the same.

(iii) *Safe harbor for service-crediting.* The manner in which service is credited under a plan for a specified purpose is deemed to satisfy this paragraph (d)(2) if each combination of service-crediting provisions applied for that purpose would satisfy the nondiscriminatory availability requirements of §1.401(a)(4)–4 if that combination were an other right or feature.

(iv) *Examples.* The following examples illustrate the rules in this paragraph (d)(2):

Example 1. (a) Plan A covers both salaried employees and hourly employees. All of the HCEs in Plan A are salaried employees. For administrative convenience, salaried employees in Plan A (none of whom are part-time) have their years of service calculated in accordance with the elapsed time provisions in §1.410(a)–7. Hourly employees in Plan A (most of whom are scheduled to work 2,000 hours in a year) have their hours of service calculated in accordance with 29 CFR 2530.200b–2 and are credited with a year of service for each plan year in which they complete 1,000 hours of service.

(b) Plan A does not fail to satisfy this paragraph (d)(2) merely because different service-crediting provisions are applied to salaried and hourly employees for administrative convenience. The service-crediting provisions for hourly employees in Plan A are reasonably comparable to the service-crediting provisions for salaried employees. This is because the amount of service credited to hourly employees who complete fewer than 1,000 hours of service before termination of employment (i.e., quit, retirement, discharge, or death) during the plan year (and are treated less favorably than the salaried employees with the same period of employment during the plan year) is balanced by the amount of service credited to hourly employees who complete more than 1,000 hours of service before termination of employment during the plan year (who are treated more favorably than the salaried employees with the same period of employment during the plan year).

Example 2. (a) The facts are the same as in *Example 1,* except Plan A requires hourly employees to complete 2,000 hours of service in order to be credited with a full year of service, with a pro rata reduction for hourly employees who complete fewer than 2,000 hours of service.

(b) Plan A does not fail to satisfy this paragraph (d)(2) merely because different service-crediting provisions are applied to salaried and hourly employees for administrative convenience. The service-crediting provisions for hourly employees in Plan A are reasonably comparable to the service-crediting provisions for salaried employees. This is because the amount of service credited to hourly employees whose employment terminates (i.e., quit, retire, are discharged, or die) during the plan year is reasonably comparable to the amount of service credited to salaried employees whose employment is terminated during the plan year with the same period of employment during the plan year.

(3) *Service-crediting period*—(i) *Limitation on service taken into account*—(A) *General rule.* Except as otherwise provided in this paragraph (d)(3), service for periods in which an employee does not perform services as an employee of the employer or in which the employee did not participate in the plan may not be taken into account in determining whether the plan satisfies §1.401(a)(4)–1 (b)(2) and (b)(3). In addition, in determining whether a plan satisfies §1.401(a)(4)–1 (b)(2) and (b)(3), no more

than one year of service may be taken into account with respect to any 12-consecutive-month period (with adjustments for shorter periods, if appropriate) unless the additional service is required to be credited under section 410 or 411, whichever is applicable.

(B) *Past service.* Notwithstanding paragraph (d)(3)(i)(A) of this section, service for periods in which an employee performed services as an employee of the employer and did not participate in a plan, but in which the employee would have participated in the plan but for the fact that the plan (or the plan amendment extending coverage to the employee) was not in existence during that period, may be taken into account in determining whether the plan satisfies §1.401(a)(4)–1 (b)(2) and (b)(3). This is because service for such periods generally would have been credited for the employee but for the timing of the plan establishment or amendment, and the timing of the plan establishment or amendment must satisfy §1.401(a)(4)–5(a).

(C) *Pre-participation and imputed service.* Notwithstanding paragraph (d)(3)(i)(A) of this section, to the extent that a plan treats pre-participation service and imputed service as actual service with the employer, such service may be taken into account in determining whether the plan satisfies §1.401(a)(4)–1 (b)(2) and (b)(3) if the service satisfies each of the requirements in paragraph (d)(3)(iii) of this section taking into account, in the case of imputed service, the additional rules in paragraph (d)(3)(iv) of this section.

(D) *Additional limitations on service-crediting in the case of certain offsets.* Notwithstanding paragraphs (d)(3)(i) (B) and (C) of this section, if a plan credits benefit service or accrual service under paragraph (d)(3)(i) (B) or (C) of this section for a period before an employee becomes a participant in the plan, but offsets the benefits determined under the plan by benefits under another plan (whether or not qualified or terminated) that are attributable to the same period for which that service is credited, then that service may not be taken into account for purposes of determining whether the first plan satisfies §1.401(a)(4)–1 (b)(2) or (b)(3) unless the offset provision applies on the same basis to all similarly-situated employees (within the meaning of paragraph (d)(3)(iii)(A) of this section).

(ii) *Definitions*—(A) *Pre-participation service.* For purposes of this section, pre-participation service includes all years of service credited under a plan for years of service with the employer or a prior employer for periods before the employee commenced or recommenced participation in the plan (other than past service described in paragraph (d)(3)(i)(B) of this section).

(B) *Imputed service.* For purposes of this section, imputed service includes any service credited for periods after an employee has commenced participation in a plan while the employee is not performing services as an employee for the employer (including a period in which the employee performs services for another employer, e.g., a joint venture), or while the employee has a reduced work schedule and would not otherwise be credited with service at the level being credited under the general terms of the plan.

(iii) *Requirements for pre-participation and imputed service*—(A) *Provision applied to all similarly-situated employees*—(*1*) *General rule.* A plan provision crediting pre-participation service or imputed service to any HCE must apply on the same terms to all similarly-situated NHCEs. Whether two employees are similarly situated for this purpose must be determined based on reasonable business criteria, generally taking into account only the circumstances resulting in the employees being covered under the plan or being granted imputed service and on the situation of the employees (e.g., the plan in which the employees benefit or the employer by which they are employed) during the period for which the pre-participation service or imputed service is credited. For example, employees who enter a plan as a result of a particular merger and who participated in the same plan of a prior employer are generally similarly situated. As another example, employees who are transferred to different joint ventures or different spun-off divisions are generally not similarly situated.

(*2*) *Examples*. The following examples illustrate the rules in this paragraph (d)(3)(iii)(A):

Example 1. Employer X maintains defined benefit Plans A and B and defined contribution Plan C. Plan A covers all employees who work at the headquarters of Employer X. Plan B covers some employees in Division M of Employer X, and Plan C covers the other employees of Division M. Plans B and C have not been aggregated for purposes of satisfying section 401(a)(4) or 410(b) for the period for which service is being credited. Plan A provides that, whenever an employee covered by Plan B transfers from Division M to the headquarters, the employee's service credited under Plan B is credited under Plan A, and the employee's benefit under Plan A is offset by the employee's benefit under Plan B. However, Plan A provides for no similar recognition of service or offset for employees covered by Plan C who transfer from Division M to the headquarters. Plan A does not fail to satisfy this paragraph (d)(3)(iii)(A) merely because it credits service for employees transferring from Plan B but not from Plan C, because it is reasonable to treat employees participating in different plans that have not been aggregated as not being similarly situated.

Example 2. The facts are the same as in *Example 1*, except that Employer X acquires two trades or businesses from different employers. Employees of the acquired trades or businesses become employees of Division M and become covered by Plan B. In addition, Plan B is amended to credit service with one of the trades or businesses but not the other. Plan B does not fail to satisfy this paragraph (d)(3)(iii)(A) merely because it credits service for one acquired trade or business but not another, because it is reasonable to treat employees of one acquired trade or business as not similarly situated to employees of another acquired trade or business.

(B) *Legitimate business reason*—(*1*) *General rule*. There must be a legitimate business reason, based on all of the relevant facts and circumstances, for a plan to credit imputed service or for a plan to credit pre-participation service for a period of service with another employer.

(*2*) *Relevant facts and circumstances when crediting service with another employer*. The following are examples of relevant facts and circumstances for determining whether a legitimate business reason exists for a plan to credit pre-participation or imputed service for a period of service with another employer as service with the employer: whether one employer has a significant ownership, control, or similar interest in, or relationship with, the other employer (though not enough to cause the two employers to be treated as a single employer under section 414); whether the two employers share interrelated business operations; whether the employers maintain the same multiple-employer plan; whether the employers share similar attributes, such as operation in the same industry or the same geographic area; and whether the employees are an acquired group of employees or the employees became employed by the other employer in a transaction between the two employers that was a stock or asset acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business. Other factors may also be relevant for this purpose, such as the plan's treatment of service with other employers with which the employer has a similar relationship and the type of service being credited (e.g., vesting service as compared to benefit service or accrual service). A legitimate business reason is deemed to exist for a plan to credit military service as service with the employer.

(*3*) *Examples*. The following examples illustrate the rules in this paragraph (d)(3)(iii)(B):

Example 1. Twenty unrelated employers jointly sponsor a multiple-employer plan that covers all employees of the employers. From time to time, employees transfer employment among the employers. There is a legitimate business reason for a disaggregated portion of the plan that benefits the employees of one of the employers to treat service with any of the other employers as service with the employer.

Example 2. Employer X owns 20 percent of the outstanding stock of Employer Y. From time to time, employees transfer from Employer X to Employer Y at the request of Employer X. Employer X maintains defined benefit Plan A. Plan A provides that years of service include an employee's years of service with Employer Y. There is a legitimate business reason for Plan A to credit service with Employer Y because Employer X, through its 20-percent ownership interest, benefits from the service that the transferred employees provide to Employer Y.

Example 3. Employer Z manufactures widgets and belongs to the National Widget Manufacturers' Association. From time to time, Employer Z hires employees from other

widget manufacturers. Employer Z maintains a defined benefit plan, Plan B, which credits pre-participation service for periods of service with all other members of the Association located in the western half of the United States as service with Employer Z. There is a legitimate business reason for Plan B to treat service with other members of the Association as service with Employer Z.

(C) *No significant discrimination*—(*1*) *General rule*. Based on all of the relevant facts and circumstances, a plan provision crediting pre-participation or imputed service must not by design or in operation discriminate significantly in favor of HCEs.

(*2*) *Relevant facts and circumstances*. The following are examples of relevant facts and circumstances for determining whether a plan provision crediting pre-participation service or imputed service discriminates significantly in favor of HCEs: whether the service credit does not duplicate benefits but merely makes an employee whole (i.e., prevents the employee from being disadvantaged with respect to benefits by a change in job or employer or provides the employee with benefits comparable to those of other employees); the degree of business ties between the current employer and the prior employer, such as the degree of ownership interest or other affiliation; the degree of excess coverage under section 410(b) of NHCEs for the plan crediting the service, taking into account employees who are credited with pre-participation service; whether the other employer maintains a qualified plan for its employees; the existence of reciprocal service credit under other plans of the employer or the prior employer; the circumstances underlying the employee's transfer into the group of employees covered by the plan; the type of service being credited; and the relative number of employees other than five-percent owners or the most highly-paid HCEs of the employer (determined without regard to the one officer rule of section 414(q)(5)(B)) who are being credited with pre-participation service or imputed service. The relative number referred to in the last factor is determined taking into account all employees who have been over time, or are reasonably expected to be in the future, credited with such service.

(*3*) *Examples*. The following examples illustrate the rules in this paragraph (d)(3)(iii)(C). It is assumed that facts not described in an example do not, in the aggregate, suggest that the relevant plan provision either does or does not discriminate significantly in favor of HCEs.

Example 1. (a) Employer U maintains defined benefit Plans A and B. Plan A covers all employees who work at the headquarters of Employer U. Plan B covers all employees of Division M of Employer U. Plan A provides that, whenever an employee transfers from Division M to the headquarters, the employee's service credited under Plan B is credited under Plan A, and the employee's benefit under Plan A is offset by the employee's benefit under Plan B. Employees, including a meaningful number of NHCEs, are periodically transferred from Division M to the headquarters of Employer U for bona fide business reasons.

(b) The Plan A provision crediting service under Plan B does not discriminate significantly in favor of HCEs. The provision is designed only to prevent employees from being disadvantaged by being transferred from Division M to the headquarters, and a meaningful number of NHCEs can be expected to benefit from it.

Example 2. (a) The facts are the same as in *Example 1*, except that the only employees transferred from Division M to the headquarters of Employer U are HCEs (but not the most highly-paid HCEs of Employer U).

(b) Employer U determines that Plan A would have satisfied sections 401(a)(4) and 410(b) for the period for which the transferred employees are being credited with pre-participation service had the employees participated in Plan A during that period. This determination is based on test results under sections 401(a)(4) and 410(b) for the current year, taking into account significant demographic changes over this period.

(c) The Plan A provision crediting service under Plan B does not significantly discriminate in favor of HCEs in the current year. This conclusion is based on the fact that the circumstances underlying the transfers indicate that they were made for bona fide business reasons, that Plan A would have satisfied sections 401(a)(4) and 410(b) had the transferred employees participated in Plan A during the period for which the pre-participation service is credited, and that the transferred employees are not the most highly-paid HCEs of Employer U.

Example 3. (a) The facts are the same as in *Example 1*, except that the only employee who is transferred from Division M to the headquarters of Employer U is Employee P,

who is among the most highly-paid HCEs of Employer U. Plan A provides an unreduced early retirement benefit at age 55 for employees with 20 years of service, but Plan B's early retirement benefits are not subsidized. Employee P is transferred to the headquarters with 20 years of service credited under Plan B and shortly before attainment of age 55. Employee P is expected to retire upon reaching age 55.

(b) The Plan A provision crediting service under Plan B discriminates significantly in favor of HCEs in the year of the transfer. This is because the circumstances underlying this transfer (i.e., its occurrence shortly before Employee P's expected retirement and the fact that the transfer significantly increased Employee P's early retirement benefits) indicate that Employee P was transferred to the headquarters primarily to obtain the higher pension benefits provided under Plan A.

(c) Because of this conclusion, the pre-participation service credited to Employee P cannot be taken into account in determining whether Plan A satisfies §1.401(a)(4)–1 (b)(2) and (b)(3). Thus, if Plan A credits the service, it cannot be a safe harbor plan because the benefit formula will take into account service that may not be taken into account under this paragraph (d)(3). In addition, Employee P's accrual rates under the general test in §1.401(a)(4)–3(c) are likely to be higher than those of other employees because, while the pre-participation service may be used to determine Employee P's benefits under Plan A, the service must be disregarded in determining Employee P's testing service. Also, if Employee P's pre-participation service is used in determining Employee P's entitlement to a benefit, right, or feature under Plan A, the fact that the service must be disregarded in determining Employee P's entitlement service for purposes of §1.401(a)(4)–4 may cause the benefit, right, or feature to be treated as a separate benefit, right, or feature that is currently available only to Employee P.

Example 4. (a) Employer V manufactures widgets and belongs to the National Widget Manufacturers' Association. Each member of the Association maintains a defined benefit plan that credits pre-participation service for periods of service with other members and offsets benefits under the plan by benefits under the plans of the other members. Employer V maintains defined benefit Plan C. Employer V periodically hires employees from other widget manufacturers who are not among its most highly-paid HCEs. In 1997, however, the only employee hired by Employer V from another member of the Association is Employee Q, who is among Employer V's most highly-paid HCEs. Employee Q receives pre-participation service credit in accordance with the terms of Plan C. Some of the plans maintained by other members of the Association credited pre-participation service to NHCEs for the same period for which the pre-participation service is credited to Employee Q.

(b) The provision of Plan C crediting pre-participation service with other members of the Association does not discriminate significantly in 1997, despite the fact that the only employee who received pre-participation service credit under the provision in that year was among the most highly-paid HCEs of Employer V. This conclusion is based on the relative number of employees other than Employer V's most highly-paid HCEs who have been credited in the past, or are reasonably expected to be credited in the future, with pre-participation service for periods of service with other members of the Association, and the fact that other employees who are NHCEs are being credited with pre-participation service under a reciprocal agreement.

Example 5. Employer W owns 79 percent of the outstanding stock of Employer X. From time to time, employees transfer from Employer W to Employer X at the request of Employer W. The only employees who have ever been transferred are HCEs. Employer W maintains a defined benefit plan, Plan D, which credits employees transferred to Employer X with imputed benefit and accrual service while employed by Employer X. Employer X maintains no qualified plan. Plan D would fail either section 401(a)(4) or section 410(b) in the current plan year if the individuals employed by Employer X were treated as employed by Employer W. In addition, Plan D would fail either section 401(a)(4) or section 410(b) in the current plan year if the portion of Plan D covering the transferred employees were treated as maintained by Employer X. The Plan D provision crediting imputed benefit and accrual service to employees transferred to Employer X significantly discriminates in favor of HCEs in the current plan year.

Example 6. The facts are the same as in Example 5, except that Plan D credits the individuals who transfer to Employer X only with imputed vesting and entitlement service. The Plan D provision crediting imputed vesting and entitlement service to individuals transferred to Employer X does not significantly discriminate in favor of HCEs in the current plan year, because there is less potential for discrimination when the only types of service being imputed are vesting and entitlement service.

(iv) *Additional rules for imputed service*—(A) *Legitimate business reasons for crediting imputed service*—(*1*) *General rule*. A legitimate business reason does not exist for a plan to impute service after an individual has permanently

ceased to perform services as an employee (within the meaning of §1.410(b)–9) for the employer maintaining the plan, i.e., is not expected to resume performing services as an employee for the employer. The preceding sentence does not apply in the case of an individual who is not performing services for the employer because of disability or is performing services for another employer under an arrangement (such as a transfer of the employee to another employer) that provides some ongoing business benefit to the original employer. The first sentence in this paragraph (d)(3)(iv)(A)(*1*) also does not apply in the case of vesting and entitlement service if the employee is performing services for another employer that is being treated under the plan as actual service with the original employer.

(*2*) *Certain presumptions applicable.* Whether an individual has permanently ceased to perform services as an employee for an employer is determined taking into account all of the relevant facts and circumstances. There is a rebuttable presumption for a period of up to two years that an individual who has ceased to perform services as an employee for an employer is nonetheless expected to resume performing services as an employee for the employer, if the employer continues to treat the individual as an employee for significant purposes unrelated to the plan. After two years, there is a rebuttable presumption that an individual who has ceased to perform services as an employee for the employer is not expected to resume performing services as an employee for the employer. The fact that an individual is absent to perform jury duty or military service automatically rebuts the latter presumption. Other evidence, such as the employer's layoff policy, the terms of an employment contract, or specific leave to pursue a degree requiring more than two years of study, may also rebut this presumption.

(*3*) *Imputed service for part-time employees.* Rules similar to the rules in paragraph (d)(3)(iv)(A) (*1*) and (*2*) of this section apply in the case of an employee whose work hours are temporarily reduced and who therefore would normally be credited with service at a reduced rate, but who continues to be credited with service at the same rate as before the reduction (e.g., an employee who continues to be credited with service as if the employee were a full-time employee during a temporary change from a full-time to a part-time work schedule).

(B) *Additional factors for determining whether a provision crediting imputed service discriminates significantly.* In addition to the factors described in paragraph (d)(3)(iii)(C)(*2*) of this section, relevant facts and circumstances for determining whether a plan provision crediting imputed service during a leave of absence or a period of reduced services discriminates significantly include any employer policies or practices that restrict the ability of employees to take leaves of absence or work temporarily on a part-time basis, respectively.

(v) *Satisfaction of other service-crediting rules.* A plan does not fail to satisfy this paragraph (d)(3) merely because it credits service to the extent necessary to satisfy the service-crediting rules in section 410(a), 411(a), 413, or 414(a), §1.410(a)–7 (elapsed-time method of service-crediting) or 29 CFR 2530.200b–2 (regarding hours of service to be credited), whichever is applicable, or 29 CFR §2530.204–2(d) (regarding double proration of service and compensation).

(e) *Family aggregation rules.* [Reserved]

(f) *Governmental plans.* [Reserved]

(g) *Corrective amendments*—(1) *In general.* A corrective amendment that satisfies the rules of this paragraph (g) is taken into account for purposes of satisfying certain section 401(a) requirements for a plan year, by treating the corrective amendment as if it were adopted and effective as of the first day of the plan year. These rules apply in addition to the rules of section 401(b). Paragraph (g)(2) of this section describes the scope of the corrective amendments that are permitted to be made. Paragraph (g)(3) of this section specifies the conditions under which a corrective amendment may be made. Paragraph (g)(4) of this section provides a rule prohibiting a corrective amendment from being taken into account to the extent that it does not

have substance. Paragraph (g)(5) of this section discusses the effect of the corrective amendments permitted under this paragraph (g) under provisions other than section 401(a).

(2) *Scope of corrective amendments*. For purposes of satisfying the minimum coverage requirements of section 410(b), the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2), or the nondiscriminatory plan amendment requirement of § 1.401(a)(4)–1(b)(4), a corrective amendment may retroactively increase accruals or allocations for employees who benefited under the plan during the plan year being corrected, or may grant accruals or allocations to individuals who did not benefit under the plan during the plan year being corrected. In addition, for purposes of satisfying the nondiscriminatory current availability requirement of § 1.401(a)(4)–4(b) for benefits, rights, or features, a corrective amendment may make a benefit, right, or feature available to employees to whom it was previously not available. A corrective amendment may not, however, correct for a failure to incorporate the pre-termination restrictions of § 1.401(a)(4)–5(b).

(3) *Conditions for corrective amendments*—(i) *In general*. A corrective amendment is not taken into account prior to its adoption under this paragraph (g) unless it satisfies each of the requirements of paragraph (g)(3) (ii) through (vii) of this section, whichever are applicable. Thus, for example, if any of the applicable requirements are not satisfied, any additional accruals arising from an amendment adopted after the end of a plan year are not given retroactive effect and, thus, are tested in the plan year in which the amendment is adopted.

(ii) *Benefits not reduced*. Except as permitted under paragraph (g)(3)(vi)(C)(*2*) of this section, the corrective amendment may not result in a reduction of an employee's benefits (including any benefit, right, or feature), determined based on the terms of the plan in effect immediately before the amendment.

(iii) *Amendment effective for all purposes*. For purposes of determining an employee's rights and benefits under the plan, the corrective amendment must generally be effective as if the amendment had been made on the first day of the plan year being corrected. Thus, if the corrective amendment is made after the close of the plan year being corrected, an employee's allocations or accruals, along with the associated benefits, rights, and features, must be increased to the level at which they would have been had the amendment been in effect for the entire preceding plan year. Accordingly, such increases are taken into account for testing purposes as if the increases had actually occurred in the prior plan year. However, to the extent that an amendment makes a benefit, right, or feature available to a group of employees, the amendment does not fail to satisfy this paragraph (g)(3)(iii) merely because it is not effective prior to the date of adoption and, therefore, the benefit, right, or feature is not made currently available to those employees before that date.

(iv) *Time when amendment must be adopted and put into effect*—(A) *General rule*. Any corrective amendment intended to apply to the preceding plan year must be adopted and implemented on or before the 15th day of the 10th month after the close of the plan year in order to be taken into account for the preceding plan year.

(B) *Determination letter requested by employer or plan administrator*. If, on or before the end of the period set forth in paragraph (g)(3)(iv)(A) of this section, the employer or plan administrator files a request pursuant to § 601.201(o) of this chapter (Statement of Procedural Rules) for a determination letter on the amendment, the initial or continuing qualification of the plan, or the trust that is part of the plan, the period set forth in paragraph (g)(3)(iv)(A) of this section is extended in the same manner as provided for an extension of the remedial amendment period under § 1.401(b)–1(d)(3).

(v) *Corrective amendment for coverage or amounts testing*—(A) *Retroactive benefits must be provided to nondiscriminatory group*. Except as provided in paragraph (g)(3)(v)(B) of this section, if the corrective amendment is adopted after the close of the plan year, the additional

allocations or accruals for the preceding year resulting from the corrective amendment must separately satisfy section 401(a)(4) for the preceding plan year and must benefit a group of employees that separately satisfies section 410(b) (determined by applying the same rules as are applied in determining whether a component plan separately satisfies section 410(b) under §1.401(a)(4)–9(c)(4)). Thus, for example, in applying the rules of this paragraph (g)(3)(v), an employer may not aggregate the additional accruals or allocations for the preceding plan year resulting from the corrective amendment with the other accruals or allocations already provided under the terms of the plan as in effect during the preceding plan year without regard to the corrective amendment.

(B) *Corrective amendment to conform to safe harbor*. The requirements of paragraph (g)(3)(v)(A) of this section need not be met if the corrective amendment is for purposes of conforming the plan to one of the safe harbors in §1.401(a)(4)–2(b) or §1.401(a)(4)–3(b) (including for purposes of applying the requirements of those safe harbors under the optional testing methods in §1.401(a)(4)–8 (b)(3) or (c)(3)), or ensuring that the plan continues to meet one of those safe harbors.

(vi) *Conditions for corrective amendment of the availability of benefits, rights, and features*. A corrective amendment may not be taken into account under this paragraph (g) for purposes of satisfying §1.401(a)(4)–4(b) for a given plan year unless—

(A) The corrective amendment is not part of a pattern of amendments being used to correct repeated failures with respect to a particular benefit, right, or feature;

(B) The relevant provisions of the plan immediately after the corrective amendment with respect to the benefit, right, or feature (including a corrective amendment eliminating the benefit, right, or feature) remain in effect until the end of the first plan year beginning after the date of the amendment; and

(C) The corrective amendment either—

(*1*) Expands the group of employees to whom the benefit, right, or feature is currently available so that for each plan year in which the corrective amendment is taken into account in determining whether the plan satisfies §1.401(a)(4)–4(b), the group of employees to whom the benefit, right, or feature is currently available, after taking into account the amendment, satisfies the nondiscriminatory classification requirement of §1.410(b)–4 (and thus the current availability requirement of §1.401(a)(4)–4(b)) with a ratio percentage greater than or equal to the lesser of—

(*i*) The safe harbor percentage applicable to the plan; and

(*ii*) The ratio percentage of the plan; or

(*2*) Eliminates the benefit, right, or feature (to the extent permitted under section 411(d)(6)) on or before the last day of the plan year for which the corrective amendment is taken into account.

(vii) *Special rules for section 401(k) plans and section 401(m) plans*—(A) *Minimum coverage requirements*. In the case of a section 401(k) plan, a corrective amendment may only be taken into account for purposes of satisfying §1.410(b)–3(a)(2)(i) under this paragraph (g) for a given plan year to the extent that the corrective amendment grants qualified nonelective contributions within the meaning of §1.401(k)–1(g)(13)(ii) (QNECs) to nonhighly compensated nonexcludable employees who were not eligible employees within the meaning of §1.401(k)–1(g)(4) for the given plan year, and the amount of the QNECs granted to each nonhighly compensated nonexcludable employee equals the product of the nonhighly compensated nonexcludable employee's plan year compensation and the actual deferral percentage (within the meaning of section 401(k)(3)(B)) for the given plan year for the group of NHCEs who are eligible employees. Similarly, in the case of a section 401(m) plan, a corrective amendment may only be taken into account for purposes of satisfying §1.410(b)–3(a)(2)(i) under this paragraph (g) for a given plan year to the extent that the corrective amendment grants qualified nonelective contributions (QNECs) to nonhighly compensated nonexcludable employees who were not eligible employees within the meaning of §1.401(m)–1(f)(4) for the given plan

year, and the amount of the QNECs granted to each nonhighly compensated nonexcludable employee equals the product of the nonhighly compensated nonexcludable employee's plan year compensation and the actual contribution percentage (within the meaning of section 401(m)(3)) for the given plan year for the group of NHCEs who are eligible employees.

(B) *Correction of rate of match.* In the case of a section 401(m) plan, allocations for a given plan year granted under a corrective amendment to NHCEs who made contributions for the plan year eligible for a matching contribution may be treated as matching contributions. These allocations treated as matching contributions may be taken into account for purposes of satisfying the current availability requirement of §1.401(a)(4)–4(b) with respect to the right to a rate of match, but may not be taken into account for satisfying other amounts testing.

(4) *Corrective amendments must have substance.* A corrective amendment is not taken into account in determining whether a plan satisfies section 401(a)(4) or 410(b) to the extent the amendment affects nonvested employees whose employment with the employer terminated on or before the close of the preceding year, and who therefore would not have received any economic benefit from the amendment if it had been made in the prior year. Similarly, in determining whether the requirements of paragraph (g)(3)(vi)(C)(*1*) of this section are satisfied, a corrective amendment making a benefit, right, or feature available to employees is not taken into account to the extent the benefit, right, or feature is not currently available to any of those employees immediately after the amendment. However, a plan will not fail to satisfy the requirements of paragraph (g)(3)(vi)(C)(*1*) of this section by operation of the provisions in this paragraph (g)(4) if the benefit, right, or feature is made available to all employees in the plan as of the date of the amendment.

(5) *Effect under other statutory requirements.* A corrective amendment under this paragraph (g) is treated as if it were adopted and effective as of the first day of the plan year only for the specific purposes described in this paragraph (g). Thus, for example, the corrective amendment is taken into account not only for purposes of sections 401(a)(4) and 410(b), but also for purposes of determining whether the plan satisfies sections 401(l). By contrast, the amendment is not given retroactive effect for purposes of section 404 (deductions for employer contributions) or section 412 (minimum funding standards), unless otherwise provided for in rules applicable to those sections.

(6) *Examples.* The following examples illustrate the rules in this paragraph (g):

Example 1. Employer U maintains a calendar year defined benefit plan that in 1994 is tested using the safe harbor for flat benefit plans in §1.401(a)(4)–3(b)(4). In 1996, Employer U is concerned that the plan will not satisfy the demographic requirement in §1.401(a)(4)–3(b)(4)(i)(C)(*3*) for the 1995 plan year because the average of the normal accrual rates for all NHCEs is less than 70 percent of the average of the normal accrual rates for all HCEs. Provided the corrective amendment would otherwise satisfy this paragraph (g), Employer U may make a corrective amendment to the plan to increase the number of NHCEs so that the amended plan satisfies the safe harbor for the 1995 plan year. The corrective amendment need not satisfy paragraph (g)(3)(v)(A) of this section because Employer U is retroactively amending the plan to conform to a safe harbor in §1.401(a)(4)–3(b). See paragraph (g)(3)(v)(B) of this section.

Example 2. (a) Employer V maintains a calendar year defined contribution plan covering all the employees in Division M and Division N. Under the plan, only employees in Division M have the right to direct the investments in their account. For plan years prior to 1996, the plan met the current availability requirement of §1.401(a)(4)–4(b) because the employees in Division M were a group of employees that satisfied the nondiscriminatory classification test of §1.410(b)–4. Because of attrition in the employee population in Division M in 1996, the group of employees to whom the right to direct investments is available during that plan year no longer meets the nondiscriminatory classification test of §1.410(b)–4. Thus, the right to direct investments under the plan does not meet the current availability requirement of §1.401(a)(4)–4(b) during the 1996 plan year.

(b) Employer V may amend the plan in 1997 (but on or before October 15) to make the right to direct investments available from the date of the corrective amendment to a larger group of employees and the corrective

amendment may be taken into account for purposes of satisfying the current availability requirement of §1.401(a)(4)–4(b) for 1996 if the amendment satisfies this paragraph (g). Thus, for example, the group of employees to whom the right to direct investments is currently available, after taking into account the corrective amendment, must satisfy the nondiscriminatory classification test of §1.410(b)–4 for 1996 using a safe harbor percentage (or if lower, the ratio percentage of the plan for 1996). In addition, the corrective amendment making the right to direct investments available to a larger group of employees must remain in effect through the end of the 1998 plan year.

(c) In order for Employer V to take the corrective amendment into account for purposes of satisfying the current availability requirement of §1.401(a)(4)–4(b) for the portion of the 1997 plan year before the amendment, the group of employees to whom the right to direct investments is currently available, taking into account the amendment, must satisfy the nondiscriminatory classification test of §1.410(b)–4 for 1997 using a safe harbor percentage (or if lower, the ratio percentage of the plan for 1997).

(d) Alternatively, if Employer V adopts the corrective amendment before the end of the 1996 plan year, the corrective amendment need only remain in force through the end of the 1997 plan year, or the corrective amendment may eliminate the right to direct investments (provided that the elimination remains in effect through the end of the 1997 plan year).

Example 3. The facts are the same as in *Example 2*. In 1997, Employer V makes a corrective amendment to extend the plan to employees of Division O as well as Divisions M and N. Assume that the corrective amendment satisfies paragraph (g)(3)(v)(A) of this section, and thus, may be taken into account for purposes of satisfying the nondiscriminatory amounts requirement of §1.401(a)(4)–1(b)(2) or the minimum coverage requirements of section 410(b). However, the employees in Division O will not be taken into account in determining whether the right to direct investments meets the current availability requirements of §1.401(a)(4)–4(b) unless the corrective amendment meets the requirements of paragraph (g)(3)(vi) of this section. Thus, for example, the group of employees to whom the right to direct investments is made available as a result of the expansion of coverage, after taking into account the corrective amendment, must satisfy the nondiscriminatory clarification test of §1.410(b)–4 for 1996 using a safe harbor percentage (or if lower, the ratio percentage of the plan for 1996). In addition, the amendment making the right to direct investments available to a larger group of employees must remain in effect though the end of the 1998 plan year.

Example 4. Employer W maintains a defined benefit plan that covers all employees and that offsets an employee's benefit by the employee's projected primary insurance amount. The plan is not eligible to use the safe harbors under §1.401(a)(4)–3(b) because the plan does not satisfy section 401(l). Under the plan, the accrual rates for all HCEs (determined under the general test of §1.401(a)(4)–3(c)) for 1998 are less than 1.5 percent of average annual compensation, and the accrual rates for all NHCEs (determined under the general test of §1.401(a)(4)–3(c)) for 1998 are two percent of average annual compensation. If Employer W adopts a corrective amendment adopted in 1999 that retroactively increases HCEs' benefits under the plan so that their accrual rates equal those of the NHCEs, the corrective amendment may not be taken into account in testing the 1998 plan year (i.e., the accruals that result from the corrective amendment are treated as 1999 accruals), because the accruals for the 1998 plan year resulting from the corrective amendment would not separately satisfy sections 410(b) and 401(a)(4). This is the case even if, after taking the amendment into account, the plan would satisfy sections 410(b) and 401(a)(4) for the 1998 plan year.

Example 5. Employer X maintains two plans—Plan A and Plan B. Plan A satisfies the ratio percentage test of §1.410(b)–2(b)(2), but Plan B does not. Thus, in order to satisfy section 410(b), Plan B must satisfy the average benefits test of §1.410(b)–2(b)(3). The average benefit percentage of Plan B is 60 percent. Employer X may take into account a corrective amendment that increases the accruals under either Plan A or Plan B so that the average benefit percentage meets the 70 percent requirement of the average benefits test, if the amendment satisfies paragraph (g)(3)(v) of this section.

Example 6. Employer Y maintains Plan C, which does not satisfy section 401(a)(4) in a plan year. Under the terms of paragraph (g)(2) of this section, Employer Y amends Plan C to increase the benefits of certain employees retroactively. In designing the amendment, Employer Y identifies those employees who have terminated without vested benefits during the period after the end of the prior plan year and before the adoption date of the amendment, and the amendment provides increases in benefits primarily to those employees. It would be inconsistent with the purpose of preventing discrimination in favor of HCEs for Plan C to treat the amendment as retroactively effective under this paragraph (g). See §1.401(a)(4)–1(c)(2).

Example 7. Employer Z maintains both a section 401(k) plan and a section 401(m) plan that provides matching contributions at a rate of 50 percent with respect to elective contributions under the section 401(k) plan. In plan year 1995, the section 401(k) plan fails to satisfy the actual deferral percentage test

of section 401(k)(3). In order to satisfy section 401(k)(3), Employer Z makes corrective distributions to HCEs H1 through H10 of their excess contributions as provided under §1.401(k)–1(f). The matching contributions that H1 through H10 had received on account of their excess contributions are not forfeited, however. Thus, the effective rate of matching contributions provided to H1 through H10 is increased as a result of the corrective distributions. See §1.401(a)(4)–4(e)(3)(iii)(G). Since no NHCE in the section 401(m) plan is provided with an equivalent rate of matching contributions, the rate of matching contributions provided to H1 through H10 does not satisfy the nondiscriminatory availability requirement of §1.401(a)(4)–4 in plan year 1995. Employer Z makes a corrective amendment by October 15, 1996, that grants allocations to NHCEs who made contributions for the 1995 plan year eligible for a matching contribution. Employer Z may treat the allocations granted under the corrective amendment to those NHCEs as matching contributions for the 1995 plan year and, as a result, take them into account in determining whether the availability of the rate of matching contributions provided to H1 through H10 satisfies the current availability requirement of §1.401(a)(4)–4(b) for the 1995 plan year.

[T.D. 8485, 58 FR 46813, Sept. 3, 1993]

§1.401(a)(4)–12 Definitions.

Unless otherwise provided, the definitions in this section govern in applying the provisions of §§1.401(a)(4)–1 through 1.401(a)(4)–13.

Accumulation plan. Accumulation plan means a defined benefit plan under which the benefit of every employee for each plan year is separately determined, using plan year compensation (if benefits are determined as a percentage of compensation rather as than a dollar amount) separately calculated for the plan year, and each employee's total accrued benefit as of the end of a plan year is the sum of the separately determined benefit for that plan year and the total accrued benefit as of the end of the preceding plan year.

Acquired group of employees. Acquired group of employees means employees of a prior employer who become employed by the employer in a transaction between the employer and the prior employer that is a stock or asset acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business, plus employees hired by or transferred into the acquired trade or business on or before a date selected by the employer that is within the transition period defined in section 410(b)(6)(C)(ii). In addition, in the case of a transaction prior to the effective date of these regulations, the date by which employees must be hired by or transferred into the acquired trade or business in order to be included in the acquired group of employees may be any date prior to February 11, 1993, without regard to whether it is later than the end of the transition period defined in section 410(b)(6)(C)(ii).

Actuarial equivalent. An amount or benefit is the actuarial equivalent of, or is actuarially equivalent to, another amount or benefit at a given time if the actuarial present value of the two amounts or benefits (calculated using the same actuarial assumptions) at that time is the same.

Actuarial present value. Actuarial present value means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is—

(1) Multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied; and

(2) Discounted according to an assumed rate of interest to reflect the time value of money.

Ancillary benefit. Ancillary benefit is defined in §1.401(a)(4)–4(e)(2).

Average annual compensation. Average annual compensation is defined in §1.401(a)(4)–3(e)(2).

Base benefit percentage. Base benefit percentage is defined in §1.401(l)–1(c)(3).

Benefit formula. Benefit formula means the formula a defined benefit plan applies to determine the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) in the form of an annual benefit commencing at normal retirement age of an employee who continues in service until normal retirement age. Thus, for example, the benefit formula does not include the accrual method the plan applies (in conjunction with the benefit formula) to determine the accrued benefit of an employee who terminates employment before normal retirement age. For purposes of this definition, a change in

plan provisions that applies only to certain employees who terminate within a limited period of time (e.g., an early retirement window benefit) is treated as a change in the plan's benefit formula for the employees to whom the change is potentially applicable during the period that the change is potentially applicable to them. The preceding sentence applies only to the extent that the change in plan provisions would result in a change in the benefit formula if it were permanent and applied without regard to when the employees' employment was terminated.

Benefit, right, or feature. Benefit, right, or feature means an optional form of benefit, an ancillary benefit, or an other right or feature within the meaning of §1.401(a)(4)–4(e).

Contributory DB plan. Contributory DB plan means a defined benefit plan that includes employee contributions not allocated to separate accounts.

Defined benefit excess plan. Defined benefit excess plan is defined in §1.401(l)–1(c)(16)(i).

Defined benefit plan. Defined benefit plan is defined in §1.410(b)–9.

Defined contribution plan. Defined contribution plan is defined in §1.410(b)–9.

Determination date. Determination date is defined in §1.401(a)(4)–8(b)(3)(iv)(A).

Employee. With respect to a plan for a given plan year, employee means an employee (within the meaning of §1.410(b)–9) who benefits as an employee under the plan for the plan year (within the meaning of §1.410(b)–3).

Employer. Employer is defined in §1.410(b)–9.

ESOP. ESOP is defined in §1.410(b)–9.

Excess benefit percentage. Excess benefit percentage is defined in §1.401(l)–1(c)(14).

Former employee. With respect to a plan for a given plan year, former employee means a former employee (within the meaning of §1.410(b)–9).

Former HCE. Former HCE means a highly compensated former employee as defined in §1.410(b)–9.

Former NHCE. Former NHCE means a former employee who is not a former HCE.

Fresh-start date. Fresh-start date is defined in §1.401(a)(4)–13(c)(5)(iii).

Fresh-start group. Fresh-start group is defined in §1.401(a)(4)–13(c)(5)(ii).

Gross benefit percentage. Gross benefit percentage is defined in §1.401(l)–1(c)(18).

HCE. HCE means a highly compensated employee as defined in §1.410(b)–9 who benefits under the plan for the plan year (within the meaning of §1.410(b)–3).

Integration level. Integration level is defined in §1.401(l)–1(c)(20).

Measurement period. Measurement period is defined in §1.401(a)(4)–3(d)(1)(iii).

Multiemployer plan. Multiemployer plan is defined in §1.410(b)–9.

NHCE. NHCE means an employee who is not an HCE.

Nonexcludable employee. Nonexcludable employee means an employee within the meaning of §1.410(b)–9, other than an excludable employee with respect to the plan as determined under §1.410(b)–6. A nonexcludable employee may be either a highly or nonhighly compensated nonexcludable employee, depending on the nonexcludable employee's status under section 414(q).

Normalize. With respect to a benefit payable to an employee in a particular form, normalize means to convert the benefit to an actuarially equivalent straight life annuity commencing at the employee's testing age. The actuarial assumptions used in normalizing a benefit must be reasonable and must be applied on a gender-neutral basis. A standard interest rate and a standard mortality table are among the assumptions considered reasonable for this purpose.

Offset plan. Offset plan is defined in §1.401(l)–1(c)(24).

Optional form of benefit. Optional form of benefit is defined in §1.401(a)(4)–4(e)(1).

Other right or feature. Other right or feature is defined in §1.401(a)(4)–4(e)(3).

Plan. Plan means a plan within the meaning of §1.410(b)–7 (a) and (b), after application of the mandatory disaggregation rules of §1.410(b)–7(c) and the permissive aggregation rules of §1.410(b)–7(d).

Plan year. Plan year is defined in §1.410(b)–9.

Plan year compensation—(1) *In general.* Plan year compensation means section 414(s) compensation for the plan year determined by measuring section 414(s) compensation during one of the periods described in paragraphs (2) through (4) of this definition. Whichever period is selected must be applied uniformly to determine the plan year compensation of every employee.

(2) *Plan year.* This period consists of the plan year.

(3) *Twelve-month period ending in the plan year.* This period consists of a specified 12-month period ending with or within the plan year, such as the calendar year or the period for determining benefit accruals described in § 1.401(a)(4)–3(f)(6).

(4) *Period of plan participation during the plan year.* This period consists of the portion of the plan year during which the employee is a participant in the plan. This period may be used to determine plan year compensation for the plan year in which participation begins, the plan year in which participation ends, or both. This period may be used to determine plan year compensation when substituted for average annual compensation in § 1.401(a)(4)–3(e)(2)(ii)(A) only if the plan year is also the period for determining benefit accruals under the plan rather than another period as permitted under § 1.401(a)(4)–3(f)(6). Further, selection of this period must be made on a reasonably consistent basis from plan year to plan year in a manner that does not discriminate in favor of HCEs.

(5) *Special rule for new employees.* Notwithstanding the uniformity requirement of paragraph (1) of this definition, if employees' plan year compensation for a plan year is determined based on a 12-month period ending within the plan year under paragraph (3) of this definition, then the plan year compensation of any employees whose date of hire was less than 12 months before the end of that 12-month period must be determined uniformly based either on the plan year or on the employees' periods of participation during the plan year, as provided in paragraphs (2) and (4), respectively, of this definition.

QJSA. QJSA means a qualified joint and survivor annuity as defined in section 417(b).

QSUPP—(1) *In general.* QSUPP or qualified social security supplement means a social security supplement that meets each of the requirements in paragraphs (2) through (6) of this definition.

(2) *Accrual*—(i) *General rule.* The amount of the social security supplement payable at any age for which the employee is eligible for the social security supplement must be equal to the lesser of—

(A) The employee's old-age insurance benefit, unreduced on account of age, under title II of the Social Security Act; and

(B) The accrued social security supplement, determined under one of the methods in paragraph (2) (ii) through (iv) of this definition.

(ii) *Section 401(l) plans.* In the case of a section 401(l) plan that is a defined benefit excess plan, each employee's accrued social security supplement equals the employee's average annual compensation up to the integration level, multiplied by the disparity provided by the plan for the employee's years of service used in determining the employee's accrued benefit under the plan. In the case of a section 401(l) plan that is an offset plan, each employee's accrued social security supplement equals the dollar amount of the offset accrued for the employee under the plan.

(iii) *PIA offset plan.* In the case of a PIA offset plan, each employee's accrued social security supplement equals the dollar amount of the offset accrued for the employee under the plan. For this purpose, a PIA offset plan is a plan that reduces an employee's benefit by an offset based on a stated percentage of the employee's primary insurance amount under the Social Security Act.

(iv) *Other plans.* In the case of any other plan, each employee's social security supplement accrues ratably over the period beginning with the later of the employee's commencement of participation in the plan or the effective date of the social security supplement and ending with the earliest age at which the social security supplement is payable to the employee. The effective date of the social security supplement is the later of the effective date of the

amendment adding the social security supplement or the effective date of the amendment modifying an existing social security supplement to comply with the requirements of this definition. If, by the end of the first plan year to which these regulations apply, as set forth in § 1.401(a)(4)–13 (a) and (b), an amendment is made to a social security supplement in existence on September 19, 1991, the employer may treat the accrued portion of the social security supplement, as determined under the plan without regard to amendments made after September 19, 1991, as included in the employee's accrued social security supplement, provided that the remainder of the social security supplement is accrued under the otherwise-applicable method.

(3) *Vesting*. The plan must provide that an employee's right to the accrued social security supplement becomes nonforfeitable within the meaning of section 411 as if it were an early retirement benefit.

(4) *Eligibility*. The plan must impose the same eligibility conditions on receipt of the social security supplement as on receipt of the early retirement benefit in conjunction with which the social security supplement is payable. Furthermore, if the service required for an employee to become eligible for the social security supplement exceeds 15 years, then the ratio percentage of the group of employees who actually satisfy the eligibility conditions on receipt of the QSUPP in the current plan year must equal or exceed the unsafe harbor percentage applicable to the plan under § 1.410(b)–4(c)(4)(ii).

(5) *QJSA*. At each age, the most valuable QSUPP commencing at that age must be payable in conjunction with the QJSA commencing at that age. In addition, the plan must provide that, in the case of a social security supplement payable in conjunction with a QJSA, the social security supplement will be paid after the employee's death on the same terms as the QJSA, but in no event for a period longer than the period for which the social security supplement would have been paid to the employee had the employee not died. For example, if the QJSA is in the form of a joint annuity with a 50-percent survivor's benefit, the social security supplement must provide a 50-percent survivor's benefit. When section 417(c) requires the determination of a QJSA for purposes of determining a qualified pre-retirement survivor's annuity as defined in section 417(c) (QPSA), the social security supplement payable in conjunction with that QJSA must be paid in conjunction with the QPSA.

(6) *Protection*. The plan must specifically provide that the social security supplement is treated as an early retirement benefit that is protected under section 411(d)(6) (other than for purposes of sections 401(a)(11) and 417). Thus, the accrued social security supplement must continue to be payable notwithstanding subsequent amendment of the plan (including the plan's termination), and an employee may meet the eligibility requirements for the social security supplement after plan termination.

Qualified plan. Qualified plan means a plan that satisfies section 401(a). For this purpose, a qualified plan includes an annuity plan described in section 403(a).

Rate group. Rate group is defined in § 1.401(a)(4)–2(c)(1) or is defined in § 1.401(a)(4)–3(c)(1).

Ratio percentage. Ratio percentage is defined in § 1.410(b)–9.

Section 401(a)(17) employee. Section 401(a)(17) employee is defined in § 1.401(a)(17)–1(e)(2)(ii).

Section 401(k) plan. Section 401(k) plan is defined in § 1.410(b)–9.

Section 401(l) plan. Section 401(l) plan is defined in § 1.410(b)–9.

Section 401(m) plan. Section 401(m) plan is defined in § 1.410(b)–9.

Section 414(s) compensation—(1) *General rule*. When used with reference to compensation for a plan year, 12-month period, or other specified period, section 414(s) compensation means compensation measured using an underlying definition that satisfies section 414(s) for the applicable plan year. Whether an underlying definition of compensation satisfies section 414(s) is determined on a year-by-year basis, based on the provisions of section 414(s) in effect for the applicable plan year and, if relevant, the employer's HCEs and NHCEs for that plan year. See § 1.414(s)–1(i) for transition rules for

plan years beginning before the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b). For a plan year or 12-month period beginning before January 1, 1988, any underlying definition of compensation may be used to measure the amount of employees' compensation for purposes of this definition, provided that the definition was nondiscriminatory based on the facts and circumstances in existence for that plan year or for the plan year in which that 12-month period ends.

(2) *Determination period for section 414(s) nondiscrimination requirement*—(i) *General rule*. If an underlying definition of compensation must satisfy the nondiscrimination requirement in §1.414(s)–1(d)(3) in order to satisfy section 414(s) for a plan year, any one of the following determination periods may be used to satisfy the nondiscrimination requirement—

(A) The plan year;

(B) The calendar year ending in the plan year; or

(C) The 12-month period ending in the plan year that is used to determine the underlying definition of compensation.

(ii) *Exception for partial plan year compensation*. Notwithstanding the general rule in paragraph (2)(i) of this definition, if the period for measuring the underlying compensation is the portion of the plan year during which each employee is a participant in the plan (as provided in paragraph (4) of the definition of plan year compensation in this section), that period must be used as the determination period.

(3) *Plans using permitted disparity*. In the case of a section 401(l) plan or a plan that imputes permitted disparity in accordance with §1.401(a)(4)–7, an underlying definition of compensation is not section 414(s) compensation if the definition results in significant underinclusion of compensation for employees.

(4) *Double proration of service and compensation*. If a defined benefit plan prorates benefit accruals as permitted under section 411(b)(4)(B) by crediting less than full years of participation, then compensation for a plan year, 12-month period, or other specified period that is used to determine the amount of an employee's benefits under the plan will not fail to be section 414(s) compensation, merely because the amount of compensation for that period is adjusted to reflect the equivalent of full-time compensation to the extent necessary to satisfy the requirements of 29 CFR 2530.204–2(d) (regarding double proration of service and compensation). This adjustment is disregarded in determining whether the underlying definition of compensation used satisfies the requirements of section 414(s). Thus, for example, if the underlying definition of compensation is an alternative definition that must satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3), in determining whether that requirement is satisfied with regard to the underlying definition, the compensation included for any employee is determined without any adjustment to reflect the equivalent of full-time compensation required by 29 CFR 2530.204–2(d).

Social security supplement. Social security supplement is defined in §1.411(a)–7(c)(4)(ii).

Standard interest rate. Standard interest rate means an interest rate that is neither less than 7.5 percent nor greater than 8.5 percent, compounded annually. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard interest rate.

Standard mortality table. Standard mortality table means one of the following tables: the UP–1984 Mortality Table (Unisex); the 1983 Group Annuity Mortality Table (1983 GAM) (Female); the 1983 Group Annuity Mortality Table (1983 GAM) (Male); the 1983 Individual Annuity Mortality Table (1983 IAM) (Female); the 1983 Individual Annuity Mortality Table (1983 IAM) (Male); the 1971 Group Annuity Mortality Table (1971 GAM) (Female); the 1971 Group Annuity Mortality Table (1971 GAM) (Male); the 1971 Individual Annuity Mortality Table (1971 IAM) (Female); or the 1971 Individual Annuity Mortality Table (1971 IAM) (Male). These standard mortality tables are available from the Society of Actuaries, 475 N. Martingale Road, Suite 800, Schaumberg, Illinois 60173. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard mortality table. See

§ 601.601(d)(2)(ii)(*b*) of this Chapter. The applicable mortality table under section 417(e)(3)(A)(ii)(I) is also a standard mortality table.

Straight life annuity. Straight life annuity means an annuity payable in equal installments for the life of the employee that terminates upon the employee's death.

Testing age. With respect to an employee, testing age means the age determined for the employee under the following rules:

(1) If the plan provides the same uniform normal retirement age for all employees, the employee's testing age is the employee's normal retirement age under the plan.

(2) If a plan provides different uniform normal retirement ages for different employees or different groups of employees, the employee's testing age is the employee's latest normal retirement age under any uniform normal retirement age under the plan, regardless of whether that particular uniform normal retirement age actually applies to the employee under the plan.

(3) If the plan does not provide a uniform normal retirement age, the employee's testing age is 65.

(4) If an employee is beyond the testing age otherwise determined for the employee under paragraphs (1) through (3) of this definition, the employee's testing age is the employee's current age. The rule in the preceding sentence does not apply in the case of a defined benefit plan that fails to satisfy the requirements of § 1.401(a)(4)–3(f)(3)(i) (permitting certain increases in benefits that commence after normal retirement age to be disregarded).

Testing service. Testing service is defined in § 1.401(a)(4)–3(d)(1)(iv).

Uniform normal retirement age—(1) *General rule*. Uniform normal retirement age means a single normal retirement age under the plan that does not exceed the maximum age in paragraph (2) of this definition and that is the same for all of the employees in a given group. A group of employees does not fail to have a uniform normal retirement age merely because the plan contains provisions described in paragraphs (3) and (4) of this definition.

(2) *Maximum age*. The maximum age is generally 65. However, if all employees have the same social security retirement age (within the meaning of section 415(b)(8)), the maximum age is the employees' social security retirement age. Thus, for example, a component plan has a uniform normal retirement age of 67 if it defines normal retirement age as social security retirement age and all employees in the component plan have a social security retirement age of 67.

(3) *Stated anniversary date*—(i) *General rule*. A group of employees does not fail to have a uniform normal retirement age merely because the plan provides that the normal retirement age of all employees in the group is the later of a stated age (not exceeding the maximum age in paragraph (2) of this definition) or a stated anniversary no later than the fifth anniversary of the time each employee commenced participation in the plan. For employees who commenced participation in the plan before the first plan year beginning on or after January 1, 1988, the stated anniversary date may be later than the anniversary described in the preceding sentence if it is no later than the earlier of the tenth anniversary of the date the employee commenced participation in the plan (or such earlier anniversary selected by the employer, if less than 10) or the fifth anniversary of the first day of the first plan year beginning on or after January 1, 1988.

(ii) *Use of service other than anniversary of commencement of participation*. In lieu of using a stated anniversary date as permitted under paragraph (3)(i) of this definition, a plan may use a stated number of years of service measured on another basis, provided that the determination is made on a basis that satisfies section 411(a)(8) and that the stated number of years of service does not exceed the number of anniversaries permitted under paragraph (3)(i) of this definition. For example, a uniform normal retirement age could be based on the earlier of the fifth anniversary of the commencement of participation and the completion of five years of vesting service.

(4) *Conversion of normal retirement age to normal retirement date*. A group of employees does not fail to have a uniform normal retirement age merely because a defined benefit plan provides

for the commencement of normal retirement benefits on different retirement dates for different employees if each employee's normal retirement date is determined on a reasonable basis with reference to an otherwise uniform normal retirement age and the difference between the normal retirement date and the uniform normal retirement age cannot exceed six months for any employee. Thus, for example, benefits under a plan do not fail to commence at a uniform normal retirement age of age 62 for purposes of § 1.401(a)(4)–3(b)(2)(i), merely because the plan's normal retirement date is defined as the last day of the plan year nearest attainment of age 62.

Year of service. Year of service means a year of service as defined in the plan for a specific purpose, including the method of crediting service for that purpose under the plan.

[T.D. 8485, 58 FR 46820, Sept. 3, 1993, as amended by T.D. 8954, 66 FR 34545, June 29, 2001]

§ 1.401(a)(4)–13 Effective dates and fresh-start rules.

(a) *General effective dates*—(1) *In general.* Except as otherwise provided in this section, §§ 1.401(a)(4)–1 through 1.401(a)(4)–13 apply to plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations.* In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§ 1.401(a)(4)–1 through 1.401(a)(4)–13 apply to plan years beginning on or after January 1, 1996.

(3) *Compliance during transition period.* For plan years beginning before the effective date of these regulations, as set forth in paragraph (a)(1) and (2) of this section, and on or after the first day of the first plan year to which the amendments made to section 410(b) by section 1112(a) of the Tax Reform Act of 1986 (TRA '86) apply, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(4), taking into account pre-existing guidance and the amendments made by TRA '86 to related provisions of the Code (including, for example, sections 401(l), 401(a)(17), and 410(b)). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(a)(4) will generally be determined on the basis of all the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(a)(4) if it is operated in accordance with the terms of §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

(b) *Effective date for governmental plans.* In the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§ 1.401(a)(4)–1 through 1.401(a)(4)–13 apply to plan years beginning on or after the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. Such plans are deemed to satisfy section 401(a)(4) for plan years before that effective date. For purposes of this paragraph (b), the governing body with authority to amend the plan is the legislature, board, commission, council, or other governing body with authority to amend the plan.

(c) *Fresh-start rules for defined benefit plans*—(1) *Introduction.* This paragraph (c) provides rules that must be satisfied in order to use the fresh-start testing options for defined benefit plans in § 1.401(a)(4)–3(b)(6)(vii) and (d)(3)(iii), relating to the safe harbors and the general test, respectively. Those fresh-start options are designed to allow a plan to be tested without regard to benefits accrued before a selected fresh-start date. To the extent provided in paragraph (d) of this section, those options also may be used to disregard certain increases in benefits attributable to compensation increases after a fresh-start date. Although this paragraph (c) generally requires a plan to be amended to freeze employees' accrued benefits as of a fresh-start date and to provide any additional accrued benefits after the fresh-start date solely in accordance with certain specified formulas, certain of these requirements do not apply to a plan that is tested

under the general test of §1.401(a)(4)–3(c). See §1.401(a)(4)–3(b)(6)(vii) and (d)(3)(iii).

(2) *General rule.* A defined benefit plan satisfies this paragraph (c) if—

(i) Accrued benefits of employees in the fresh-start group are frozen as of the fresh-start date in accordance with paragraph (c)(3) of this section;

(ii) Accrued benefits after the fresh-start date for employees in the fresh-start group are determined under one of the fresh-start formulas in paragraph (c)(4) of this section; and

(iii) Paragraph (c)(5) of this section is satisfied.

(3) *Definition of frozen*—(i) *General rule.* An employee's accrued benefit under a plan is frozen as of the fresh-start date if it is determined as if the employee terminated employment with the employer as of the fresh-start date (or the date the employee actually terminated employment with the employer, if earlier), and without regard to any amendment to the plan adopted after that date, other than amendments recognized as effective as of or before that date under section 401(b) or §1.401(a)(4)–11(g). The assumption that an employee has terminated employment applies solely for purposes of this paragraph (c)(3). Thus, for example, the fresh start has no effect on the service taken into account for purposes of determining vesting and eligibility for benefits, rights, and features under the plan.

(ii) *Permitted compensation adjustments.* An employee's accrued benefit under a plan that satisfies paragraph (d) of this section does not fail to be frozen as of the fresh-start date merely because the plan makes the adjustments described in paragraph (d)(7) and (8) of this section with regard to the fresh-start date. In addition, if the frozen accrued benefit of an employee under the plan includes top-heavy minimum benefits, an employee's accrued benefit under a plan does not fail to be frozen as of the fresh-start date merely because the plan increases the frozen accrued benefit of each employee in the fresh-start group solely to the extent necessary to comply with the average compensation requirement of section 416(c)(1)(D)(i).

(iii) *Permitted changes in optional forms.* An employee's accrued benefit under a plan does not fail to be frozen as of the fresh-start date merely because the plan provides a new optional form of benefit with respect to the frozen accrued benefit, if—

(A) The optional form is provided with respect to each employee's entire accrued benefit (i.e., accrued both before and after the fresh-start date);

(B) The plan provided meaningful coverage as of the fresh-start date, as described in paragraph (d)(4) of this section; and

(C) The plan provides meaningful current benefit accruals as described in paragraph (d)(6) of this section.

(iv) *Floor-offset plans.* In the case of a plan that was a floor-offset plan described in §1.401(a)(4)–8(d) prior to the fresh-start date, an employee's accrued benefit as of the fresh-start date does not fail to be frozen merely because the actuarial equivalent of the account balance in the defined contribution plan that is offset against the defined benefit plan varies as a result of investment return that is different from the assumed interest rate used to determine the actuarial equivalent of the account balance.

(4) *Fresh-start formulas*—(i) *Formula without wear-away.* An employee's accrued benefit under the plan is equal to the sum of—

(A) The employee's frozen accrued benefit; and

(B) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year (current formula) as applied to the employee's years of service after the fresh-start date.

(ii) *Formula with wear-away.* An employee's accrued benefit under the plan is equal to the greater of—

(A) The employee's frozen accrued benefit; or

(B) The employee's accrued benefit determined under the current formula as applied to the employee's total years of service (before and after the fresh-start date) taken into account under the current formula.

(iii) *Formula with extended wear-away.* An employee's accrued benefit under the plan is equal to the greater of—

(A) The amount determined under paragraph (c)(4)(i) of this section; or

(B) The amount determined under paragraph (c)(4)(ii)(B) of this section.

(5) *Rules of application*—(i) *Consistency requirement*. This paragraph (c)(5) is not satisfied unless the fresh-start rules in this paragraph (c) (and paragraph (d) of this section, if applicable) are applied consistently to all employees in the fresh-start group. Thus, for example, the same fresh-start date and fresh-start formula (within the meaning of paragraph (c)(4) of this section) must apply to all employees in the fresh-start group. Similarly, if a plan makes a fresh start for all employees with accrued benefits on the fresh-start date and, for a later plan year, is aggregated for purposes of section 401(a)(4) with another plan that did not make the same fresh start, the aggregated plan must make a new fresh start in order to use the fresh-start rules for that later plan year or any subsequent plan year.

(ii) *Definition of fresh-start group*. Generally, the fresh-start group with respect to a fresh start consists of all employees who have accrued benefits as of the fresh-start date and have at least one hour of service with the employer after that date. However, a fresh-start group with respect to a fresh start may consist exclusively of all employees who have accrued benefits as of the fresh-start date, have at least one hour of service with the employer after that date, and are—

(A) Section 401(a)(17) employees;

(B) Members of an acquired group of employees (provided the fresh-start date is the date determined under paragraph (c)(5)(iii)(B) of this section); or

(C) Employees with a frozen accrued benefit that is attributable to assets and liabilities transferred to the plan as of a fresh-start date in connection with the transfer (provided the fresh-start date is the date determined under paragraph (c)(5)(iii)(C) of this section) and for whom the current formula is different from the formula used to determine the frozen accrued benefit.

(iii) *Definition of fresh-start date*. Generally, the fresh-start date is the last day of a plan year. However, a plan may use a fresh-start date other than the last day of the plan year if—

(A) The plan satisfied the safe harbor rules of §1.401(a)(4)–3(b) for the period from the beginning of the plan year through the fresh-start date;

(B) The fresh-start group is an acquired group of employees, and the fresh-start date is the latest date of hire or transfer into an acquired trade or business selected by the employer for any employees to be included in the acquired group of employees; or

(C) The fresh-start group is the group of employees with a frozen accrued benefit that is attributable to assets and liabilities transferred to the plan and the fresh-start date is the date as of which the employees begin accruing benefits under the plan.

(6) *Examples*. The following examples illustrate the rules in this paragraph (c):

Example 1. (a) Employer X maintains a defined benefit plan with a calendar plan year. The plan formula provides an employee with a normal retirement benefit at age 65 of one percent of average annual compensation up to covered compensation multiplied by the employee's years of service for Employer X, plus 1.5 percent of average annual compensation in excess of covered compensation, multiplied by the employee's years of service for Employer X up to 40.

(b) For plan years beginning after 1994, Employer X amends the plan formula to provide a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation multiplied by the employee's total years of service for Employer X up to 35, plus 1.4 percent of average annual compensation in excess of covered compensation multiplied by the employee's years of service for Employer X up to 35. For plan years after 1994, each employee's accrued benefit is determined under the fresh-start formula in paragraph (c)(4)(iii) of this section (formula with extended wear-away), using December 31, 1994, as the fresh-start date.

(c) As of December 31, 1994, Employee M has 10 years of service for Employer X, has average annual compensation of $38,000, and has covered compensation of $30,000. Employee M's accrued benefit as of December 31, 1994, is therefore $4,200 ((1 percent×$30,000×10 years)+(1.5 percent×$8,000×10 years)). As of December 31, 1995, Employee M has 11 years of service for Employer X, has average annual compensation of $40,000 (determined by taking into account compensation before and after the fresh-start date), and has covered compensation of $32,000. Employee M's accrued benefit as of December 31, 1995, is $4,552, the greater of—

(1) $4,552, the sum of Employee M's accrued benefit frozen as of December 31, 1994, ($4,200) and the amended formula applied to Employee M's years of service after 1994 ((0.75 percent×$32,000×1 year)+(1.4 percent×$8,000×1 year), or $352); or

(2) $3,872, the amended formula applied to Employee M's total years of service ((0.75 percent×$32,000×11 years)+(1.4 percent×$8,000×11 years)).

Example 2. (a) Employer Y maintains a defined benefit plan, Plan A, that has a calendar plan year. For the 1995 plan year, Plan A satisfies the requirements for a safe harbor plan in §1.401(a)(4)–3(b). Employer Y selects a date in 1995 for all the employees, freezes the employees' accrued benefits as of that date under the rules of paragraph (c)(3) of this section, and, in accordance with the rules of this paragraph (c), amends Plan A to determine benefits for all employees after that date using the formula with wear-away described in paragraph (c)(4)(ii) of this section. The new benefit formula would satisfy the requirements for a safe harbor plan in §1.401(a)(4)–3(b) if all accrued benefits were determined under it.

(b) Because Plan A satisfied the requirements for a safe harbor plan for the period from the beginning of the plan year through the selected date, paragraph (c)(5)(iii)(A) of this section permits the selected date to be a fresh-start date, even if it is not the last day of the plan year. Thus, Plan A satisfies the requirements in this paragraph (c) for a fresh start as of the fresh-start date.

(c) Under §1.401(a)(4)–3(b)(6)(vii), a plan does not fail to satisfy the requirements of §1.401(a)(4)–3(b), merely because of benefits accrued under a different formula prior to a fresh-start date. Thus, Plan A still satisfies the safe harbor requirements of §1.401(a)(4)–3(b) after the amendment to the benefit formula. Because Plan A satisfied the requirements for a safe harbor plan for the period from the beginning of the plan year, taking the amendment into account, Employer Y may select any date within the plan year (which may be the same date as the first fresh-start date) and apply the fresh-start rules in this paragraph (c) a second time as of that date.

(d) *Compensation adjustments to frozen accrued benefits*—(1) *Introduction.* In addition to the fresh-start rules in paragraph (c) of this section, this paragraph (d) sets forth requirements that must be satisfied in order for a plan to disregard increases in benefits accrued as of a fresh-start date that are attributable to increases in employees' compensation after the fresh-start date.

(2) *In general.* In the case of a defined benefit plan that is tested under the safe harbors in §1.401(a)(4)–3(b) or §1.401(a)(4)–8(c)(3), an employee's adjusted accrued benefit (determined under the rules in paragraph (d)(8) of this section) may be substituted for the employee's frozen accrued benefit in applying the formulas in paragraph (c)(4) of this section (or paragraph (f)(2) of this section, if applicable) if paragraphs (d)(3) through (d)(7) of this section are satisfied. Thus, for example, in determining whether such a plan satisfies §1.401(a)(4)–3(b), any compensation adjustments to the employee's frozen accrued benefit described in paragraph (d)(8) of this section are disregarded. Similarly, in the case of a defined benefit plan tested under the general test in §1.401(a)(4)–3(c), the compensation adjustments described in paragraph (d)(8) of this section may be disregarded under the rules of §1.401(a)(4)–3(d)(3)(iii) if paragraphs (d)(3) through (d)(7) of this section are satisfied. Of course, any increases in accrued benefits exceeding these adjustments must be taken into account under the general test, and a plan providing such excess increases generally will fail to satisfy the safe harbor requirements of §1.401(a)(4)–3(b). Where paragraphs (d)(3) through (d)(7) of this section are satisfied with respect to a plan as of the fresh-start date, but one or more of those paragraphs fail to be satisfied for a later plan year, further compensation adjustments described in paragraph (d)(8) of this section may not be disregarded in testing the plan under §1.401(a)(4)–3.

(3) *Plan requirements*—(i) *Pre-fresh-start date.* As of the fresh-start date, the plan must have contained a benefit formula under which benefits of each employee in the fresh-start group that are accrued as of the fresh-start date and are attributable to service before the fresh-start date would be affected by the employee's compensation after the fresh-start date. A plan satisfies this requirement, for example, if it based benefits on an employee's highest average pay over a fixed period of years or on an employee's average pay over the employee's entire career with the employer. A plan does not satisfy this paragraph (d)(3)(i) if the Commissioner determines, based on all of the relevant facts and circumstances, that the plan provision described in the first

sentence of this paragraph (d)(3) was added primarily in order to provide additional benefits to HCEs that are disregarded under the special testing rules described in this paragraph (d).

(ii) *Post-fresh-start date.* The plan by its terms must provide that the accrued benefits of each employee in the fresh-start group after the fresh-start date be at least equal to the employee's adjusted accrued benefit (i.e., the frozen accrued benefit as of the fresh-start date, adjusted as provided under paragraph (d)(7) of this section, plus the compensation adjustments described in paragraph (d)(8) of this section).

(4) *Meaningful coverage as of fresh-start date.* The plan must have provided meaningful coverage as of the fresh-start date. A plan provided meaningful coverage as of the fresh-start date if the group of employees with accrued benefits under the plan as of the fresh-start date satisfied the minimum coverage requirements of section 410(b) as in effect on that date (determined without regard to section 410(b)(6)(C)). In order to satisfy the requirement in the preceding sentence, an employer may amend the plan to grant past service credit under the formula in effect as of the fresh-start date to NHCEs, if the amount of past service granted them is reasonably comparable, on average, to the amount of past service HCEs have under the plan. Any benefit increase that results from the grant of past service credit to a NHCE under this paragraph (d)(4) is included in the employee's frozen accrued benefit.

(5) *Meaningful ongoing coverage*—(i) *General rule.* The fresh-start group must have satisfied the minimum coverage requirements of section 410(b) for all plan years from the first plan year beginning after the fresh-start date through the current plan year. Thus, if a fresh-start group fails to satisfy the minimum coverage requirements of section 410(b) for any plan year, this paragraph (d)(5) is not satisfied for that plan year or any subsequent plan year; however, such a failure is not taken into account in determining whether this paragraph (d)(5) is satisfied for any previous plan year.

(ii) *Alternative rules.* Notwithstanding paragraph (d)(5)(i) of this section, a fresh-start group is deemed to satisfy this paragraph (d)(5) for all plan years following the fresh-start date if any one of the following requirements is satisfied:

(A) *Section 410(b) coverage for first five years.* The fresh-start group must have satisfied the minimum coverage requirements of section 410(b) for the first five plan years beginning after the fresh-start date.

(B) *Ratio percentage coverage as of fresh-start date.* The fresh-start group must have satisfied the ratio percentage test of §1.410(b)–2(b)(2) as of the fresh-start date.

(C) *Fresh start for acquired group of employees.* The fresh-start group must consist of an acquired group of employees that satisfied the minimum coverage requirements of section 410(b) (determined without regard to section 410(b)(6)(C)) as of the fresh-start date.

(D) *Fresh start before applicable effective date.* The fresh-start date with respect to the fresh-start group must have been on or before the effective date applicable to the plan under paragraph (a) or (b) of this section.

(6) *Meaningful current benefit accruals.* The benefit formula and accrual method under the plan that applies to the fresh-start group in the aggregate must provide benefit accruals in the current plan year (other than increases in benefits accrued as of the fresh-start date) at a rate that is meaningful in comparison to the rate at which benefits accrued for the fresh-start group in plan years beginning before the fresh-start date. Whether this requirement is satisfied with respect to a fresh-start group that does not include all employees in the plan with an hour of service after the fresh-start date may be determined taking into account the rate at which benefits are provided to other employees in the plan.

(7) *Minimum benefit adjustment*—(i) *In general.* In the case of a section 401(l) plan or a plan that imputes disparity under §1.401(a)(4)–7, the plan must make the minimum benefit adjustment described in paragraph (d)(7)(ii) or (iii) of this section.

(ii) *Excess or offset plans.* In the case of a plan that is a defined benefit excess plan as of the fresh-start date, each employee's frozen accrued benefit

is adjusted so that the base benefit percentage is not less than 50 percent of the excess benefit percentage. In the case of a plan that is a PIA offset plan (as defined in paragraph (2)(iii) of the definition of QSUPP in §1.401(a)(4)–12) as of the fresh-start date, each employee's offset as applied to determine the frozen accrued benefit is adjusted so that it does not exceed 50 percent of the benefit determined without applying the offset.

(iii) *Other plans.* In the case of a plan that is not described in paragraph (d)(7)(ii) of this section, each employee's frozen accrued benefit is adjusted in a manner that is economically equivalent to the adjustment required under that paragraph, taking into account the plan's benefit formula, accrual rate, and relevant employee factors, such as period of service.

(8) *Adjusted accrued benefit*—(i) *General rule.* The term adjusted accrued benefit means an employee's frozen accrued benefit that is adjusted as provided in paragraph (d)(7) of this section and then multiplied by a fraction (not less than one), the numerator of which is the employee's compensation for the current plan year and the denominator of which is the employee's compensation as of the fresh-start date determined under the same definition. For purposes of this adjustment, the compensation definition must be either the same compensation definition and formula used to determine the frozen accrued benefit or average annual compensation (determined without regard to §1.401(a)(4)–3(e)(2)(ii)(A) (use of plan year compensation)).

(ii) *Alternative formula for pre-effective-date fresh starts.* In the case of a fresh-start date before the effective date that applies to the plan under paragraph (a) or (b) of this section, the adjusted accrued benefit may be determined by multiplying the frozen accrued benefit by a fraction (not less than one) determined under this paragraph (d)(8)(ii). The numerator of the fraction is the employee's average annual compensation for the current plan year. The denominator of the fraction is the employee's reconstructed average annual compensation as of the fresh-start date. An employee's reconstructed average annual compensation is determined by—

(A) Selecting a single plan year beginning after the fresh-start date but beginning not later than the last day of the first plan year to which these regulations apply under paragraph (a) or (b) of this section;

(B) Determining the employee's average annual compensation for the selected plan year under the same method used to determine the employee's average annual compensation for the current plan year under this paragraph (d)(8)(ii); and

(C) Multiplying the employee's average annual compensation for the selected plan year by a fraction, the numerator of which is the employee's compensation as of the fresh-start date determined under the same compensation definition and formula used to determine the employee's frozen accrued benefit and the denominator of which is the employee's compensation for the selected plan year determined under the compensation definition and formula used to determine the employee's frozen accrued benefit.

(iii) *Effect of section 401(a)(17).* In determining the numerators and the denominators of the fractions described in this paragraph (d)(8), the annual compensation limit under section 401(a)(17) generally applies. See, however, §1.401(a)(17)–1(e)(4) for special rules applicable to section 401(a)(17) employees.

(iv) *Option to make less than the full permitted adjustment.* A plan may limit the increase in an employee's frozen accrued benefit for the current and all future years to a percentage (not more than 100 percent) of the increase otherwise provided under this paragraph (d)(8). Furthermore, the plan may, at any time, terminate all future adjustments permitted under this paragraph (d).

(v) *Alternative determination of adjusted accrued benefit.* In lieu of applying the fractions in paragraph (d)(8)(i) or (ii) of this section, a plan may determine an employee's adjusted accrued benefit by substituting the employee's compensation for the current plan year (determined under the same compensation formula and underlying definition of compensation used to determine the

employee's frozen accrued benefit) in the benefit formula used to determine the frozen accrued benefit. For this purpose, insignificant changes in the underlying definition of compensation to reflect current compensation practices will not be treated as a change in the definition of compensation. A plan may apply the alternative in this paragraph (d)(8)(v), only if it is reasonable to expect as of the fresh-start date that, over time, the use of this method instead of the general rule of paragraph (d)(8)(i) will not discriminate significantly in favor of HCEs.

(9) *Examples*. The following examples illustrate the rules of this paragraph (d).

Example 1. (a) Employer X maintains a defined benefit plan that is an excess plan with a calendar plan year. For plan years before 1989, the plan is integrated with benefits provided under the Social Security Act, providing each employee with a normal retirement benefit equal to one percent of the employee's average annual compensation in excess of the employee's covered compensation, multiplied by the employee's years of service for Employer X. The benefit formula thus provides no benefit with respect to average annual compensation up to covered compensation.

(b) As of December 31, 1988, Employee M has 10 years of service for Employer X and has covered compensation of $25,000 and average annual compensation of $20,000. Employee M's average annual compensation has never exceeded $20,000. Therefore, as of December 31, 1988, Employee M's accrued benefit under the plan is zero.

(c) Effective with the 1989 plan year, the plan is amended to provide each employee with a normal retirement benefit of 0.6 percent of average annual compensation up to covered compensation plus 1.2 percent of average annual compensation in excess of covered compensation, multiplied by the employee's years of service up to 35. The plan also provides that, for plan years after 1988, each employee's accrued benefit is determined under the formula in paragraph (c)(4)(i) of this section (formula without wear-away) and, in applying the fresh-start formula, each employee's frozen accrued benefit under paragraph (c)(4)(i) of this section will be adjusted under this paragraph (d), using the same compensation definition and formula used to determine the frozen accrued benefit under paragraph (d)(8)(i) of this section.

(d) The plan uses the permitted disparity of section 401(l) and thus must also make the minimum benefit adjustment under paragraph (d)(7) of this section. Because the excess benefit percentage under the plan for years before 1989 was one percent, the plan must provide a base benefit percentage for those years of at least 0.5 percent. After the minimum benefit adjustment, Employee M's accrued benefit as of December 31, 1988, is $1,000 (0.5 percent×$20,000×10 years).

(e) As of December 31, 1992, Employee M has 14 years of service and has covered compensation of $30,000 and average annual compensation of $35,000. Employee M's adjusted accrued benefit as of December 31, 1992, is $1,750 ($1,000×$35,000/$20,000), and Employee M's accrued benefit as of December 31, 1992, is $2,710 (the sum of $1,750 plus $960 ((0.6 percent×$30,000×4 years) plus (1.2 percent×$5,000×4 years))).

Example 2. (a) The facts are the same as in *Example 1*, except that in determining adjusted accrued benefits, the plan specifies the alternative method of paragraph (d)(8)(v) of this section. This method may be used because it is reasonable to expect as of the fresh-start date that, over time, the use of this method instead of the general rule of paragraph (d)(8)(i) will not discriminate significantly in favor of HCEs.

(b) As of December 31, 1992, Employee M's adjusted accrued benefit is $2,000 (10 years of service prior to the fresh-start date×(0.5 percent of $30,000+1.0 percent of the excess of $35,000 over $30,000)).

(c) Alternatively, Employer X may choose to use the method of paragraph (d)(8)(v) of this section but freezes the covered compensation level at the dollar level in place as of the fresh-start date. In such case, Employee M's adjusted accrued benefit as of December 31, 1992, would have been $2,250 (10 years of service prior to the fresh-start date×(0.5 percent of $25,000+1.0 percent of the excess of $35,000 over $25,000)). This method may be used because it is reasonable to expect as of the fresh-start date that, over time, the use of this method instead of the general rule of paragraph (d)(8)(i) will not discriminate significantly in favor of HCEs.

Example 3. (a) The facts are the same as in *Example 1*, except that for plan years before 1989, the plan provided a minimum benefit to certain employees equal to $120 per year of service. Employee M is entitled to the minimum benefit, and thus, Employee M's frozen accrued benefit as of December 31, 1988 was $1,200 (the greater of 10 years of service×$120 and $1,000, Employee M's benefit under the underlying formula, after the minimum benefit adjustment of paragraph (d)(7) of this section).

(b) Employer X's plan specifies instead the alternative method of adjusting accrued benefits described in paragraph (d)(8)(v) of this section. (The fact that a minimum benefit applying to certain employees is not adjusted under the alternative method of paragraph (d)(8)(v) of this section, but would be adjusted under the general rule of paragraph

(d)(8)(i) of this section does not change the conclusion in *Example 2*, that the plan may apply the alternative method).

(e) *Determination of initial theoretical reserve for target benefit plans*—(1) *General rule*. In the case of a target benefit plan the stated benefit formula under which takes into account service for years in which the plan did not satisfy §1.401(a)(4)–8(b)(3), as permitted under §1.401(a)(4)–8(b)(3)(vii), the theoretical reserve as of the determination date for the last plan year beginning before the first day of the first plan year in which the plan satisfies §1.401(a)(4)–8(b)(3) of an employee who was a participant in the plan on that determination date, is determined as follows:

(i) Determine the actuarial present value, as of that determination date, of the stated benefit that the employee is projected to have at the employee's normal retirement age, using the actuarial assumptions, the provisions of the plan, and the employee's compensation as of that determination date. For an employee whose attained age equals or exceeds the employee's normal retirement age, determine the actuarial present value of the employee's stated benefit at the employee's current age, but using an immediate straight life annuity factor for an employee whose attained age equals the employee's normal retirement age.

(ii) Calculate the actuarial present value of future required employer contributions (without regard to limitations under section 415 or additional contributions described in §1.401(a)(4)–8(b)(3)(v)) as of that determination date (i.e., the actuarial present value of the level contributions due for each plan year through the end of the plan year in which the employee attains normal retirement age). This calculation is made assuming that the required contribution in each future year will be equal to the required contribution for the plan year that includes that determination date, and applying the interest rate that was used in determining that required contribution.

(iii) Determine the excess, if any, of the amount determined in paragraph (e)(1)(i) of this section over the amount determined in paragraph (e)(1)(ii) of this section. This excess is the employee's theoretical reserve on that determination date.

(2) *Example*. The following example illustrates the determination of an employee's theoretical reserve.

Example. (a) A target benefit plan was adopted and in effect before September 19, 1991, and satisfied the requirements of Rev. Rul. 76–464, 1976–2 C.B. 115, with respect to all years credited under the stated benefit formula through 1993. The plan provides a stated benefit equal to 40 percent of compensation, payable annually as a straight life annuity beginning at normal retirement age. Normal retirement age under the plan is 65. The stated interest rate under the plan is six percent. The determination date for required contributions under the plan is the last day of the plan year. Employee M is 38 years old on the determination date for the 1993 plan year, has participated in the plan for five years, and has compensation equal to $60,000 in 1993. The amount of employer contribution to Employee M's account for 1993 was $2,468.

(b) Under these facts, Employee M's theoretical reserve is equal to $13,909, calculated as follows:

(1) The actuarial present value of Employee M's stated benefit is calculated using the actuarial assumptions, provisions of the plan and Employee M's compensation as of the determination date for the 1993 plan year. This amount is equal to $46,512, Employee M's stated benefit of $24,000 ($60,000 multiplied by 40 percent), multiplied by 1.938, the actuarial present value factor applicable to a participant who is 38 years old using a stated interest rate of six percent.

(2) The actuarial present value of future employer contributions is calculated assuming that the required contribution in each future year will be equal to the required contribution for the 1993 plan year and assuming the same interest rate as was used in determining that contribution. This amount is equal to $32,603, which is equal to the amount of the level annual employer contribution ($2,468) multiplied by a factor of 13.2105 (the temporary annuity factor for a period of 27 years, assuming the six percent interest rate that was used to determine the required employer contribution).

(3) Employee M's theoretical reserve is $13,909, the excess of the amount determined in paragraph (b)(1) of this *Example* over the amount determined in paragraph (b)(2) of this *Example*.

(f) *Special fresh-start rules for cash balance plans*—(1) *In general*. In order to satisfy the optional testing method of §1.401(a)(4)–8(c)(3) after a fresh-start date, a cash balance plan must apply

the rules of paragraph (c) of this section as modified under this paragraph (f). Paragraph (f)(2) of this section provides an alternative formula that may be used in addition to the formulas in paragraphs (c)(2) through (c)(4) of this section. Paragraph (f)(3) of this section sets forth certain limitations on use of the formulas in paragraph (c) or (f)(2) of this section.

(2) *Alternative formula*—(i) *In general.* An employee's accrued benefit under the plan is equal to the greater of—

(A) The employee's frozen accrued benefit, or

(B) The employee's accrued benefit determined under the plan's benefit formula applicable to benefit accruals in the current plan year as applied to years of service after the fresh-start date, modified in accordance with paragraph (f)(2)(ii) of this section.

(ii) *Addition of opening hypothetical account.* As of the first day after the fresh-start date, the plan must credit each employee's hypothetical account with an amount equal to the employee's opening hypothetical account (determined under paragraph (f)(2)(iii) of this section), adjusted for interest for the period that begins on the first day after the fresh-start date and that ends at normal retirement age. The interest adjustment in the preceding sentence must be made using the same interest rate applied to the hypothetical allocation for the first plan year beginning after the fresh-start date.

(iii) *Determination of opening hypothetical account*—(A) *General rule.* An employee's opening hypothetical account equals the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date. For this purpose, if the plan provides for a single sum distribution as of the fresh-start date, the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date equals the amount of a single sum distribution payable under the plan on that date, assuming that the employee terminated employment on the fresh-start date, the employee's accrued benefit was 100-percent vested, and the employee satisfied all eligibility requirements under the plan for the single sum distribution. If the plan does not offer a single sum distribution as of the fresh-start date, the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date must be determined using a standard mortality table and the applicable section 417(e) rates, as defined in §1.417(e)–1(d).

(B) *Alternative opening hypothetical account.* Alternatively, the employee's opening hypothetical account is the greater of the opening hypothetical account determined under paragraph (f)(2)(ii)(A) of this section and the employee's hypothetical account as of the fresh-start date determined in accordance with §1.401(a)(4)–8(c)(3)(v)(A) calculated under the plan's benefit formula applicable to benefit accruals in the current plan year as applied to the employee's total years of service through the fresh-start date in a manner that satisfies the past service credit rules of §1.401(a)(4)–8(c)(3)(viii).

(3) *Limitations on formulas*—(i) *Past service restriction.* If the plan does not satisfy the uniform hypothetical allocation formula requirement of §1.401(a)(4)–8(c)(3)(iii)(B) as of the fresh-start date, under §1.401(a)(4)–8(c)(3)(viii) the plan may not provide for past service credits, and thus may not use the formula in paragraph (c)(3) of this section (formula with wear-away), the formula in paragraph (c)(4) of this section (formula with extended wear-away), or the alternative determination of the opening hypothetical account in paragraph (f)(2)(iii)(B) of this section.

(ii) *Change in interest rate.* If the interest rate used to adjust employees' hypothetical allocations under §1.401(a)(4)–8(c)(3)(iv) for the plan year is different from the interest rate used for this purpose in the immediately preceding plan year, the plan must use the formula in paragraph (c)(2) of this section (formula without wear-away).

(iii) *Meaningful benefit requirement.* A plan is permitted to use the formula provided in paragraph (f)(2) of this section only if the plan satisfies paragraphs (d)(3) through (d)(5) of this section (regarding coverage as of fresh-start date, current benefit accruals,

and minimum benefit adjustment, respectively).

[T.D. 8360, 56 FR 47598, Sept. 19, 1991; 57 FR 4721, Feb. 7, 1992; 57 FR 10953, Mar. 31, 1992, as amended by T.D. 8485, 58 FR 46823, Sept. 3, 1993]

§ 1.401(a)(5)–1 Special rules relating to nondiscrimination requirements.

(a) *In general.* Section 401(a)(5) sets out certain provisions that will not of themselves be discriminatory within the meaning of section 410(b)(2)(A)(i) or section 401(a)(4). The exceptions specified in section 401(a)(5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered that will not of themselves constitute prohibited discrimination in contributions or benefits. See section 401(a)(4) and the regulations thereunder for the basic nondiscrimination rules. See § 1.410(b)–4 for the rule of section 410(b)(2)(A)(i) (relating to the nondiscriminatory classification test that is part of the minimum coverage requirements) referred to in section 401(a)(5)(A). See paragraphs (b) through (f) of this section for special rules used in applying the section 401(a)(4) nondiscrimination requirements under the remaining provisions of section 401(a)(5).

(b) *Salaried or clerical employees.* A plan does not fail to satisfy the nondiscrimination requirements of section 401(a)(4) merely because contributions or benefits provided under the plan are limited to salaried or clerical employees.

(c) *Uniform relationship to compensation.* A plan does not fail to satisfy the nondiscrimination requirements of section 401(a)(4) merely because the contributions or benefits of, or on behalf of, the employees under the plan bear a uniform relationship to the compensation (within the meaning of section 414(s)) of those employees.

(d) *Certain disparity permitted.* Under section 401(a)(5)(C), a plan does not discriminate in favor of highly compensated employees (as defined in section 414(q)), within the meaning of section 401(a)(4), in the amount of employer-provided contributions or benefits solely because—

(1) In the case of a defined contribution plan, employer contributions allocated to the accounts of employees favor highly compensated employees in a manner permitted by section 401(l) (relating to permitted disparity in plan contributions and benefits), and

(2) In the case of a defined benefit plan, employer-provided benefits favor highly compensated employees in a manner permitted by section 401(l) (relating to permitted disparity in plan contributions and benefits).

See §§ 1.401(l)–1 through 1.401(l)–6 for rules under which a plan may satisfy section 401(l) for purposes of the safe harbors of §§ 1.401(a)(4)–2(b)(3) and 1.401(a)(4)–3(b).

(e) *Defined benefit plans integrated with social security*—(1) *In general.* Under section 401(a)(5)(D), a defined benefit plan does not discriminate in favor of highly compensated employees (as defined in section 414(q)) with respect to the amount of employer-provided contributions or benefits solely because the plan provides that, with respect to each employee, the employer-provided accrued retirement benefit under the plan is limited to the excess (if any) of—

(i) The employee's final pay from the employer, over

(ii) The employer-provided retirement benefit created under the Social Security Act and attributable to service by the employee for the employer.

(2) *Final pay.* For purposes of paragraph (e)(1)(i) of this section, an employee's final pay from the employer as of a plan year is the employee's compensation (as defined in section 414(q)(7)) for the year (ending with or within the 5-plan-year period ending with the plan year in which the employee terminates from employment with the employer) in which the employee receives the highest compensation from the employer. Notwithstanding the preceding sentence, final pay for each employee under the plan may be determined with reference to the 5-plan-year period ending with the plan year before the plan year in which the employee terminates from employment with the employer. In determining an employee's final pay, the plan may specify any 12-month period (ending with or within the applicable 5-plan-year period) as a year provided

the specified 12-month period is uniformly and consistently applied with respect to all employees. In determining an employee's final pay, compensation for any year in excess of the applicable limit under section 401(a)(17) for the year may not be taken into account.

(3) *Rules for determining amount of employer-provided social security retirement benefit.* For purposes of paragraph (e)(1)(ii) of this section, the following rules apply.

(i) The employer-provided retirement benefit on which any reduction or offset in the employee's accrued retirement benefit is based is limited solely to the employer-provided primary insurance amount payable under section 215 of the Social Security Act attributable to service by the employee for the employer.

(ii) The employer-provided primary insurance amount attributable to service by the employee for the employer is determined by multiplying the employer-provided portion of the employee's projected primary insurance amount by a fraction (not exceeding 1), the numerator of which is the employee's number of complete years of covered service for the employer under the Social Security Act, and the denominator of which is 35.

(4) *Projected primary insurance amount.* (i) As of a plan year, an employee's projected primary insurance amount is the primary insurance amount, determined as of the close of the plan year (the ''determination date''), payable to the employee upon attainment of the employee's social security retirement age (as determined under section 415(b)(8)), assuming the employee's annual compensation from the employer that is treated as wages for purposes of the Social Security Act remains the same from the plan year until the employee's attainment of social security retirement age. With respect to service by the employee for the employer before the determination date, the actual compensation paid to the employee by the employer during all periods of service of the employee for the employer covered by the Social Security Act must be used in determining an employee's projected primary insurance amount. With respect to years before the employee's commencement of service for the employer, in determining the employee's projected primary insurance amount, it may be assumed that the employee received compensation in an amount computed by using a six-percent salary scale projected backwards from the determination date to the employee's 21st birthday. However, if the employee provides the employer with satisfactory evidence of the employee's actual past compensation for the prior years treated as wages under the Social Security Act at the time the compensation was earned and the actual past compensation results in a smaller projected primary insurance amount, the plan must use the actual past compensation. The plan administrator must give clear written notice to each employee of the employee's right to supply actual compensation history and of the financial consequences of failing to supply the history. The notice must be given each time the summary plan description is provided to the employee and must also be given upon the employee's separation from service. The notice must also state that the employee can obtain the actual compensation history from the Social Security Administration. In determining the employee's projected primary insurance amount, the employer may not take into account any compensation from any other employer while the employee is employed by the employer.

(ii) As of a plan year, the employer-provided portion of the employee's projected primary insurance amount under the Social Security Act is 50 percent of the employee's projected primary insurance amount (as determined under paragraph (e)(4)(i) of this section).

(5) *Employer-provided accrued retirement benefit.* For purposes of this section, the employee's employer-provided accrued retirement benefit as of a plan year is the employee's accrued retirement benefit under the plan (determined on an actual basis and not on a projected basis) attributable to employer contributions under the plan. With respect to plans that provide for employee contributions, see section

411(c) for rules relating to the allocation of accrued benefits between employer contributions and employee contributions.

(6) *Additional rules.* (i) As of a plan year, paragraph (e)(1) of this section does not apply to the extent that its application would result in a decrease in an employee's accrued benefit. See sections 411(b)(1)(G) and 411(d)(6).

(ii) Section 401(a)(5)(D) and this paragraph (e) do not apply to a plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(iii) If a plan provides for the payment of an employee's accrued retirement benefit (whether or not subsidized) commencing before an employee's social security retirement age, the projected employer-provided primary insurance amount attributable to service by the employee for the employer (as determined under paragraphs (e)(3) and (e)(4) of this section) that may be applied as an offset to limit the employee's accrued retirement benefit must be reduced in accordance with § 1.401(l)–3(e)(1). The reduction is made by multiplying the employee's projected employer-provided primary insurance amount by a fraction, the numerator of which is the appropriate factor under § 1.401(l)–3(e)(1), and the denominator of which is 0.75 percent.

(iv) The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of this section, including rules relating to the determination of an employee's projected primary insurance amount attributable to the employee's service for former employers and rules applying section 401(a)(5)(D) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not for other years.

(7) *Examples.* The following examples illustrate this paragraph (e).

Example 1. Employer Z maintains a noncontributory defined benefit plan that uses the calendar year as its plan year. The plan provides a normal retirement benefit, commencing at age 65, equal to $500 a year, multiplied by the employee's years of service for Z, limited to the excess of the amount of the employee's final pay from Z (as determined in accordance with paragraph (e)(2) of this section) over the employee's employer-provided primary insurance amount attributable to the employee's service for Z. If an employee's social security retirement age is greater than 65, the plan provides for reduction of the employee's employer-provided primary insurance amount in accordance with paragraph (e)(6)(iii) of this section. The plan provides no limitation on the number of years of service taken into account in determining benefits under the plan. Employee A retires on July 6, 1995, at A's social security retirement age of 65 with 35 years of service for Z. The plan uses the plan year as the 12–month period for determining an employee's year of final highest pay from the employer. A's compensation for A's final 5 plan years is as follows:

1995 plan year	$10,500
1994 plan year	$20,000
1993 plan year	$18,000
1992 plan year	$17,000
1991 plan year	$16,500

A's annual primary insurance amount under social security, determined as of A's social security retirement age, is $9,000, of which $4,500 is the employer-provided portion attributable to A's service for Z ($9,000 × 50 percent × 35/35). Under the plan's benefit formula (disregarding the final pay limitation), A would be entitled to receive a normal retirement benefit of $17,500 ($500 × 35 years). However, under the plan, A's otherwise determined normal retirement benefit of $17,500 is limited to the excess of the amount of A's final pay from Z over A's employer-provided primary insurance amount under social security attributable to A's service for Z. Accordingly, A's normal retirement benefit is determined to be $15,500 ($20,000 (A's final pay from Z) less $4,500 (A's employer-provided primary insurance amount attributable to A's service for Z)) rather than $17,500. The final pay limitation in Z's plan satisfies section 401(a)(5)(D) and this paragraph (e). Accordingly, the plan maintained by Z does not discriminate in favor of highly compensated employees within the meaning of section 401(a)(4) merely because of the final pay limitation contained in the plan.

Example 2. Assume the same facts as in *Example 1,* except that A has 32 years of service for Z when A retires at A's social security retirement age. Under the plan's benefit formula (disregarding the final pay limitation), A would be entitled to receive an annual normal retirement benefit of $16,000 ($500 × 32 years). However, the plan provides that A's normal retirement benefit of $16,000 will be limited to $15,500 ($20,000 (the amount of A's final pay from Z) less $4,500 (½ of A's primary insurance amount under the Social Security Act)). The final pay limitation does not satisfy this paragraph (e). The portion of A's employer-provided primary insurance amount under the Social Security Act attributable to A's service for Z is 32/35 × $4,500, or $4,114. Therefore, to satisfy this paragraph (e), the final pay provision in Z's plan may not limit A's otherwise determined normal retirement benefit of $16,000 to less than $15,886 ($20,000 (the amount of X's final pay) minus $4,114 (the portion of A's employer-provided primary insurance amount attributable to A's service for Z)).

Example 3. (a) Employer X maintains a noncontributory defined benefit plan that uses the calendar year as its plan year. The formula for determining benefits under the plan provides a normal retirement benefit at age 65 equal to 90 percent of an employee's final average compensation, with the benefit reduced by 1/30th for each year of the employee's service less than 30 and limited to the employee's final pay (as determined in accordance with paragraph (e)(2) of this section) less the employee's employer-provided primary insurance amount under social security attributable to the employee's service for X. The plan determines an employee's employer-provided projected primary insurance amount under social security attributable to the employee's service for X in accordance with paragraph (e)(3) of this section and applies the reductions applicable under paragraph (e)(6)(iii) of this section if benefits commence before social security retirement age. The plan determines an employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C).

(b) Employee A commences participation in the plan on January 1, 1990, when A is 35 years of age. A's social security retirement age is 67. As of the close of the 2014 plan year, A's final average compensation from X is $15,000; A's final pay from X is $15,400, and A's projected employer-provided annual primary insurance amount under social security attributable to A's service for X is $4,000 (after the reduction applicable under paragraph (e)(6)(iii) of this section). Under the plan formula, A's accrued benefit as of the close of the 2014 plan year is $11,250 (90 percent × $15,000 × 25/30). As of the close of the 2014 plan year, the plan's final pay limitation does not affect A's benefit because A's benefit under the plan as of the close of the plan year and before application of the final pay limitation ($11,250) does not exceed A's final pay of $15,400 from X, determined as of the close of the plan year, less A's employer-provided projected primary insurance amount under social security attributable to A's service for X ($4,000).

(c) Assume that, as of the close of the 2015 plan year, A's final average compensation from X is $14,500 and A's final pay from X is $15,400. Assume also that as of the close of the 2015 plan year, A's employer-provided primary insurance amount attributable to A's service for X is $4,200 (after the reduction applicable under paragraph (e)(6)(iii) of this section). Accordingly, A's benefit as of the close of the 2015 plan year and before application of the final pay limitation is $11,310 (90 percent × $14,500 × 26/30). Under the plan's final pay limitation, A's benefit of $11,310 would be limited to $11,200, the amount of A's final pay from X ($15,400), less A's employer-provided projected primary insurance amount under social security attributable to A's service for X ($4,200). However, the plan's final pay limitation may not be applied to limit A's accrued benefit for the 2015 plan year to an amount below $11,250, which was A's accrued benefit under the plan at the close of the prior plan year. The foregoing is further illustrated in the following table for the plan years presented above and for additional years of service performed by A for X.

TABLE

[In dollar amounts]

1	2	3	4	5	6	7
Years of service	Final average compensation	Benefit under plan formula (Column 2 × 0.9 × years of service/30)	Final pay	Employer-provided projected primary insurance amount under social security attributable to service for employer	Benefit if final pay reduction is applied in full (Column 4 − Column 5)	Benefit to which A is entitled (smaller of Column 6 or Column 3, but not less than Column 7 for prior year)
25	$15,000	$11,250	$15,400	$4,000	$11,400	$11,250
26	14,500	11,310	15,400	4,200	11,200	11,250

TABLE—Continued

[In dollar amounts]

1	2	3	4	5	6	7
Years of service	Final average compensation	Benefit under plan formula (Column 2 × 0.9 × years of service/30)	Final pay	Employer-provided projected primary insurance amount under social security attributable to service for employer	Benefit if final pay reduction is applied in full (Column 4 − Column 5)	Benefit to which A is entitled (smaller of Column 6 or Column 3, but not less than Column 7 for prior year)
27	15,500	12,555	15,800	4,400	11,400	11,400
28	15,500	13,020	16,000	4,500	11,500	11,500
29	15,000	13,050	16,000	4,800	11,200	11,500
30	14,500	13,050	16,000	5,000	11,000	11,500

(f) *Certain benefits not taken into account*. In determining whether a plan satisfies section 401(a)(4) and this section, other benefits created under state or federal law (e.g., worker's compensation benefits or black lung benefits) may not be taken into account.

(g) *More than one plan treated as single plan*. [Reserved]

(h) *Effective date*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, this section is effective for plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations*. In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), this section is effective for plan years beginning on or after January 1, 1996.

(3) *Compliance during transition period*. For plan years beginning before the effective date of these regulations, as set forth in paragraphs (h)(1) and (h)(2) of this section, and on or after the first day of the first plan year to which the amendments made to section 401(a)(5) by section 1111(b) of the Tax Reform Act of 1986 (TRA '86) apply, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(5), taking into account pre-existing guidance and the amendments made by TRA '86 to related provisions of the Code. Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(a)(5) will generally be determined based on all of the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(a)(5) if it is operated in accordance with the terms of this section.

[T.D. 8359, 56 FR 47614, Sept. 19, 1991; 57 FR 10817, 10818, 10951, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46830, Sept. 3, 1993]

§ 1.401(a)(17)–1 Limitation on annual compensation.

(a) *Compensation limit requirement*—(1) *In general*. In order to be a qualified plan, a plan must satisfy section 401(a)(17). Section 401(a)(17) provides an annual compensation limit for each employee under a qualified plan. This limit applies to a qualified plan in two ways. First, a plan may not base allocations, in the case of a defined contribution plan, or benefit accruals, in the case of a defined benefit plan, on compensation in excess of the annual compensation limit. Second, the amount of an employee's annual compensation that may be taken into account in applying certain specified nondiscrimination rules under the Internal Revenue Code is subject to the annual compensation limit. These two limitations are set forth in paragraphs (b) and (c) of this section, respectively. Paragraph (d) of this section provides the effective dates of section 401(a)(17), the amendments made by section 13212 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), and this section. Paragraph (e) of this section provides

rules for determining post-effective-date accrued benefits under the fresh-start rules.

(2) *Annual compensation limit for plan years beginning before January 1, 1994.* For purposes of this section, for plan years beginning prior to the OBRA '93 effective date, annual compensation limit means $200,000, adjusted as provided by the Commissioner. The amount of the annual compensation limit is adjusted at the same time and in the same manner as under section 415(d). The base period for the annual adjustment is the calendar quarter ending December 31, 1988, and the first adjustment is effective on January 1, 1990. Any increase in the annual compensation limit is effective as of January 1 of a calendar year and applies to any plan year beginning in that calendar year. In any plan year beginning prior to the OBRA '93 effective date, if compensation for any plan year beginning prior to the statutory effective date is used for determining allocations or benefit accruals, or when applying any nondiscrimination rule, then the annual compensation limit for the first plan year beginning on or after the statutory effective date (generally $200,000) must be applied to compensation for that prior plan year.

(3) *Annual compensation limit for plan years beginning on or after January 1, 1994*—(i) *In general.* For purposes of this section, for plan years beginning on or after the OBRA '93 effective date, annual compensation limit means $150,000, adjusted as provided by the Commissioner. The adjusted dollar amount of the annual compensation limit is determined by adjusting the $150,000 amount for changes in the cost of living as provided in paragraph (a)(3)(ii) of this section and rounding this adjusted dollar amount as provided in paragraph (a)(3)(iii) of this section. Any increase in the annual compensation limit is effective as of January 1 of a calendar year and applies to any plan year beginning in that calendar year. For example, if a plan has a plan year beginning July 1, 1994, and ending June 30, 1995, the annual compensation limit in effect on January 1, 1994 ($150,000), applies to the plan for the entire plan year.

(ii) *Cost of living adjustment.* The $150,000 amount is adjusted for changes in the cost of living by the Commissioner at the same time and in the same manner as under section 415(d). The base period for the annual adjustment is the calendar quarter ending December 31, 1993.

(iii) *Rounding of adjusted compensation limit.* After the $150,000, adjusted in accordance with paragraph (a)(3)(ii) of this section, exceeds the annual compensation limit for the prior calendar year by $10,000 or more, the annual compensation limit will be increased by the amount of such excess, rounded down to the next lowest multiple of $10,000.

(4) *Additional guidance.* The Commissioner may, in revenue rulings and procedures, notices, and other guidance, published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), provide any additional guidance that may be necessary or appropriate concerning the annual limits on compensation under section 401(a)(17).

(b) *Plan limit on compensation*—(1) *General rule.* A plan does not satisfy section 401(a)(17) unless it provides that the compensation taken into account for any employee in determining plan allocations or benefit accruals for any plan year is limited to the annual compensation limit. For purposes of this rule, allocations and benefit accruals under a plan include all benefits provided under the plan, including ancillary benefits.

(2) *Plan-year-by-plan-year requirement.* For purposes of this paragraph (b), the limit in effect for the current plan year applies only to the compensation for that year that is taken into account in determining plan allocations or benefit accruals for the year. The compensation for any prior plan year taken into account in determining an employee's allocations or benefit accruals for the current plan year is subject to the applicable annual compensation limit in effect for that prior year. Thus, increases in the annual compensation limit apply only to compensation taken into account for the plan year in which the increase is effective. In addition, if compensation for any plan year

beginning prior to the OBRA '93 effective date is used for determining allocations or benefit accruals in a plan year beginning on or after the OBRA '93 effective date, then the annual compensation limit for that prior year is the annual compensation limit in effect for the first plan year beginning on or after the OBRA '93 effective date (generally $150,000).

(3) *Application of limit to a plan year*—(i) *In general*. For purposes of applying this paragraph (b), the annual compensation limit is applied to the compensation for the plan year on which allocations or benefit accruals are based.

(ii) *Compensation for the plan year*. If a plan determines compensation used in determining allocations or benefit accruals for a plan year based on compensation for the plan year, then the annual compensation limit that applies to the compensation for the plan year is the limit in effect for the calendar year in which the plan year begins. Alternatively, if a plan determines compensation used in determining allocations or benefit accruals for the plan year on the basis of compensation for a 12-consecutive-month period, or periods, ending no later than the last day of the plan year, then the annual compensation limit applies to compensation for each of those periods based on the annual compensation limit in effect for the respective calendar year in which each 12-month period begins.

(iii) *Compensation for a period of less than 12-months*—(A) *Proration required*. If compensation for a period of less than 12 months is used for a plan year, then the otherwise applicable annual compensation limit is reduced in the same proportion as the reduction in the 12-month period. For example, if a defined benefit plan provides that the accrual for each month in a plan year is separately determined based on the compensation for that month and the plan year accrual is the sum of the accruals for all months, then the annual compensation limit for each month is 1/12th of the annual compensation limit for the plan year. In addition, if the period for determining compensation used in calculating an employee's allocation or accrual for a plan year is a short plan year (i.e., shorter than 12 months), the annual compensation limit is an amount equal to the otherwise applicable annual compensation limit multiplied by a fraction, the numerator of which is the number of months in the short plan year, and the denominator of which is 12.

(B) *No proration required for participation for less than a full plan year*. Notwithstanding paragraph (b)(3)(iii)(A) of this section, a plan is not treated as using compensation for less than 12 months for a plan year merely because the plan formula provides that the allocation or accrual for each employee is based on compensation for the portion of the plan year during which the employee is a participant in the plan. In addition, no proration is required merely because an employee is covered under a plan for less than a full plan year, provided that allocations or benefit accruals are otherwise determined using compensation for a period of at least 12 months. Finally, notwithstanding paragraph (b)(3)(iii)(A) of this section, no proration is required merely because the amount of elective contributions (within the meaning of § 1.401(k)–1(g)(3)), matching contributions (within the meaning of § 1.401(m)–1(f)(12)), or employee contributions (within the meaning of § 1.401(m)–1(f)(6)) that is contributed for each pay period during a plan year is determined separately using compensation for that pay period.

(4) *Limits on multiple employer and multiemployer plans*. For purposes of this paragraph (b), in the case of a plan described in section 413(c) or 414(f) (a plan maintained by more than one employer), the annual compensation limit applies separately with respect to the compensation of an employee from each employer maintaining the plan instead of applying to the employee's total compensation from all employers maintaining the plan.

(5) *Family aggregation*. [Reserved]

(6) *Examples*. The following examples illustrate the rules in this paragraph (b).

Example 1. Plan X is a defined benefit plan with a calendar year plan year and bases benefits on the average of an employee's high 3 consecutive years' compensation. The OBRA '93 effective date for Plan X is January 1, 1994. Employee A's high 3 consecutive

years' compensation prior to the application of the annual compensation limits is $160,000 (1994), $155,000 (1993), and $135,000 (1992). To satisfy this paragraph (b), Plan X cannot base plan benefits for Employee A in 1994 on compensation in excess of $145,000 (the average of $150,000 (A's 1994 compensation capped by the annual compensation limit), $150,000 (A's 1993 compensation capped by the $150,000 annual compensation limit applicable to all years before 1994), and $135,000 (A's 1992 compensation capped by the $150,000 annual compensation limit applicable to all years before 1994)). For purposes of determining the 1994 accrual, each year (1994, 1993, and 1992), not the average of the 3 years, is subject to the 1994 annual compensation limit of $150,000.

Example 2. Assume the same facts as Example 1, except that Employee A's high 3 consecutive years' compensation prior to the application of the limits is $185,000 (1997), $175,000 (1996), and $165,000 (1995). Assume that the annual compensation limit is first adjusted to $160,000 for plan years beginning on or after January 1, 1997. Plan X cannot base plan benefits for Employee A in 1997 on compensation in excess of $153,333 (the average of $160,000 (A's 1997 compensation capped by the 1997 limit), $150,000 (A's 1996 compensation capped by the 1996 limit), and $150,000 (A's 1995 compensation capped by the 1995 limit)).

Example 3. Plan Y is a defined benefit plan that bases benefits on an employee's high consecutive 36 months of compensation ending within the plan year. Employee B's high 36 months are the period September 1995 to August 1998, in which Employee B earned $50,000 in each month. Assume that the annual compensation limit is first adjusted to $160,000 for plan years beginning on or after January 1, 1997. The annual compensation limit is $150,000, $150,000, and $160,000 in 1995, 1996, and 1997, respectively. To satisfy this paragraph (b), Plan Y cannot base Employee B's plan benefits for the 1998 plan year on compensation in excess of $153,333. This amount is determined by applying the applicable annual compensation limit to compensation for each of the three 12-consecutive-month periods. The September 1995 to August 1996 period is capped by the annual compensation limit of $150,000 for 1995; the September 1996 to August 1997 period is capped by the annual compensation limit of $150,000 for 1996; and the September 1997 to August 1998 period is capped by the annual compensation limit of $160,000 for 1997. The average of these capped amounts is the annual compensation limit applicable in determining benefits for the 1998 year.

Example 4. (a) Employer P is a partnership. Employer P maintains Plan Z, a profit-sharing plan that provides for an annual allocation of employer contributions of 15 percent of plan year compensation for employees other than self-employed individuals, and 13.0435 percent of plan year compensation for self-employed individuals. The plan year of Plan Z is the calendar year. The OBRA '93 effective date for Plan Z is January 1, 1994. In order to satisfy section 401(a)(17), as amended by OBRA '93, the plan provides that, beginning with the 1994 plan year, the plan year compensation used in determining the allocation of employer contributions for each employee may not exceed the annual limit in effect for the plan year under OBRA '93. Plan Z defines compensation for self-employed individuals (employees within the meaning of section 401(c)(1)) as the self-employed individual's net profit from self-employment attributable to Employer P minus the amount of the self-employed individual's deduction under section 164(f) for one-half of self-employment taxes. Plan Z defines compensation for all other employees as wages within the meaning of section 3401(a). Employee C and Employee D are partners of Employer P and thus are self-employed individuals. Neither Employee C nor Employee D owns an interest in any other business or is a common-law employee in any business. For the 1994 calendar year, Employee C has net profit from self-employment of $80,000, and Employee D has net profit from self-employment of $175,000. The deduction for Employee C under section 164(f) for one-half of self-employment taxes is $4,828. The deduction for Employee D under section 164(f) for one-half of self-employment taxes is $6,101

(b) The plan year compensation under the plan formula for Employee C is $75,172 ($80,000 minus $4,828). The allocation of employer contributions under the plan allocation formula for 1994 for Employee C is $9,805 ($75,172 (Employee C's plan year compensation for 1994) multiplied by 13.0435%). The plan year compensation under the plan formula before application of the annual limit under section 401(a)(17) for Employee D is $168,899 ($175,000 minus $6101). After application of the annual limit, the plan year compensation for the 1994 plan year for Employee D is $150,000 (the annual limit for 1994). Therefore, the allocation of employer contributions under the plan allocation formula for 1994 for Employee D is $19,565 ($150,000 (Employee D's plan year compensation after application of the annual limit for 1994) multiplied by 13.0435%).

Example 5. The facts are the same as in *Example 4*, except that Plan Z provides that plan year compensation for self-employed individuals is defined as earned income within the meaning of section 401(c)(2) attributable to Employer P. In addition, Plan Z provides for an annual allocation of employer contributions of 15 percent of plan year compensation for all employees in the plan, including self-employed individuals, such as Employees C and D. The net profit from self-employment for Employee C and the net profit from self-employment for Employee D

are the same as provided in *Example 4*. However, the earned income of Employee C determined in accordance with section 401(c)(2) is $65,367 ($80,000 minus $4,828 minus $9,805). The earned income of Employee D determined in accordance with section 401(c)(2) is $146,869 ($175,000 minus $6,101 minus $22,030). Therefore, the allocation of employer contributions under the plan allocation formula for 1994 for Employee C is $9,805 ($65,367 (Employee C's plan year compensation for 1994) multiplied by 15%). Employee D's earned income for 1994 does not exceed the 1994 annual limit of $150,000. Therefore, the allocation of employer contributions under the plan allocation formula for 1994 for Employee D is $22,030 ($146,869 (Employee D's plan year compensation for 1994) multiplied by 15%).

(c) *Limit on compensation for nondiscrimination rules*—(1) *General rule*. The annual compensation limit applies for purposes of applying the nondiscrimination rules under sections 401(a)(4), 401(a)(5), 401(l), 401(k)(3), 401(m)(2), 403(b)(12), 404(a)(2) and 410(b)(2). The annual compensation limit also applies in determining whether an alternative method of determining compensation impermissibly discriminates under section 414(s)(3). Thus, for example, the annual compensation limit applies when determining a self-employed individual's total earned income that is used to determine the equivalent alternative compensation amount under § 1.414(s)–1(g)(1). This paragraph (c) provides rules for applying the annual compensation limit for these purposes. For purposes of this paragraph (c), compensation means the compensation used in applying the applicable nondiscrimination rule.

(2) *Plan-year-by-plan-year requirement*. For purposes of this paragraph (c), when applying an applicable nondiscrimination rule for a plan year, the compensation for each plan year taken into account is limited to the applicable annual compensation limit in effect for that year, and an employee's compensation for that plan year in excess of the limit is disregarded. Thus, if the nondiscrimination provision is applied on the basis of compensation determined over a period of more than one year (for example, average annual compensation), the annual compensation limit in effect for each of the plan years that is taken into account in determining the average applies to the respective plan year's compensation. In addition, if compensation for any plan year beginning prior to the OBRA '93 effective date is used when applying any nondiscrimination rule in a plan year beginning on or after the OBRA '93 effective date, then the annual compensation limit for that prior year is the annual compensation limit for the first plan year beginning on or after the OBRA '93 effective date (generally $150,000).

(3) *Plan-by-plan limit*. For purposes of this paragraph (c), the annual compensation limit applies separately to each plan (or group of plans treated as a single plan) of an employer for purposes of the applicable nondiscrimination requirement. For this purpose, the plans included in the testing group taken into account in determining whether the average benefit percentage test of § 1.410(b)–5 is satisfied are generally treated as a single plan.

(4) *Application of limit to a plan year*. The rules provided in paragraph (b)(3) of this section regarding the application of the limit to a plan year apply for purposes of this paragraph (c).

(5) *Limits on multiple employer and multiemployer plans*. The rule provided in paragraph (b)(4) of this section regarding the application of the limit to multiple employer and multiemployer plans applies for purposes of this paragraph (c).

(d) *Effective date*—(1) *Statutory effective date*—(i) *General rule*. Except as otherwise provided in this paragraph (d), section 401(a)(17) applies to a plan as of the first plan year beginning on or after January 1, 1989. For purposes of this section, statutory effective date generally means the first day of the first plan year that section 401(a)(17) is applicable to a plan. In the case of governmental plans, statutory effective date means the first day of the first plan year for which the plan is not deemed to satisfy section 401(a)(17) by reason of paragraph (d)(4) of this section.

(ii) *Exception for collectively bargained plans*. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, section 401(a)(17) applies to allocations

and benefit accruals for plan years beginning on or after the earlier of—

(A) January 1, 1991; or

(B) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension or renegotiation of any agreement occurring after February 28, 1986). For purposes of this paragraph (d)(1)(ii), the rules of §1.410(b)–10(a)(2) apply for purposes of determining whether a plan is maintained pursuant to one or more collective bargaining agreements, and any extension or renegotiation of a collective bargaining agreement, which extension or renegotiation is ratified after February 28, 1986, is to be disregarded in determining the date on which the agreement terminates.

(2) *OBRA '93 effective date*—(i) *In general*. For purposes of this section, OBRA '93 effective date means the first day of the first plan year beginning on or after January 1, 1994, except as provided in this paragraph (d)(2).

(ii) *Exception for collectively bargained plans*—(A) *In general*. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and 1 or more employers ratified before August 10, 1993, OBRA '93 effective date means the first day of the first plan year beginning on or after the earlier of—

(*1*) The latest of—

(*i*) January 1, 1994;

(*ii*) The date on which the last of such collective bargaining agreements terminates (without regard to any extension, amendment, or, modification of such agreements on or after August 10, 1993); or

(*iii*) In the case of a plan maintained pursuant to collective bargaining under the Railway Labor Act, the date of execution of an extension or replacement of the last of such collective bargaining agreements in effect on August 10, 1993; or

(*2*) January 1, 1997.

(B) *Determination of whether plan is collectively bargained*. For purposes of this paragraph (d)(2)(ii), the rules of §1.410(b)–10(a)(2) apply for purposes of determining whether a plan is maintained pursuant to one or more collective bargaining agreements, except that August 10, 1993, is substituted for March 1, 1986, as the date before which the collective bargaining agreements must be ratified.

(3) *Regulatory effective date*. This §1.401(a)(17)–1 applies to plan years beginning on or after the OBRA '93 effective date. However, in the case of a plan maintained by an organization that is exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), this §1.401(a)(17)–1 applies to plan years beginning on or after January 1, 1996. For plan years beginning before the effective date of these regulations and on or after the statutory effective date, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(17), taking into account, if applicable, the OBRA '93 reduction to the annual compensation limit under section 401(a)(17).

(4) *Special rules for governmental plans*—(i) *Deemed satisfaction by governmental plans*. In the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), section 401(a)(17) is considered satisfied for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. For purposes of this paragraph (d)(4), the term governing body with authority to amend the plan means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(ii) *Transition rule for governmental plans*—(A) *In general*. In the case of an eligible participant in a governmental plan (within the meaning of section 414(d)), the annual compensation limit under this section shall not apply to the extent that the application of the limitation would reduce the amount of compensation that is allowed to be taken into account under the plan below the amount that was allowed to be taken into account under the plan as in effect on July 1, 1993. Thus, for example, if a plan as in effect on July 1,

1993, determined benefits without any reference to a limit on compensation, then the annual compensation limit in effect under this section will not apply to any eligible participant in any future year.

(B) *Eligible participant*. For purposes of this paragraph (d)(4)(ii), an eligible participant is an individual who first became a participant in the plan prior to the first day of the first plan year beginning after the earlier of—

(*1*) The last day of the plan year by which a plan amendment to reflect the amendments made by section 13212 of OBRA '93 is both adopted and effective; or

(*2*) December 31, 1995.

(C) *Plan must be amended to incorporate limits*. This paragraph (d)(4)(ii) shall not apply to any eligible participant in a plan unless the plan is amended so that the plan incorporates by reference the annual compensation limit under section 401(a)(17), effective with respect to noneligible participants for plan years beginning after December 31, 1995 (or earlier, if the plan amendment so provides).

(5) *Benefits earned prior to effective date*—(i) *In general*. Allocations under a defined contribution plan or benefits accrued under a defined benefit plan for plan years beginning before the statutory effective date are not subject to the annual compensation limit. Allocations under a defined contribution plan or benefits accrued under a defined benefit plan for plan years beginning on or after the statutory effective date, but before the OBRA '93 effective date, are subject to the annual compensation limit under paragraph (a)(2) of this section. However, these allocations or accruals are not subject to the OBRA '93 reduction to the annual compensation limit described in paragraph (a)(3) of this section.

(ii) *Allocation for a plan year*. The allocations for a plan year include amounts described in §1.401(a)(4)–2(c)(ii) or §1.401(m)–1(f)(6) plus the earnings, expenses, gains, and losses attributable to those amounts.

(iii) *Benefits accrued for years before the effective date*. The benefits accrued for plan years prior to a specified date by any employee are the employee's benefits accrued under the plan, determined as if those benefits had been frozen (as defined in §1.401(a)(4)–13(c)(3)(i)) as of the day immediately preceding such specified date. Thus, for example, benefits accrued for those plan years generally do not include any benefits accrued under an amendment increasing prior benefits that is adopted after the date on which the employee's benefits under the plan must be treated as frozen.

(e) *Determination of post-effective-date accrued benefits*—(1) *In general*. The plan formula that is used to determine the amount of allocations or benefit accruals for plan years beginning on or after the dates described in paragraph (d)(1) or (2) must comply with section 401(a)(17) as in effect on such date. This paragraph (e) provides rules for applying section 401(a)(17) in the case of section 401(a)(17) employees who accrue additional benefits under a defined benefit plan in a plan year beginning on or after the relevant effective date. Paragraph (e)(2) of this section contains definitions used in applying these rules. Paragraphs (e)(3) and (e)(4) of this section explain the application of the fresh-start rules in §1.401(a)(4)–13 to the determination of the accrued benefits of section 401(a)(17) employees.

(2) *Definitions*. For purposes of this paragraph (e), the following definitions apply:

(i) *Section 401(a)(17) employee*. An employee is a section 401(a)(17) employee as of a date, on or after the statutory effective date, if the employee's current accrued benefit as of that date is based on compensation for a year prior to the statutory effective date that exceeded the annual compensation limit for the first plan year beginning on or after the statutory effective date. In addition, an employee is a section 401(a)(17) employee as of a date, on or after the OBRA '93 effective date, if the employee's current accrued benefit as of that date is based on compensation for a year prior to the OBRA '93 effective date that exceeded the annual compensation limit for the first plan year beginning on or after the OBRA '93 effective date. For this purpose, a current accrued benefit is not treated as based on compensation that exceeded the relevant annual compensation limit, if a plan makes a fresh start

using the formula with wear-away described in §1.401(a)(4)–13(c)(4)(ii), and the employee's accrued benefit determined under §1.401(a)(4)–13(c)(4)(ii)(B), taking into account the annual compensation limit, exceeds the employee's frozen accrued benefit (or, if applicable, the employee's adjusted accrued benefit) as of the fresh-start date.

(ii) *Section 401(a)(17) fresh-start date.* Section 401(a)(17) fresh-start date means a fresh-start date as defined in §1.401(a)(4)–12 not earlier than the last day of the last plan year beginning before the statutory effective date, and not later than the last day of the last plan year beginning before the effective date of these regulations.

(iii) *OBRA '93 fresh-start date.* OBRA '93 fresh-start date means a fresh-start date as defined in §1.401(a)(4)–12 not earlier than the last day of the last plan year beginning before the OBRA '93 effective date, and not later than the last day of the last plan year beginning before the effective date of these regulations.

(iv) *Section 401(a)(17) frozen accrued benefit.* Section 401(a)(17) frozen accrued benefit means the accrued benefit for any section 401(a)(17) employee frozen (as defined in §1.401(a)(4)–13(c)(3)(i)) as of the last day of the last plan year beginning before the statutory effective date.

(v) *OBRA '93 frozen accrued benefit.* OBRA '93 frozen accrued benefit means the accrued benefit for any section 401(a)(17) employee frozen (as defined in §1.401(a)(4)–13(c)(3)(i)) as of the OBRA '93 fresh-start date.

(3) *Application of fresh-start rules*—(i) *General rule.* In order to satisfy section 401(a)(17), a defined benefit plan must determine the accrued benefit of each section 401(a)(17) employee by applying the fresh-start rules in §1.401(a)(4)–13(c). The fresh-start rules must be applied using a section 401(a)(17) fresh-start date and using the plan benefit formula, after amendment to comply with section 401(a)(17) and this section, as the formula applicable to benefit accruals in the current plan year. In addition, the fresh-start rules must be applied to determine the accrued benefit of each section 401(a)(17) employee using an OBRA '93 fresh-start date and using the plan benefit formula, after amendment to comply with the reduction in the section 401(a)(17) annual compensation limit described in paragraph (a)(3) of this section, as the formula applicable to benefit accruals in the current plan year.

(ii) *Consistency rules in §1.401(a)(4)–13(c) and (d)*—(A) *General rule.* In applying the fresh-start rules of §1.401(a)(4)–13(c) and (d), the group of section 401(a)(17) employees is a fresh-start group. See §1.401(a)(4)–13(c)(5)(ii)(A). Thus, the consistency rules of those sections govern, unless otherwise provided. For example, if the plan is using a fresh-start date applicable to all employees and is not adjusting frozen accrued benefits under §1.401(a)(4)–13(d) for employees who are not section 401(a)(17) employees, then the frozen accrued benefits for section 401(a)(17) employees may not be adjusted under §1.401(a)(4)–13(d) or this paragraph (e).

(B) *Determination of adjusted accrued benefit.* If the fresh-start rules of §1.401(a)(4)–13(c) and (d) are applied to determine the benefits of all employees after a fresh-start date, the plan will not fail to satisfy the consistency requirement of §1.401(a)(4)–13(c)(5)(i) merely because the plan makes the adjustment described in §1.401(a)(4)–13(d) to the frozen accrued benefits of employees who are not section 401(a)(17) employees, but does not make the adjustment to the frozen accrued benefits of section 401(a)(17) employees. In addition, the plan does not fail to satisfy the consistency requirement of §1.401(a)(4)–13(c)(5)(i) merely because the plan makes the adjustment described in §1.401(a)(4)–13(d) for section 401(a)(17) employees on the basis of the compensation formula that was used to determine the frozen accrued benefit (as required under paragraph (e)(4)(iii) of this section) but makes the adjustment for employees who are not section 401(a)(17) employees on the basis of any other method provided in §1.401(a)(4)–13(d)(8).

(4) *Permitted adjustments to frozen accrued benefit of section 401(a)(17) employees*—(i) *General rule.* Except as otherwise provided in paragraphs (e)(4)(ii) and (iii) of this section, the rules in §1.401(a)(4)–13(c)(3) (permitting certain adjustments to frozen accrued benefits)

apply to section 401(a)(17) frozen accrued benefits or OBRA '93 frozen accrued benefits.

(ii) *Optional forms of benefit.* After either the section 401(a)(17) fresh-start date or the OBRA '93 fresh-start date, a plan may be amended either to provide a new optional form of benefit or to make an optional form of benefit available with respect to the section 401(a)(17) frozen accrued benefit or the OBRA '93 frozen accrued benefit, provided that the optional form of benefit is not subsidized. Whether an optional form is subsidized may be determined using any reasonable actuarial assumptions.

(iii) *Adjusting section 401(a)(17) accrued benefits*—(A) *In general.* If the plan adjusts accrued benefits for employees under the rules of §1.401(a)(4)–13(d) as of a fresh-start date, the adjusted accrued benefit (within the meaning of section §1.401(a)(4)–13(d)) for each section 401(a)(17) employee must be determined after the fresh-start date by reference to the plan's compensation formula that was actually used to determine the frozen accrued benefit as of the fresh-start date. For this purpose, the plan's compensation formula incorporates the plan's underlying compensation definition and compensation averaging period. In making the adjustment, the denominator of the adjustment fraction described in §1.401(a)(4)–13(d)(8)(i) is the employee's compensation as of the fresh-start date using the plan's compensation formula as of that date and, in the case of an OBRA '93 fresh-start date, reflecting the annual compensation limits that applied as of the fresh-start date. The numerator of the adjustment fraction is the employee's updated compensation (i.e., compensation for the current plan year within the meaning of §1.401(a)(4)–13(d)(8)), determined after applying the annual compensation limits to each year's compensation that is used in the plan's compensation formula as of the fresh-start date. Similarly, in applying the alternative rule in §1.401(a)(4)–13(d)(8)(v), the updated compensation that is substituted must be determined after applying the annual compensation limits to each year's compensation that is used in the plan's compensation formula. Thus, no adjustment will be permitted unless the updated compensation (determined after applying the annual compensation limit) exceeds the compensation that was used to determine the employee's frozen accrued benefit.

(B) *Multiple fresh starts.* If a plan makes more than one fresh start with respect to a section 401(a)(17) employee, the employee's frozen accrued benefit as of the latest fresh-start date will either be determined by applying the current benefit formula to the employee's total years of service as of that fresh-start date or will consist of the sum of the employee's frozen accrued benefit (or adjusted accrued benefit (as defined in §1.401(a)(4)–13(d)(8)(i))) as of the previous fresh-start date plus additional frozen accruals since the previous fresh start. If the frozen accrued benefit consists of such a sum, in making the adjustments described in paragraph (e)(4)(iii)(A) of this section, separate adjustments must be made to that previously frozen accrued benefit (or adjusted accrued benefit) and the additional frozen accruals to the extent that the frozen accrued benefit and the additional accruals have been determined using different compensation formulas or different compensation limits (i.e., the section 401(a)(17) limit before and after the reduction in limit described in paragraph (a)(3) of this section). In this case, if the plan is applying the adjustment fraction of §1.401(a)(4)–13(d)(8)(i), the denominator of the separate adjustment fraction for adjusting each portion of the frozen accrued benefit must reflect the actual compensation formula, and, if applicable, compensation limit, originally used for determining that portion. For example, the frozen accrued benefit of a section 401(a)(17) employee as of the OBRA '93 fresh-start date may be based on the sum of the section 401(a)(17) frozen accrued benefit (determined without any annual compensation limit) plus benefit accruals in the years between the statutory effective date and the OBRA '93 effective date (based on compensation that was subject to the annual compensation limits for those years). In this example, in adjusting the section 401(a)(17) frozen accrued benefit,

the denominator of the adjustment fraction does not reflect any annual compensation limit. Similarly, in adjusting the frozen accruals for years between the statutory effective date and the OBRA '93 effective date, the denominator of the adjustment fraction reflects the level of the annual compensation limit in effect for those years.

(5) *Examples*. The following examples illustrate the rules in this paragraph (e).

Example 1. (a) Employer X maintains Plan Y, a calendar year defined benefit plan providing an annual benefit for each year of service equal to 2 percent of compensation averaged over an employee's high 3 consecutive calendar years' compensation. Section 401(a)(17) applies to Plan Y in 1989. As of the close of the last plan year beginning before January 1, 1989 (i.e., the 1988 plan year), Employee A, with 5 years of service, had accrued a benefit of $25,000 which equals 10 percent (2 percent multiplied by 5 years of service) of average compensation of $250,000. Employer X decides to comply with the provisions of this section for plan years before the effective date of this section. Employer X decides to make the amendment effective for plan years beginning on or after January 1, 1989, and uses December 31, 1988 as the section 401(a)(17) fresh-start date. Plan Y, as amended, provides that, in determining an employee's benefit, compensation taken into account is limited in accordance with the provisions of this section to the annual compensation limit under section 401(a)(17), and that, for section 401(a)(17) employees, the employee's accrued benefit is the greater of

(i) The employee's benefit under the plan's benefit formula (after the plan formula is amended to comply with section 401(a)(17)) as applied to the employee's total years of service; and

(ii) The employee's accrued benefit as of December 31, 1988, determined as though the employee terminated employment on that date without regard to any plan amendments after that date.

Employer X decides not to amend Plan Y to provide for the adjustments permitted under § 1.401(a)(4)–13(d) to the accrued benefit of section 401(a)(17) employees as of December 31, 1988.

(b) Under Plan Y, Employee A's accrued benefit at the end of 1989 is $25,000, which is the greater of Employee A's accrued benefit as of the last day of the 1988 plan year ($25,000), and $24,000, which is Employee A's benefit based on the plan's benefit formula applied to Employee A's total years of service ($200,000 multiplied by (2 percent multiplied by 6 years of service)). The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in § 1.401(a)–13(c)(4)(ii) (formula with wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section, and the December 31, 1988 fresh-start date used for the plan is a section 401(a)(17) fresh-start date within the meaning of paragraph (e)(2)(ii) of this section. Thus, Plan Y, as amended, satisfies paragraph (e)(3)(i) of this section for plan years commencing prior to the OBRA '93 effective date.

Example 2. Assume the same facts as in *Example 1*, except that the plan formula provides that effective January 1, 1989, for section 401(a)(17) employees, an employee's benefit will equal the sum of the employee's accrued benefit as of December 31, 1988 (determined as though the employee terminated employment on that date and without regard to any amendments after that date), and 2 percent of compensation averaged over an employee's high 3 consecutive years' compensation times years of service taking into account only years of service after December 31, 1988. Thus, under Plan Y's formula, Employee A's accrued benefit as of December 31, 1989 is $29,000, which is equal to the sum of $25,000 (Employee A's accrued benefit as of December 31, 1988) plus $4,000 ($200,000 multiplied by (2 percent multiplied by 1 year of service)). The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in § 1.401(a)–13(c)(4)(i) (formula without wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section, and the December 31, 1988 fresh-start date used for the plan is a section 401(a)(17) fresh-start date within the meaning of paragraph (e)(2)(ii) of this section. Thus, Plan Y, as amended, satisfies paragraph (e)(3)(i) of this section for plan years commencing prior to the OBRA '93 effective date.

Example 3. (a) Assume the same facts as in *Example 1*, except that the plan formula provides that effective January 1, 1989, an employee's benefit equals the greater of the plan formulas in *Example 1* and *Example 2*. The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in § 1.401(a)–13(c)(4)(iii) (formula with extended wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section, and the December 31, 1988 fresh-start date used for the plan is a section 401(a)(17) fresh-start date within the meaning of paragraph (e)(2)(ii) of this section. Thus, Plan Y, as amended, satisfies paragraph

(e)(3)(i) of this section for plan years commencing prior to the OBRA '93 effective date.

(b) Assume that for each of the years 1991–93 Employee A's annual compensation under the plan compensation formula, disregarding the amendment to comply with section 401(a)(17) is $300,000. The annual compensation limit is adjusted to $222,220, $228,860, and $235,840 for plan years beginning January 1, 1991, 1992, and 1993, respectively. Because Employer X has decided to amend Plan Y to comply with the provisions of this section effective for plan years beginning on or after January 1, 1989, and has used December 31, 1988 as the section 401(a)(17) fresh-start date, the compensation that may be taken into account for plan benefits in 1993 cannot exceed $228,973 (the average of $222,220, $228,860, and $235,840). Therefore, as of December 31, 1993, the benefit determined under the fresh-start formula with wear-away would be $45,795 ($228,973 multiplied by (2 percent multiplied by 10 years of service)). The benefit determined under the fresh-start formula without wear-away would be $47,897, which is equal to $25,000 (Employee A's section 401(a)(17) frozen accrued benefit) plus $22,897 ($228,973 multiplied by (2 percent multiplied by 5 years of service)). Because Employee A's accrued benefit is being determined using the fresh-start formula with extended wear-away, Employee A's accrued benefit as of December 31, 1993, is equal to $47,897, the greater of the two amounts.

Example 4. (a) Assume the same facts as in *Example 3,* except that Plan Y satisfies §1.401(a)(4)–13(d)(3) through (d)(7) and that the amendment to Plan Y effective for plan years beginning after December 31, 1988, also provided for adjustments to the section 401(a)(17) frozen accrued benefit in accordance with §1.401(a)(4)-13(d) using the fraction described in §1.401(a)(4)-13(d)(8)(i).

(b) As of December 31, 1993, the numerator of Employee A's compensation fraction is $228,973 (the average of Employee A's annual compensation for 1991, 1992, and 1993, as limited by the respective annual limit for each of those years). The denominator of Employee A's compensation fraction determined in accordance with paragraph (e)(4)(iii) of this section is $250,000 (the average of Employee A's high 3 consecutive calendar year compensation as of December 31, 1988, determined without regard to section 401(a)(17)). Therefore, Employee A's compensation fraction is $228,973/$250,000. Because the compensation adjustment fraction is less than 1, Employee A's section 401(a)(17) frozen accrued benefit is not adjusted. Therefore, Employee A's accrued benefit as of December 31, 1993, would still be $47,897, which is equal to $25,000 (Employee A's section 401(a)(17) frozen accrued benefit) plus $22,897 ($228,973 multiplied by (2 percent multiplied by 5 years of service).

Example 5. (a) Assume the same facts as in *Example 3,* except that as of January 1, 1994, Plan Y is amended to provide that benefits will be determined based on compensation of $150,000 (the limit in effect under section 401(a)(17) for plan years beginning on or after the OBRA '93 effective date) and that for section 401(a)(17) employees, each employee's accrued benefit will be determined under §1.401(a)(4)–13(c)(4)(i) (formula without wear-away) using December 31, 1993 as the OBRA '93 fresh-start date.

(b) Assume that for each of the years 1996–98 Employee A's annual compensation under the plan compensation definition, disregarding the amendment to comply with section 401(a)(17), is $400,000. Assume that the annual compensation limit is first adjusted to $160,000 for plan years beginning on or after January 1, 1997, and is not adjusted for the plan year beginning on or after January 1, 1998. The compensation that may be taken into account for the 1998 plan year cannot exceed $156,667 (the average of $150,000 for 1996, $160,000 for 1997, and $160,000 for 1998).

(c) Therefore, at the end of December 31, 1998, Employee A's accrued benefit is $63,564, which is equal to $47,897 (Employee A's OBRA '93 frozen accrued benefit) plus $15,667 ($156,667 multiplied by (2 percent multiplied by 5 years of service)).

Example 6. (a) Assume the same facts as in *Example 5,* except that, for the fresh-start group (in this case the section 401(a)(17) employees), the amendments to Plan Y provide for adjustments to the section 401(a)(17) frozen accrued benefit and the OBRA '93 frozen accrued benefit in accordance with §1.401(a)(4)–13(d) using the fraction described in §1.401(a)(4)–13(d)(8)(i).

(b) Employee A's frozen accrued benefit as of December 31, 1993, is adjusted as of December 31, 1998, as follows:

(1) Employee A's frozen accrued benefit as of December 31, 1993, is the sum of Employee A's section 401(a)(17) frozen accrued benefit ($25,000) and Employee A's frozen accruals for the years 1989–93 ($22,897).

(2) The numerator of Employee A's adjustment fraction is $156,667 (the average of $150,000, $160,000, and $160,000). The denominator of Employee A's adjustment fraction with respect to Employee A's section 401(a)(17) frozen accrued benefit is $250,000, and the denominator of Employee A's adjustment fraction with respect to the rest of Employee A's frozen accrued benefit is $228,973 (the average of Employee A's annual compensation for 1991, 1992, and 1993, as limited by the respective annual limit for each of those years).

(3) Employee A's section 401(a)(17) frozen accrued benefit as adjusted through December 31, 1998, remains $25,000. The compensation adjustment fraction determined in accordance with paragraph (e)(4)(iii) of this

section is less than one ($156,667 divided by $250,000).

(4) Employee A's frozen accruals for the years 1989–93, as adjusted through December 31, 1998, remain $22,897 because the adjustment fraction is less than one ($156,667 divided by $228,973).

(5) Employee A's adjusted accrued benefit as of December 31, 1998, equals $47,897 (the sum of the $25,000 and $22,897 amounts from paragraphs (b)(3) and (b)(4), respectively, of this *Example*).

(c) Employee A's section 401(a)(17) frozen accrued benefit will not be adjusted for compensation increases until the numerator of the fraction used to adjust that frozen accrued benefit exceeds the denominator of $250,000 used in determining those accruals.

Similarly, the portion of Employee A's OBRA '93 frozen accrued benefit attributable to the frozen accruals for the years 1989–1993 will not be adjusted for compensation increases until the numerator of the fraction used to adjust those frozen accruals exceeds the denominator of $228,973 used in determining those accruals.

[T.D. 8547, 59 FR 32905, June 27, 1994]

§ 1.401(a)(26)–0 Table of contents.

This section contains a listing of the headings of §§ 1.401 (a)(26)–1 through 1.401(a)(26)–9.

§ 1.401(a)(26)–1 Minimum participation requirements

(a) General rule.
(b) Exceptions to section 401(a)(26).
(1) Plans that do not benefit any highly compensated employees.
(2) Multiemployer plans.
(i) In general.
(ii) Multiemployer plans covering non-collectively bargained employees.
(A) In general.
(B) Special testing rule.
(3) Certain underfunded defined benefit plans.
(i) In general.
(ii) Eligible plans.
(iii) Actuarial certification.
(iv) Cessation of all benefit accruals.
(4) Section 401(k) plan maintained by employers that include certain governmental or tax-exempt entities.
(5) Certain acquisitions or dispositions.
(i) General rule.
(ii) Special rule for transactions that occur in the plan year prior to the first plan year to which section 401(a)(26) applies.
(iii) Definition of ''acquisition'' or ''disposition''.
(c) Additional rules.

§ 1.401(a)(26)–2 Minimum participation rule

(a) General rule.
(b) Frozen plans.
(c) Plan.
(d) Disaggregation of certain plans.
(1) Mandatory disaggregation.
(i) ESOPs and non-ESOPs.
(ii) Plans maintained by more than one employer.
(A) Multiple employer plans.
(B) Multiemployer plans.
(iii) Defined benefit plans with other arrangements.
(A) In general.
(B) Examples.
(iv) Plans benefiting employees of qualified separate lines of business.
(2) Permissive disaggregation.
(i) Plans benefiting collectively bargained employees.
(ii) Plans benefiting otherwise excludable employees.

§ 1.401(a)(26)–3 Rules applicable to a defined benefit plan's prior benefit structure

(a) General rule.
(b) Prior benefit structure.
(c) Testing a prior benefit structure.
(1) General rule.
(2) Meaningful benefits.
(d) Multiemployer plan rule.

§ 1.401(a)(26)–4 Testing former employees

(a) Scope.
(b) Minimum participation rule for former employees.
(c) Special rule.
(d) Excludable former employees.
(1) General rule.
(2) Exception.

§ 1.401(a)(26)–5 Employees who benefit under a plan

(a) Employees benefiting under a plan.
(1) In general.
(2) Sequential or concurrent benefit offset arrangements.
(i) In general.
(ii) Offset by sequential or grandfathered benefits.
(iii) Concurrent benefit offset arrangements.
(A) General rule.
(B) Special rules for certain section 414(n) employer-recipients.
(b) Former employees benefiting under a plan.

§ 1.401(a)(26)–6 Excludable employees

(a) In general.
(b) Excludable employees.
(1) Minimum age and service exclusions.
(i) In general.
(ii) Plans benefiting otherwise excludable employees.
(iii) Examples.
(2) Certain air pilots.
(3) Certain nonresident aliens.

(i) In general.
(ii) Special treaty rule.
(4) Employees covered pursuant to a collective bargaining agreement.
(5) Employees not covered pursuant to a collective bargaining agreement.
(6) Examples.
(7) Certain terminating employees.
(i) In general.
(ii) Hours of service.
(8) Employees of qualified separate lines of business.
(c) Former employees.
(1) In general.
(2) Employees terminated before a specified date.
(3) Previously excludable employees.
(4) Vested accrued benefits eligible for mandatory distribution.
(d) Certain police or firefighters.

§ 1.401(a)(26)–7 Testing methods

(a) Testing on each day of the plan year.
(b) Simplified testing method.
(c) Retroactive correction.

§ 1.401(a)(26)–8 Definitions

Collective bargaining agreement.
Collectively bargained employee.
Covered by a collective bargaining agreement.
Defined benefit plan.
Defined contribution plan.
Employee.
Employer.
ESOP.
Former employee.
Highly compensated employee.
Highly compensated former employee.
Multiemployer plan.
Noncollectively bargained employee.
Nonhighly compensated employee.
Nonhighly compensated former employee.
Plan.
Plan year.
Professional employee.
Section 401(k) plan.
Section 401(m) plan.

§ 1.401(a)(26)–9 Effective dates and transition rules

(a) In general.
(b) Transition rules.
(1) Governmental plans and certain section 403(b) annuities.
(2) Early retirement ''window-period'' benefits.
(3) Employees who do not benefit because of a minimum-period-of-service requirement or a last-day requirement.
(4) Certain plan terminations.
(i) In general.
(ii) Exception.
(5) ESOPs and non-ESOPs.
(c) Waiver of excise tax on reversions.
(1) In general.
(2) Termination date.
(3) Failure to satisfy section 401(a)(26).
(d) Special rule for collective bargaining agreements.

[T.D. 8375, 56 FR 63413, Dec. 4, 1991]

§ 1.401(a)(26)–1 Minimum participation requirements.

(a) *General rule.* A plan is a qualified plan for a plan year only if the plan satisfies section 401(a)(26) for the plan year. A plan that satisfies any of the exceptions described in paragraph (b) of this section passes section 401(a)(26) automatically for the plan year. A plan that does not satisfy one of the exceptions in paragraph (b) of this section must satisfy §1.401(a)(26)–2(a). In addition, a defined benefit plan must satisfy §1.401(a)(26)–3 with respect to its prior benefit structure. Finally, a defined benefit plan that benefits former employees (for example, a defined benefit plan that is amended to provide an ad hoc cost-of-living adjustment to former employees) must separately satisfy §1.401(a)(26)–4 with respect to its former employees.

(b) *Exceptions to section 401(a)(26)*—(1) *Plans that do not benefit any highly compensated employees.* A plan, other than a frozen defined benefit plan as defined in §1.401(a)(26)–2(b), satisfies section 401(a)(26) for a plan year if the plan is not a top-heavy plan under section 416 and the plan meets the following requirements:

(i) The plan benefits no highly compensated employee or highly compensated former employee of the employer; and

(ii) The plan is not aggregated with any other plan of the employer to enable the other plan to satisfy section 401(a)(4) or 410(b). The plan may, however, be aggregated with the employer's other plans for purposes of the average benefit percentage test in section 410(b)(2)(A)(ii).

(2) *Multiemployer plans*—(i) *In general.* The portion of a multiemployer plan that benefits only employees included in a unit of employees covered by a collective bargaining agreement may be treated as a separate plan that satisfies section 401(a)(26) for a plan year.

(ii) *Multiemployer plans covering noncollectively bargained employees*—(A) *In general.* The rule provided in paragraph

(b)(2)(i) does not apply to the portion of a multiemployer plan that benefits employees who are not included in any collective bargaining unit covered by a collective bargaining agreement. Thus, the portion of the plan benefiting these employees must separately satisfy section 401(a)(26).

(B) *Special testing rule.* A multiemployer plan that benefits employees who are not included in any collective bargaining unit covered by a collective bargaining agreement satisfies section 401(a)(26) if the plan benefits 50 employees. For purposes of this special testing rule, employees who are included in a unit of employees covered by a collective bargaining agreement may be included in determining whether the plan benefits 50 employees.

(3) *Certain underfunded defined benefit plans*—(i) *In general.* A defined benefit plan is deemed to satisfy section 401(a)(26) for a plan year if all of the conditions of paragraphs (b)(3)(ii) through (b)(3)(iv) of this section are satisfied with respect to the plan for the plan year.

(ii) *Eligible plans.* This condition is satisfied for a plan year only if the plan is subject to Title IV of the Employee Retirement Income Security Act of 1974 (ERISA) for the plan year or, if the plan is not a Title IV plan under ERISA, it is not a top-heavy plan within the meaning of section 416. This condition does not apply for plan years beginning before January 1, 1992.

(iii) *Actuarial certification.* This condition is satisfied for a plan year only if the employer's timely filed actuarial report, as required by section 6059, evidences that the plan does not have sufficient assets to satisfy all liabilities under the plan (determined in accordance with section 401(a)(2)).

(iv) *Cessation of all benefit accruals.* This condition is satisfied for a plan year only if, for the plan year, no employee or former employee is benefiting within the meaning of §1.401(a)(26)–5(a) or (b). For this purpose, an employee is not treated as benefiting solely by reason of being a non-key employee receiving minimum benefit accruals required by section 416.

(4) *Section 401(k) plan maintained by employers that include certain governmental or tax-exempt entities.* Section 401(k)(4)(B) prevents certain State and local governments and tax-exempt organizations from maintaining a qualified cash or deferred arrangement. A plan (or portion of a plan) that is either a section 401(k) plan or a section 401(m) plan that is provided under the same general arrangement as a section 401(k) plan may be treated as a separate plan that satisfies section 401(a)(26) for a plan year if the following requirements are satisfied:

(i) The section 401(k) plan is maintained by an employer who has employees precluded from being eligible employees under the arrangement by reason of section 401(k)(4)(B), and

(ii) More than 95 percent of the employees of the employer who are not precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B) benefit under the section 401(k) plan.

(5) *Certain acquisitions or dispositions*—(i) *General rule.* Rules similar to the rules prescribed under section 410(b)(6)(C) apply under section 401(a)(26). Pursuant to these rules, the requirements of section 401(a)(26) are treated as satisfied for certain plans of an employer involved in an acquisition or disposition (transaction) for the transition period. The transition period begins on the date of the transaction and ends on the last day of the first plan year beginning after the date of the transaction.

(ii) *Special rule for transactions that occur in the plan year prior to the first plan year to which section 401(a)(26) applies.* Where there has been a transaction described in section 410(b)(6)(C) in the plan year prior to the first plan year in which section 401(a)(26) applies to a plan, the plan satisfies section 401(a)(26) for the transition period if the plan benefited 50 employees or 40 percent of the employees of the employer immediately prior to the transaction.

(iii) *Definition of* ''*acquisition*'' *and* ''*disposition.*'' For purposes of this paragraph (b)(5), the terms ''acquisition'' and ''disposition'' refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business.

(c) *Additional rules.* The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the minimum participation requirements of section 401(a)(26).

[T.D. 8375, 56 FR 63413, Dec. 4, 1991, as amended by T.D. 8487, 58 FR 46838, Sept. 3, 1993]

§ 1.401(a)(26)–2 Minimum participation rule.

(a) *General rule.* A plan satisfies this paragraph (a) for a plan year only if the plan benefits at least the lesser of—

(1) 50 employees of the employer, or

(2) 40 percent of the employees of the employer.

(b) *Frozen plans.* A plan under which no employee or former employee benefits (within the meaning of § 1.401(a)(26)–5 (a) or (b)), is a frozen plan for purposes of this section and satisfies paragraph (a) of this section automatically. Thus, a frozen defined contribution plan satisfies section 401(a)(26) automatically and a frozen defined benefit plan satisfies section 401(a)(26) for a plan year by satisfying the prior benefit structure requirements in § 1.401(a)(26)–3. For purposes of the rule in this paragraph (b), a defined benefit plan that provides only the minimum benefits for non-key employees required by section 416 is a frozen defined benefit plan.

(c) *Plan.* ''Plan'' means a plan within the meaning of § 1.401(b)–7 (a) and (b), after the application of the mandatory disaggregation rules of paragraph (d)(1) of this section and, if applicable, the permissive disaggregation rules of paragraph (d)(2) of this section.

(d) *Disaggregation of certain plans*—(1) *Mandatory disaggregation*—(i) *ESOPs and non-ESOPs.* The portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 401(a)(26), except as otherwise permitted under § 54.4975–11(e) of this Chapter.

(ii) *Plans maintained by more than one employer*—(A) *Multiple employer plans.* If a plan benefits employees of more than one employer and those employees are not included in a unit of employees covered by one or more collective bargaining agreements, the plan is a multiple employer plan. A multiple employer plan is treated as separate plans, each of which is maintained by a separate employer and must separately satisfy section 401(a)(26) by reference only to that employer's employees.

(B) *Multiemployer plans.* The portion of a multiemployer plan that benefits employees who are included in one or more units of employees covered by one or more collective bargaining agreements and the portion of that plan that benefits employees who are not included in a unit of employees covered pursuant to any collective bargaining agreement are treated as separate plans. The portion of a multiemployer plan that benefits employees who are not included in a unit of employees covered by a collective bargaining agreement is a multiple employer plan as described in paragraph (d)(1)(ii)(A) of this section. This paragraph (d)(1)(ii)(B) does not apply to the extent that the special testing rule in § 1.401(a)(26)–1(b)(2)(ii) applies. Also, this paragraph (d)(1)(B)(*2*) does not apply for purposes of prior benefit structure testing under § 1.401 (a)(26)–3.

(iii) *Defined benefit plans with other arrangements*—(A) *In general.* A defined benefit plan is treated as comprising separate plans if, under the facts and circumstances, there is an arrangement (either under or outside the plan) that has the effect of providing any employee with a greater interest in a portion of the assets of a plan in a way that has the effect of creating separate accounts. Separate plans are not created, however, merely because a partnership agreement provides for allocation among partners, in proportion to their partnership interests, of either the cost of funding the plan or surplus assets upon plan termination.

(B) *Examples.* The following examples illustrate certain situations in which other arrangements relating to a defined benefit plan are or are not treated as creating separate plans:

Example 1. Employer A maintains a defined benefit plan under which each highly compensated employee can direct the investment of the portion of the plan's assets that represents the accumulated contributions with respect to that employee's plan benefits. In addition, by agreement outside the plan, if the product of the employee's investment direction exceeds the value needed to fund that

employee's benefits, Employer A agrees to make a special payment to the participant. In this case, each separate portion of the pool of assets over which an employee has investment authority is a separate plan for the employee.

Example 2. Employer B is a partnership that maintains a defined benefit plan. The partnership agreement provides that, upon termination of the plan, a special allocation of any excess plan assets after reversion is made to the partnership on the basis of partnership share. This arrangement does not create separate plans with respect to the partners.

(iv) *Plans benefiting employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with §1.414(r)–1(b), the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the portions of the same plan that benefit employees of the other qualified separate lines of business of the employer. See §§1.414(r)–1(c)(3) and 1.414(r)–9 (separate application of section 401(a)(26) to the employees of a qualified separate line of business). The rule in this paragraph (d)(6) does not apply to a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for a plan year.

(2) *Permissive disaggregation*—(i) *Plans benefiting collectively bargained employees.* For purposes of section 401(a)(26), an employer may treat the portion of a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement as a plan separate from the portion of a plan that benefits employees who are not included in such a collective bargaining unit. This paragraph (d)(2)(i) applies separately to each collective bargaining agreement. Thus, for example, the portion of a plan that benefits employees included in a unit of employees covered by one collective bargaining agreement may be treated as a plan that is separate from the portion of the plan that benefits employees included in a unit of employees covered by another collective bargaining agreement.

(ii) *Plans benefiting otherwise excludable employees.* If an employer applies section 401(a)(26) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permissible under section 410(a), the plan is treated as comprising separate plans, one benefiting the employees who have not satisfied the lower minimum age and service but not the greatest minimum age and service conditions permitted under section 410(a) and one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under section 410(a). See §1.401(a)(26)–6(b)(1)(ii) for rules concerning testing of otherwise excludable employees.

[T.D. 8375, 56 FR 63414, Dec. 4, 1991]

§1.401(a)(26)–3 Rules applicable to a defined benefit plan's prior benefit structure.

(a) *General rule.* A defined benefit plan that does not meet one of the exceptions in §1.401(a)(26)–1(b) must satisfy paragraph (c) of this section with respect to its prior benefit structure. Defined contribution plans are not subject to this section.

(b) *Prior benefit structure.* Each defined benefit plan has only one prior benefit structure, and all accrued benefits under the plan as of the beginning of a plan year (including benefits rolled over or transferred to the plan) are included in the prior benefit structure for the year.

(c) *Testing a prior benefit structure*—(1) *General rule.* A plan's prior benefit structure satisfies this paragraph if the plan provides meaningful benefits to a group of employees that includes the lesser of 50 employees or 40 percent of the employer's employees. Thus, a plan satisfies the requirements of this paragraph (c) if at least 50 employees or 40 percent of the employer's employees currently accrue meaningful benefits under the plan. Alternatively, a plan satisfies this paragraph if at least 50 employees and former employees or 40 percent of the employer's employees and former employees have meaningful accrued benefits under the plan.

(2) *Meaningful benefits.* Whether a plan is providing meaningful benefits,

or whether individuals have meaningful accrued benefits under a plan, is determined on the basis of all the facts and circumstances. The relevant factors in making this determination include, but are not limited to, the following: the level of current benefit accruals; the comparative rate of accruals under the current benefit formula compared to prior rates of accrual under the plan; the projected accrued benefits under the current benefit formula compared to accrued benefits as of the close of the immediately preceding plan year; the length of time the current benefit formula has been in effect; the number of employees with accrued benefits under the plan; and the length of time the plan has been in effect. A rule for determining whether an offset plan provides meaningful benefits is provided in § 1.401(a)(26)–5(a)(2). A plan does not satisfy this paragraph (c) if it exists primarily to preserve accrued benefits for a small group of employees and thereby functions more as an individual plan for the small group of employees or for the employer.

(d) *Multiemployer plan rule.* A multiemployer plan is deemed to satisfy the prior benefit structure rule in paragraph (c)(1) of this section for a plan year if the multiemployer plan provides meaningful benefits to at least 50 employees for a plan year, or 50 employees have meaningful accrued benefits under the plan. For purposes of this paragraph, all employees benefiting under the multiemployer plan may be considered, whether or not these employees are included in a unit of employees covered pursuant to any collective bargaining agreement.

[T.D. 8375, 56 FR 63415, Dec. 4, 1991]

§ 1.401(a)(26)–4 Testing former employees.

(a) *Scope.* This section applies to any defined benefit plan that benefits former employees in a plan year within the meaning of § 1.401(a)(26)–5(b) and does not meet one of the exceptions in § 1.401(a)(26)–1(b).

(b) *Minimum participation rule for former employees.* Except as set forth in paragraph (c) of this section, a plan that is subject to this section must benefit at least the lesser of:

(1) 50 former employees of the employer, or

(2) 40 percent of the former employees of the employer.

(c) *Special rule.* A plan satisfies the minimum participation rule in paragraph (b) of this section if the plan benefits at least five former employees, and if either:

(1) More than 95 percent of all former employees with vested accrued benefits under the plan benefit under the plan for the plan year, or

(2) At least 60 percent of the former employees who benefit under the plan for the plan year are nonhighly compensated former employees.

(d) *Excludable former employees*—(1) *General rule.* Whether a former employee is an excludable former employee for purposes of this section is determined under § 1.401(a)(26)–6(c).

(2) *Exception.* Solely for purposes of paragraph (c) of this section, the rule in § 1.401(a)(26)–6(c)(4) (regarding vested accrued benefits eligible for mandatory distribution) does not apply to any former employee having a vested accrued benefit. Thus, a former employee who has a vested accrued benefit is not an excludable former employee merely because that vested accrued benefit does not exceed the cash-out limit in effect under § 1.411(a)–11(c)(3)(ii).

[T.D. 8375, 56 FR 63416, Dec. 4, 1991, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8891, 65 FR 44682, July 19, 2000]

§ 1.401(a)(26)–5 Employees who benefit under a plan.

(a) *Employees benefiting under a plan*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an employee is treated as benefiting under a plan for a plan year if and only if, for that plan year, the employee would be treated as benefiting under the provisions of § 1.410(b)–3(a), without regard to § 1.410(b)–3(a)(iv).

(2) *Sequential or concurrent benefit offset arrangements*—(i) *In general.* An employee is treated as accruing a benefit under a plan that includes an offset or reduction of benefits that satisfies either paragraph (a)(2)(ii) or (a)(2)(iii) of this section if either the employee accrues a benefit under the plan for the

year, or the employee would have accrued a benefit if the offset or reduction portion of the benefit formula were disregarded. In addition, an employee is treated as accruing a meaningful benefit for purposes of prior benefit structure testing under § 1.401(a)(26)–3 if the employee would have accrued a meaningful benefit if the offset or reduction portion of the benefit formula were disregarded.

(ii) *Offset by sequential or grandfathered benefits.* An offset or reduction of benefits under a defined benefit plan satisfies this paragraph (a)(2) if the benefit formula provides that an employee will not accrue additional benefits under the current portion of the benefit formula until the employee has accrued, under such portion, a benefit in excess of such employee's benefit under one or more formulas in effect for prior years that are based wholly on prior years of service. The prior benefit may have accrued under the same or a separate plan, may be provided under the same or a separate plan and may relate to service with the same or previous employers. Benefits will not fail to be treated as based wholly on prior years if they are based, directly or indirectly, on compensation earned after such prior years (including compensation earned in the current year), if they are adjusted to reflect increases in the section 415 limitations, or if they are increased to provide an ad hoc cost of living adjustment designed to adjust, in whole or in part, for inflation. Furthermore, benefits do not fail to be treated as based wholly on prior years merely because the benefits (e.g., early retirement benefits) are subject to an age or years-of-service condition and, in applying the condition or conditions, the current and prior years are taken into account.

(iii) *Concurrent benefit offset arrangements*—(A) *General rule.* An offset or reduction of benefits under a defined benefit plan satisfies the requirements of this paragraph (a)(2)(iii) if the benefit formula provides a benefit that is offset or reduced by contributions or benefits under another plan that is maintained by the same employer and the following additional requirements are met:

(*1*) The contributions or benefits under a plan that are used to offset or reduce the benefits under the positive portion of the fomula being tested accrued under such other plan;

(*2*) The employees who benefit under the formula being tested also benefit under the other plan on a reasonable and uniform basis; and

(*3*) The contributions or benefits under the plan that are used to offset or reduce the benefits under the formula being tested are not used to offset or reduce that employee's benefits under any other plan or any other formula.

(B) *Special rules for certain section 414(n) employer-recipients.* The same employer requirement in the concurrent benefit offset rule in paragraph (a)(2)(iii)(A) of this section is waived for certain section 414(n) employer-recipients. Under this exception, an employer-recipient (within the meaning of sections 414 (n) and (o)) may treat contributions or benefits under a plan maintained by a leasing organization as contributions or benefits accrued under the recipient organization plan provided the following requirements are met: the employer-recipient maintains a plan covering leased employees (which employees are treated as employees of the employer-recipient within the meaning of sections 414(n)(2) and 414(o)(2)); the leased employees are also covered under a plan maintained by the leasing organization; and contributions or benefits under the plan maintained by the employer-recipient are offset or reduced by the contributions or benefits under the leasing organization plan that are attributable to service with the recipient organization. Also, for purposes of the benefiting condition requirement in paragraph (a)(2)(iii)(A)(*2*) of this section, the employees of the employer-recipient who are not leased from the leasing organization are not required to benefit under the plan of the leasing organization.

(b) *Former employees benefiting under a plan.* A former employee is treated as benefiting for a plan year if and only if the former employee would be treated as benetiting under the rules in § 1.410(b)–3(b).

[T.D. 8375, 56 FR 63416, Dec. 4, 1991]

§ 1.401(a)(26)–6 Excludable employees.

(a) *In general.* For purposes of applying section 401(a)(26) with respect to either employees, former employees, or both employees and former employees, as applicable, all employees other than excludable employees described in paragraph (b) of this section, all former employees other than excludable former employees described in paragraph (c) of this section, or both, as the case may be, must be taken into account. Except as specifically provided otherwise in this section, the rules of this section are applied by reference only to the particular plan and must be applied on a uniform and consistent basis.

(b) *Excludable employees.* An employee is an excludable employee if the employee is covered by one or more of the following exclusions:

(1) *Minimum age and service exclusions*—(i) *In general.* If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, tbn all employees who fail to satisfy those conditions may be treated as excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date any employee with the same age and service would be eligible to commence participation in the plan, as provided in section 410(b)(4)(C).

(ii) *Plans benefiting otherwise excludable employees.* An employer may treat a plan benefiting otherwise excludable employees as two separate plans, one for the otherwise excludable employees and one for the other employees benefiting under the plan. The effect of this rule is that employees who would be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)), but for the fact that the plan does not apply the greatest permissible minimum age and service conditions, may be treated as excludable employees with respect to the plan. This treatment is only available if each of the following conditions is satisfied:

(A) The plan under which the otherwise excludable employees benefit also benefits employees who are not otherwise excludable.

(B) The plan under which the otherwise excludable employees benefit satisfies section 401(a)(26), both by reference only to otherwise excludable employees and by reference only to employees who are not otherwise excludable.

(C) The contributions or benefits provided to the otherwise excludable employees (expressed as percentages of compensation) are not greater than the contributions or benefits provided to the employees who are not otherwise excludable under the plan.

(D) No highly compensated employee is included in the group of otherwise excludable employees for more than one plan year.

(iii) *Examples.* The following examples illustrate some of the minimum-age-and-service exclusion requirements:

Example 1. Employer X maintains a defined contribution plan, Plan X, under which employees who have not completed 1 year of service are not eligible to participate. Employer X has six employees. Two of the employees participate in Plan X. The other four employees have not completed 1 year of service and are therefore not eligible to participate in Plan X. The four employees who have not completed 1 year of service are excludable employees and may be disregarded for purposes of applying the minimum participation test. Therefore, Plan X satisfies section 401(a)(26) because both of the two employees who must be considered are participants in Plan X.

Example 2. Employer Y has 100 employees and maintains two plans, Plan 1 and Plan 2. Plan 1 provides that employees who have not completed 1 year of service are not eligible to participate. Plan 2 has no minimum age or service requirement. Twenty of Y's employees do not meet the minimum service requirement under Plan 1. Each plan satisfies the ratio test under section 410(b)(1)(B). In testing Plan 1 to determine whether it satisfies section 401(a)(26), the 20 employees not meeting the minimum age and service requirement under Plan 1 are treated as excludable employees. In testing Plan 2 to determine whether it satisfies section 401(a)(26), no employees are treated as excludable employees because Plan 2 does not have a minimum age or service requirement.

(2) *Certain air pilots.* An employee who is excluded from consideration under section 410(b)(3)(B) (relating to certain

air pilots) may be treated as an excludable employee.

(3) *Certain nonresident aliens*—(i) *In general*. An employee who is excluded from consideration under section 410(b)(3)(C) (relating to certain nonresident aliens) may be treated as an excludable employee.

(ii) *Special treaty rule*. In addition, an employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who does receive earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is permitted to be excluded, if all of the employee's earned income from the employer from sources within the United States is exempt from United States income tax under an applicable income tax convention. This paragraph (b)(3)(ii) applies only if all employees described in the preceding sentence are so excluded.

(4) *Employees covered pursuant to a collective bargaining agreement*. When testing a plan benefiting only noncollectively bargained employees, an employee who is excluded from consideration under section 410(b)(3)(A) (exclusion for employees included in a unit of employees covered by a collective bargaining agreement) may be treated as an excludable employee. This rule may be applied separately to each collective bargaining agreement. See §1.401(a)(26)–8 for the definitions of the terms ''collective bargaining agreement'', ''collectively bargained employee,'' and ''covered pursuant to a collective bargaining agreement''.

(5) *Employees not covered pursuant to a collective bargaining agreement*. When testing a plan that benefits only employees who are included in a group of employees who are covered pursuant to a collective bargaining agreement, an employee who is not included in the group of employees who are covered by the collective bargaining agreement may be treated as an excludable employee.

(6) *Examples*. The following examples illustrate the excludable employee rules that relate to employees covered pursuant to collective bargaining agreements. For purposes of these examples assume that no other exclusion rules are applicable.

Example 1. Employer W has 70 collectively bargained employees and 30 non-collectively bargained employees. Employer W maintains Plan W, which benefits only the 30 non-collectively bargained employees. The 70 collectively bargained employees may be treated as excludable employees and thus may be disregarded in applying section 401(a)(26) to Plan W.

Example 2. Assume the same facts as *Example 1*, except that the Commissioner has determined that the employee representative is not a bona fide employee representative under section 7701(a)(46) and thus there are no ''collectively bargained employees.'' In this case, all employees of W must be considered in determining whether section 401(a)(26) is met.

Example 3. Employer X has collectively bargained employees and 70 noncollectively bargained employees. Employer X maintains Plan X, which benefits only the 30 collectively bargained employees. Employer X may treat the non-collectively bargained employees as excludable employees and disregard them in applying section 401(a)(26) to the collectively bargained plan.

Example 4. Assume the same facts as *Example 3*, except that the Commissioner has determined that the employee representative is not a bona fide employee representative under section 7701(a)(46) and thus there is no recognized collective bargaining agreement. In this case, Employer X may not treat the non-collectively bargained employees of X as excludable employees.

Example 5. Assume the same facts as *Example 3*, except that 3 percent of the 30 collectively bargained employees are professionals. In this case, Employer X may not treat the non-collectively bargained employees of X as excludable employees.

Example 6. Employer Y has 100 collectively bargained employees. Thirty of Y's employees are represented by Collective Bargaining Unit 1 and covered under Plan 1. Seventy of Y's employees are represented by Collective Bargaining Unit 2 and covered under Plan 2. For purposes of testing Plan 1, the employees of Collective Bargaining Unit 2 may be treated as excludable employees. Similarly, for purposes of testing Plan 2, the employees of Collective Bargaining Unit 1 may be treated as excludable employees.

(7) *Certain terminating employees*—(i) *In general*. An employee may be treated as an excludable employee for a plan year with respect to a particular plan if—

(A) The employee does not benefit under the plan for the plan year,

(B) The employee is eligible to participate in the plan,

(C) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) in order for an employee to accrue a benefit or receive an allocation for the plan year,

(D) The employee fails to accrue a benefit or receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last-day requirement,

(E) The employee terminates employment during the plan year with no more than 500 hours of service, and the employee is not an employee as of the last day of the plan year (for purposes of this paragraph (b)(7)(i)(E), a plan that uses the elapsed time method of determining years of service may use either 91 consecutive calendar days or 3 consecutive calendar months instead of 500 hours of service, provided it uses the same convention for all employees during a plan year), and

(F) If this paragraph (b)(7) is applied with respect to any employee with respect to a plan for a plan year, it is applied with respect to all employees with respect to the plan for the plan year.

(ii) *Hours of service.* For purposes of this paragraph (b)(7), the term ''hour of service'' has the same meaning as set forth in 29 CFR 2530.200b–2 under the general method of crediting service for the employee. If one of the equivalencies set forth in 29 CFR 2530.200b–3 is used for crediting service under the plan, the 500-hour requirement must be adjusted accordingly.

(8) *Employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with §1.414(r)–1(b), in testing a plan that benefits employees of one qualified separate line of business, the employees of the other qualified separate lines of business of the employer are treated as excludable employees. See §§1.414(r)–1(c)(3) and 1.414(r)–9 (separate application of section 401(a)(26) to the employees of a qualified separate line of business). The rule in this paragraph (b)(8) does not apply to a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for a plan year.

(c) *Former employees*—(1) *In general.* For purposes of applying section 401(a)(26) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described in paragraph (c)(2) through (c)(4) of this section as an excludable former employee. If any of the former employee exclusion rules under paragraphs (c)(2) through (c)(4) of this section is applied, it must be applied to all former employees for the plan year on a consistent basis.

(2) *Employees terminated before a specified date.* The employer may treat a former employee as excludable if—

(i) The former employee became a former employee either prior to January 1, 1984, or prior to the tenth calendar year preceding the calendar year in which the current plan year begins, and

(ii) The former employee became a former employee in a calendar year that precedes the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee.

(3) *Previously excludable employees.* The employer may treat a former employee as excludable if the former employee was an excludable employee (or would have been an excludable employee if these regulations had been in effect) under the rules of paragraphs (a) and (b) of this section during the plan year in which the former employee became a former employee. If the employer treats a former employee as excludable pursuant to this paragraph (c)(3), the former employee is not taken into account with respect to a plan even if the former employee is benefiting under the plan.

(4) *Vested accrued benefits eligible for mandatory distribution.* A former employee may be treated as an excludable former employee if the present value of the former employee's vested accrued benefit does not exceed the cash-out limit in effect under §1.411(a)–11(c)(3)(ii). This determination is made in accordance with the rules of sections 411(a)(11) and 417(e).

(d) *Certain police or firefighters.* An employer may apply section 401(a)(26) separately with respect to any classification of qualified public safety employees for whom a separate plan is maintained. Thus, for purposes of testing a separate plan covering a class of qualified public safety employees, all employees who are not in that classification are treated as excludable employees. Also, such employees need not be taken into account in determining whether or not any other plan satisfies section 401(a)(26). For purposes of this paragraph (d), *qualified public safety employee* means any employee of any police department or fire department organized and operated by a State or political subdivision if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of a State or political subdivision.

[T.D. 8375, 56 FR 63416, Dec. 4, 1991, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8891, 65 FR 44682, July 19, 2000]

§ 1.401(a)(26)–7 Testing methods.

(a) *Testing on each day of the plan year.* A plan satisfies section 401(a)(26) for a plan year only if the plan satisfies section 401(a)(26) on each day of the plan year. An employee benefits on a day if the employee is a participant for such day and the employee benefits under the plan for the year under the rules in § 1.401(a)(26)–5.

(b) *Simplified testing method.* A plan is treated as satisfying the requirements of paragraph (a) of this section if it satisfies section 401(a)(26) on any single plan day during the plan year, but only if that day is reasonably representative of the employer's workforce and the plan's coverage. A plan does not have to be tested on the same day each plan year.

(c) *Retroactive correction.* If a plan fails to satisfy section 401(a)(26) for a plan year, the plan may be retroactively amended during the same period and under the same conditions as provided for in § 1.401(a)(4)–11(g)(3) through (g)(5) to satisfy section 401(a)(26). A plan merger that occurs by the end of the period provided in § 1.401(a)(4)–11(g)(3)(iv) is treated solely for purposes of section 401(a)(26) as if it were effective as of the first day of the plan year. The rule of this paragraph (c) may be illustrated by the following example.

Example. Assume that an employer with 500 employees maintains two defined contribution plans. Plan A benefits 45 employees. Plan B benefits 50 employees. Immediately before the end of the period provided for in § 1.401(a)(4)–11(g)(3)(iv), the employer expands coverage under Plan A to benefit 20 more employees retroactively for the plan year. Thus, Plan A satisfies paragraph (a) of this section for the plan year. Alternatively, before the end of the period provided for in § 1.401(a)(4)–11(g)(3)(iv), or later if a later period is applicable under section 401(b), the employer could merge Plan A with Plan B to satisfy section 401(a)(26).

[T.D. 8375, 56 FR 63418, Dec. 4, 1991]

§ 1.401(a)(26)–8 Definitions.

In applying this section and §§ 1.401(a)(26)–1 through 1.401(a)(26)–9 the definitions in this section govern unless otherwise provided.

Collective bargaining agreement. Collective bargaining agreement means an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer that satisfies § 301.7701–17T. Employees described in section 413(b)(8) who are employees of the union or the plan and are treated as employees of an employer are not employees covered pursuant to a collective bargaining agreement for purposes of section 401(a)(26) unless the employees are actually covered pursuant to such an agreement.

Collectively bargained employee. Collectively bargained employee means a collectively bargained employee within the meaning of § 1.410(b)–6(d)(2).

Covered by a collective bargaining agreement. Covered by a collective bargaining agreement means covered by a collective bargaining agreement within the meaning of § 1.410(b)–6(d)(2)(iii).

Defined benefit plan. Defined benefit plan means a defined benefit plan within the meaning of § 1.410(b)–9.

Defined contribution plan. Defined contribution plan means a defined contribution plan within the meaning of § 1.410(b)–9.

Employee. Employee means an employee, within the meaning of § 1.410(b)–9.

Employer. *Employer* means the employer within the meaning of § 1.410(b)–9.

ESOP. *ESOP* means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Former employee. *Former employee* means a former employee within the meaning of § 1.410(b)–9.

Highly compensated employee. *Highly compensated employee* means an employee who is highly compensated within the meaning of section 414(q).

Highly compensated former employee. *Highly compensated former employee* means a former employee who is highly compensated within the meaning of section 414(q)(9).

Multiemployer plan. *Multiemployer plan* means a multiemployer plan within the meaning of section 414(f).

Noncollectively bargained employee. *Noncollectively bargained employee* means an employee who is not a collectively bargained employee.

Nonhighly compensated employee. *Nonhighly compensated employee'* means an employee who is not a highly compensated employee.

Nonhighly compensated former employee. *Nonhighly compensated former employee* means a former employee who is not a highly compensated former employee.

Plan. *Plan* means plan as defined in § 1.401(a)(26)–2(c).

Plan year. *Plan year* means the plan year of the plan as defined in the written plan document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Professional employee. *Professional employee* means a professional employee as defined in § 1.410(b)–9.

Section 401(k) plan. *Section 401(k) plan* means a plan consisting of elective contributions described in § 1.401(k)–1(g)(3) under a qualified cash or deferred arrangement described in § 1.401(k)–1(a)(4)(i).

Section 401(m) plan. *Section 401(m) plan* means a plan consisting of employee contributions described in § 1.401(m)–1(f)(6) or matching contributions described in § 1.401(m)–1(f)(12), or both.

[T.D. 8375, 56 FR 63418, Dec. 4, 1991]

§ 1.401(a)(26)–9 Effective dates and transition rules.

(a) *In general*. Except as provided in paragraphs (b), (c), and (d) of this section, section 401(a)(26) and the regulations thereunder apply to plan years beginning on or after January 1, 1989.

(b) *Transition rules*—(1) *Governmental plans and certain section 403(b) annuities*. Section 401(a)(26) is treated as satisfied for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously, in the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans). For purposes of this paragraph (b)(1), the term ''governing body with authority to amend the plan'' means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(2) *Early retirement ''window-period'' benefits*. Early retirement benefits available under a plan only to employees who retire within a limited period of time, not to exceed one year, are treated as satisfying section 401(a)(26) if such benefits are provided under plan terms that were adopted and in effect on or before March 14, 1989.

(3) *Employees who do not benefit because of a minimum-period-of-service requirement or a last-day requirement*. For the first plan year beginning after December 31, 1988, and before January 1, 1990, employees who are eligible to participate under the plan and who fail to accrue a benefit solely because of the failure to satisfy either a minimum-period-of-service requirement of 1000 hours of service or less or a last-day requirement may be treated as benefiting under the plan.

(4) *Certain plan terminations*—(i) *In general*. Except as provided in paragraph (b)(4)(ii) of this section, if a plan terminates after section 401(a)(26) becomes effective with respect to the plan (as determined under paragraph (a) of this section), the plan is not treated as a qualified plan upon termination unless it complies with section

401(a)(26) and the regulations thereunder (to the extent they are applicable) for all periods for which section 401(a)(26) is effective with respect to the plan.

(ii) *Exception.* Notwithstanding paragraphs (a) and (b)(4)(i) of this section, a plan does not fail to be treated as a qualified plan upon termination merely because the plan fails to satisfy the requirements of section 401(a)(26) and the regulations thereunder if the plan is terminated with a termination date on or before December 31, 1989, and either of the following conditions is satisfied:

(A) In the case of a defined benefit plan, no highly compensated employee has an accrued benefit under the plan exceeding the lesser of either the benefit the employee had accrued as of the close of the last plan year beginning before January 1, 1989, or the benefit the employee would have accrued as of the close of the last plan year under the terms of the plan in effect and applicable with respect to the employee on December 13, 1988.

(B) In the case of a defined contribution plan, no highly compensated employee receives a contribution allocation for any plan year beginning after December 31, 1988. For this purpose, a contribution allocation with respect to an employee for a plan year beginning before January 1, 1989, may be treated as a contribution allocation for a plan year beginning after December 31, 1988, if the allocation for the prior year exceeds the allocation that the employee would have received for such year under the terms of the plan in effect and applicable with respect to the employee on December 13, 1988. An allocation of forfeitures to highly compensated employees with respect to contributions made for plan years beginning before January 1, 1988, does not cause a defined contribution plan to fail to satisfy the conditions of this paragraph (b)(4)(ii)(B).

(5) *ESOPs and non-ESOPs.* Notwithstanding paragraph (a) of this section and § 54.4975–11(a)(5) of this Chapter, an employer may treat the rule in § 1.401(a)(26)–2(d)(1)(i), regarding mandatory disaggregation of ESOPs and non-ESOPs as not effective for plan years beginning before January 1, 1990.

(c) *Waiver of excise tax on reversions*—(1) *In general.* Pursuant to section 1112(e)(3) of the Tax Reform Act of 1986 (TRA '86), if certain conditions are satisfied, a waiver of the excise tax under section 4980 applies with respect to any employer reversion that occurs by reason of the termination or merger of a plan before the first year to which section 401(a)(26) applies to the plan. In general, the applicable conditions are that the plan must have been in existence on August 16, 1986; that if section 401(a)(26) was in effect for the plan year including August 16, 1986, the plan would have failed to satisfy the requirements of section 401(a)(26) and would have continued to fail the requirements at all times thereafter; that the plan satisfies the applicable conditions in paragraph (b)(4)(ii)(A) or (B) of this section; and that certain requirements regarding asset or liability transfers and mergers and spinoffs involving the plan after August 16, 1986, are satisfied.

(2) *Termination date.* An employer reversion with respect to a plan is eligible for the section 4980 excise tax waiver only if the employer reversion occurs by reason of the termination of the plan with a termination date prior to the first plan year for which section 401(a)(26) applies to the plan. Solely for purposes of this waiver, the employer reversion is treated as satisfying this paragraph (c)(2) even though the plan's termination date is during the first plan year for which section 401(a)(26) applies to the plan if the plan's termination date is on or before May 31, 1989. If the termination date occurs in the first plan year for which section 401(a)(26) applied to the plan and the employer receives a reversion that is eligible for the waiver of the section 4980 tax, the plan is subject to the interest rate restriction set forth in section 11 12(e)(3)(B) of TRA '86 as amended.

(3) *Failure to satisfy section 401(a)(26).* An employer reversion with respect to a plan is eligible for the excise tax waiver only if the plan was in existence on August 16, 1986, and, if section 401(a)(26) had applied to the plan for the plan year including such date, the plan would have failed to satisfy section 401(a)(26) for the plan year and

continuously thereafter until the plan's termination or merger. For purposes of this paragraph (c)(3), a plan is treated as though it would have failed to satisfy section 401(a)(26) before such section actually applied to the plan only if the plan (as defined under section 414(1)) failed to benefit at least the lesser of 50 employees or 40 percent of the employer's employees. In general, this determination is to be made on the basis of only the applicable statutory provisions, without regard to the regulations under section 401(a)(26). Thus, for example, the prior benefit structure rules in § 1.401(a)(26)–3 do not apply in determining whether a plan would have failed to satisfy section 401(a)(26) for plan years beginning prior to the effective date of section 401(a)(26) with respect to the plan.

(d) *Special rule for collective bargaining agreements*. In the case of a plan maintained pursuant to one or more collective bargaining agreements (as defined in § 1.401(a)(26)–8(a)) that were ratified before March 1, 1986, section 401(a)(26) and the regulations thereunder shall not apply to plan years beginning before the earlier of—

(1) January 1, 1991, or

(2) The later of—

(i) January 1, 1989, or

(ii) The date on which the last of such collective bargaining agreements terminates. For purposes of this paragraph (d), any extension or renegotiation of any collective bargaining agreement that is ratified after February 28, 1986, is disregarded in determining the date on which such collective bargaining agreement terminates.

[T.D. 8375, 56 FR 63419, Dec. 4, 1991, as amended by T.D. 8487, 58 FR 46838, Sept. 3, 1993]

§ 1.401(a)(31)–1 Requirement to offer direct rollover of eligible rollover distributions; questions and answers.

The following questions and answers relate to the qualification requirement imposed by section 401(a)(31) of the Internal Revenue Code of 1986, pertaining to the direct rollover option for eligible rollover distributions from pension, profit-sharing, and stock bonus plans. Section 401(a)(31) was added by section 522(a) of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 402(c), 402(f), 403(b)(8) and (10), and 3405(c), see §§ 1.402(c)–2, 1.402(f)–1, and 1.403(b)–2, and § 31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What are the direct rollover requirements under section 401(a)(31)?

Q–2: Does section 401(a)(31) require that a qualified plan permit a direct rollover to be made to a qualified trust that is not part of a defined contribution plan?

Q–3: What is a *direct rollover* that satisfies section 401(a)(31), and how is it accomplished?

Q–4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

Q–5: Is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover currently includible in gross income or subject to 20-percent withholding?

Q–6: What procedures may a plan administrator prescribe for electing a direct rollover, and what information may the plan administrator require a distributee to provide when electing a direct rollover?

Q–7: May the plan administrator treat a distributee as having made an election under a default procedure where the distributee does not affirmatively elect to make or not make a direct rollover within a certain time period?

Q–8: May the plan administrator establish a deadline after which the distributee may not revoke an election to make or not make a direct rollover?

Q–9: Must the plan administrator permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

Q–10: Must the plan administrator allow a distributee to divide an eligible rollover distribution into two or more separate distributions to be paid in direct rollovers to two or more eligible retirement plans?

Q–11: Will a plan satisfy section 401(a)(31) if the plan administrator does not permit a distributee to elect a direct rollover if his or her eligible rollover distributions during a year are reasonably expected to total less than $200?

Q–12: Is a plan administrator permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series?

Q–13: Is the eligible retirement plan designated by a distributee to receive a direct

rollover distribution required to accept the distribution?

Q–14. If a plan accepts an invalid rollover contribution, whether or not as a direct rollover, how will the contribution be treated for purposes of applying the qualification requirements of section 401(a) or 403(a) to the plan?

Q–15: For purposes of applying the plan qualification requirements of section 401(a), is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover a distribution and rollover or is it a transfer of assets and liabilities?

Q–16: Must a direct rollover option be provided for an eligible rollover distribution that is in the form of a plan loan offset amount?

Q–17: Must a direct rollover option be provided for an eligible rollover distribution from a qualified plan distributed annuity contract?

Q–18: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution?

Q–19: When must a qualified plan be amended to comply with section 401(a)(31)?

QUESTIONS AND ANSWERS

Q–1: What are the direct rollover requirements under section 401(a)(31)?

A–1: (a) *General rule*. To satisfy section 401(a)(31), added by UCA, a plan must provide that if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan, and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover described in Q&A–3 of this section. Thus, the plan must give the distributee the option of having his or her distribution paid in a direct rollover to an eligible retirement plan specified by the distributee. For purposes of section 401(a)(31) and this section, eligible rollover distribution has the meaning set forth in section 402(c)(4) and § 1.402(c)–2, Q&A–3 through Q&A–10 and Q&A–14, except as otherwise provided in Q&A–2 of this section, eligible retirement plan has the meaning set forth in section 402(c)(8)(B) and § 1.402(c)–2, Q&A–2.

(b) *Related Internal Revenue Code provisions*—(1) *Mandatory withholding*. If a distributee of an eligible rollover distribution does not elect to have the eligible rollover distribution paid directly from the plan to an eligible retirement plan in a direct rollover under section 401(a)(31), the eligible rollover distribution is subject to 20-percent income tax withholding under section 3405(c). See § 31.3405(c)–1 of this chapter for guidance concerning the withholding requirements applicable to eligible rollover distributions.

(2) *Notice requirement*. Section 402(f) requires the plan administrator of a qualified plan to provide, within a reasonable period of time before making an eligible rollover distribution, a written explanation to the distributee of the distributee's right to elect a direct rollover and the withholding consequences of not making that election. The explanation also is required to provide certain other relevant information relating to the taxation of distributions. See § 1.402(f)–1 for guidance concerning the written explanation required under section 402(f).

(3) *Section 403(b) annuities*. Section 403(b)(10) provides that requirements similar to those imposed by section 401(a)(31) apply to annuities described in section 403(b). See § 1.403(b)–2 for guidance concerning the direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date*. Section 401(a)(31) applies to eligible rollover distributions made on or after January 1, 1993.

(2) *Regulatory effective date*. This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, § 1.401(a)(31)–1T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan may satisfy section 401(a)(31) by substituting any or all provisions of this section for the corresponding provisions of § 1.401(a)(31)–1T, if any.

Q–2: Does section 401(a)(31) require that a qualified plan permit a direct rollover to be made to a qualified trust that is not part of a defined contribution plan?

A–2: No. Section 401(a)(31)(D) limits the types of qualified trusts that are treated as eligible retirement plans to defined contribution plans that accept

eligible rollover distributions. Therefore, although a plan is permitted, at a participant's election, to make a direct rollover to any type of eligible retirement plan, as defined in section 402(c)(8)(B) (including a defined benefit plan), a plan will not fail to satisfy section 401(a)(31) solely because the plan will not permit a direct rollover to a qualified trust that is part of a defined benefit plan. In contrast, if a distributee elects a direct rollover of an eligible rollover distribution to an annuity plan described in section 403(a), that distribution must be paid to the annuity plan, even if the recipient annuity plan is a defined benefit plan.

Q–3: What is a direct rollover that satisfies section 401(a)(31), and how is it accomplished?

A–3: A direct rollover that satisfies section 401(a)(31) is an eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee. A direct rollover may be accomplished by any reasonable means of direct payment to an eligible retirement plan. Reasonable means of direct payment include, for example, a wire transfer or the mailing of a check to the eligible retirement plan. If payment is made by check, the check must be negotiable only by the trustee of the eligible retirement plan. If the payment is made by wire transfer, the wire transfer must be directed only to the trustee of the eligible retirement plan. In the case of an eligible retirement plan that does not have a trustee (such as a custodial individual retirement account or an individual retirement annuity), the custodian of the plan or issuer of the contract under the plan, as appropriate, should be substituted for the trustee for purposes of this Q&A–3, and Q&A–4 of this section.

Q–4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

A–4: Providing the distributee with a check and instructing the distributee to deliver the check to the eligible retirement plan is a reasonable means of direct payment, provided that the check is made payable as follows: [Name of the trustee] as trustee of [name of the eligible retirement plan]. For example, if the name of the eligible retirement plan is ''Individual Retirement Account of John Q. Smith,'' and the name of the trustee is ''ABC Bank,'' the payee line of a check would read ''ABC Bank as trustee of Individual Retirement Account of John Q. Smith.'' Unless the name of the distributee is included in the name of the eligible retirement plan, the check also must indicate that it is for the benefit of the distributee. If the eligible retirement plan is not an individual retirement account or an individual retirement annuity, the payee line of the check need not identify the trustee by name. For example, the payee line of a check for the benefit of distributee Jane Doe might read, ''Trustee of XYZ Corporation Savings Plan FBO Jane Doe.''

Q–5: Is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover currently includible in gross income or subject to 20-percent withholding?

A–5: No. An eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover is not currently includible in the distributee's gross income under section 402(c) and is exempt from the 20-percent withholding imposed under section 3405(c)(2). However, when any portion of the eligible rollover distribution is subsequently distributed from the eligible retirement plan, that portion will be includible in gross income to the extent required under section 402, 403, or 408.

Q–6: What procedures may a plan administrator prescribe for electing a direct rollover, and what information may the plan administrator require a distributee to provide when electing a direct rollover?

A–6: (a) *Permissible procedures*. Except as otherwise provided in paragraph (b) of this Q&A–6, the plan administrator may prescribe any procedure for a distributee to elect a direct rollover under section 401(a)(31), provided that the procedure is reasonable. The procedure may include any reasonable requirement for information or documentation from the distributee in addition to the items of adequate information specified in § 31.3405(c)–1(b), Q&A–7 of this chapter. For example, it would be reasonable for the plan administrator

to require that the distributee provide a statement from the designated recipient plan that the plan will accept the direct rollover for the benefit of the distributee and that the recipient plan is, or is intended to be, an individual retirement account, an individual retirement annuity, a qualified annuity plan described in section 403(a), or a qualified trust described in section 401(a), as applicable. In the case of a designated recipient plan that is a qualified trust, it also would be reasonable for the plan administrator to require a statement that the qualified trust is not excepted from the definition of an eligible retirement plan by section 401(a)(31)(D) (i.e., is not a defined benefit plan).

(b) *Impermissible procedures*. A plan will fail to satisfy section 401(a)(31) if the plan administrator prescribes any unreasonable procedure, or requires information or documentation, that effectively eliminates or substantially impairs the distributee's ability to elect a direct rollover. For example, it would effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the recipient plan required the distributee to obtain an opinion of counsel stating that the eligible retirement plan receiving the rollover is a qualified plan or individual retirement account. Similarly, it would effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the distributing plan required a letter from the recipient eligible retirement plan stating that, upon request by the distributing plan, the recipient plan will automatically return any direct rollover amount that the distributing plan advises the recipient plan was paid incorrectly. It would also effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the distributing plan required, as a condition for making a direct rollover, a letter from the recipient eligible retirement plan indemnifying the distributing plan for any liability arising from the distribution.

Q–7: May the plan administrator treat a distributee as having made an election under a default procedure where the distributee does not affirmatively elect to make or not make a direct rollover within a certain time period?

A–7: Yes, the plan administrator may establish a default procedure whereby any distributee who fails to make an affirmative election is treated as having either made or not made a direct rollover election. However, the plan administrator may not make a distribution under any default procedure unless the distributee has received an explanation of the default procedure and an explanation of the direct rollover option as required under section 402(f) and §1.402(f)–1, Q&A–1 and unless the timing requirements described in §1.402(f)–1, Q&A–2 and Q&A–3 have been satisfied with respect to the explanations of both the default procedure and the direct rollover option.

Q–8: May the plan administrator establish a deadline after which the distributee may not revoke an election to make or not make a direct rollover?

A–8: Yes, but the plan administrator is not permitted to prescribe any deadline or time period with respect to revocation of a direct rollover election that is more restrictive for the distributee than that which otherwise applies under the plan to revocation of the form of distribution elected by the distributee.

Q–9: Must the plan administrator permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

A–9: Yes, the plan administrator must permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder paid to the distributee. However, the plan administrator is permitted to require that, if the distributee elects to have only a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover, that portion be equal to at least a specified minimum amount, provided the specified minimum amount is less than or equal to $500 or any greater amount as prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue

Bulletin. See § 601.601(d)(2)(ii)(*b*) of this chapter. If the entire amount of the eligible rollover distribution is less than or equal to the specified minimum amount, the plan administrator need not allow the distributee to divide the distribution.

Q–10: Must the plan administrator allow a distributee to divide an eligible rollover distribution into two or more separate distributions to be paid in direct rollovers to two or more eligible retirement plans?

A–10: No. The plan administrator is not required (but is permitted) to allow the distributee to divide an eligible rollover distribution into separate distributions to be paid to two or more eligible retirement plans in direct rollovers. Thus, the plan administrator may require that the distributee select a single eligible retirement plan to which the eligible rollover distribution (or portion thereof) will be distributed in a direct rollover.

Q–11: Will a plan satisfy section 401(a)(31) if the plan administrator does not permit a distributee to elect a direct rollover if his or her eligible rollover distributions during a year are reasonably expected to total less than $200?

A–11: Yes. A plan will satisfy section 401(a)(31) even though the plan administrator does not permit any distributee to elect a direct rollover with respect to eligible rollover distributions during a year that are reasonably expected to total less than $200 or any lower minimum amount specified by the plan administrator. The rules described in § 31.3405(c)–1, Q&A–14 of this chapter (relating to whether withholding under section 3405(c) is required for an eligible rollover distribution that is less than $200) also apply for purposes of determining whether a direct rollover election under section 401(a)(31) must be provided for an eligible rollover distribution that is less than $200 or the lower specified amount.

Q–12: Is a plan administrator permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series?

A–12: (a) Yes. A plan administrator is permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series, provided that:

(1) The employee is permitted at any time to change, with respect to subsequent payments, a previous election to make or not make a direct rollover; and

(2) The written explanation provided under section 402(f) explains that the election to make or not make a direct rollover will apply to all future payments unless the employee subsequently changes the election.

(b) See § 1.402(f)–1, Q&A–3 for further guidance concerning the rules for providing section 402(f) notices when eligible rollover distributions are made in a series of periodic payments.

Q–13: Is the eligible retirement plan designated by a distributee to receive a direct rollover distribution required to accept the distribution?

A–13: No. Although section 401(a)(31) requires qualified plans to provide distributees the option to make a direct rollover of their eligible rollover distributions to an eligible retirement plan, it imposes no requirement that any eligible retirement plan accept rollovers. Thus, a plan can refuse to accept rollovers. Alternatively, a plan can limit the circumstances under which it will accept rollovers. For example, a plan can limit the types of plans from which it will accept a rollover or limit the types of assets it will accept in a rollover (such as accepting only cash or its equivalent).

Q–14. If a plan accepts an invalid rollover contribution, whether or not as a direct rollover, how will the contribution be treated for purposes of applying the qualification requirements of section 401(a) or 403(a) to the plan?

A–14. (a) *Acceptance of invalid rollover contribution.* If a plan accepts an invalid rollover contribution, the contribution will be treated, for purposes of applying the qualification requirements of section 401(a) or 403(a) to the receiving plan, as if it were a valid rollover contribution, if the following two conditions are satisfied. First, when accepting the amount from the employee

as a rollover contribution, the plan administrator of the receiving plan reasonably concludes that the contribution is a valid rollover contribution. While evidence that the distributing plan is the subject of a determination letter from the Commissioner indicating that the distributing plan is qualified would be useful to the receiving plan administrator in reasonably concluding that the contribution is a valid rollover contribution, it is not necessary for the distributing plan to have such a determination letter in order for the receiving plan administrator to reach that conclusion. Second, if the plan administrator of the receiving plan later determines that the contribution was an invalid rollover contribution, the amount of the invalid rollover contribution, plus any earnings attributable thereto, is distributed to the employee within a reasonable time after such determination.

(b) *Definitions.* For purposes of this Q&A–14:

(1) An *invalid rollover contribution* is an amount that is accepted by a plan as a rollover within the meaning of §1.402(c)–2, Q&A–1 (or as a rollover contribution within the meaning of section 408(d)(3)(A)(ii)) but that is not an eligible rollover distribution from a qualified plan (or an amount described in section 408(d)(3)(A)(ii)) or that does not satisfy the other requirements of section 401(a)(31), 402(c), or 408(d)(3) for treatment as a rollover or a rollover contribution.

(2) A *valid rollover contribution* is a contribution that is accepted by a plan as a rollover within the meaning of §1.402(c)–2, Q&A–1 or as a rollover contribution within the meaning of section 408(d)(3) and that satisfies the requirements of section 401(a)(31), 402(c), or 408(d)(3) for treatment as a rollover or a rollover contribution.

(c) *Examples.* The provisions of paragraph (a) of this Q&A–14 are illustrated by the following examples:

Example 1. (i) Employer X maintains for its employees Plan M, a profit sharing plan qualified under section 401(a). Plan M provides that any employee of Employer X may make a rollover contribution to Plan M. Employee A is an employee of Employer X, will not have attained age 70½ by the end of the year, and has a vested account balance in Plan O (a plan maintained by Employee A's prior employer). Employee A elects a single sum distribution from Plan O and elects that it be paid to Plan M in a direct rollover.

(ii) Employee A provides the plan administrator of Plan M with a letter from the plan administrator of Plan O stating that Plan O has received a determination letter from the Commissioner indicating that Plan O is qualified.

(iii) Based upon such a letter, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the amount paid as a direct rollover is an eligible rollover distribution.

Example 2. (i) The facts are the same as *Example 1,* except that, instead of the letter provided in paragraph (ii) of *Example 1,* Employee A provides the plan administrator of Plan M with a letter from the plan administrator of Plan O representing that Plan O satisfies the requirements of section 401(a) (or representing that Plan O is intended to satisfy the requirements of section 401(a) and that the administrator of Plan O is not aware of any Plan O provision or operation that would result in the disqualification of Plan O).

(ii) Based upon such a letter, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the amount paid as a direct rollover is an eligible rollover distribution.

Example 3. (i) Same facts as *Example 1,* except that Employee A elects to receive the distribution from Plan O and wishes to make a rollover contribution described in section 402 rather than a direct rollover.

(ii) When making the rollover contribution, Employee A certifies that, to the best of Employee A's knowledge, Employee A is entitled to the distribution as an employee and not as a beneficiary, the distribution from Plan O to be contributed to Plan M is not one of a series of periodic payments, the distribution from Plan O was received by Employee A not more than 60 days before the date of the rollover contribution, and the entire amount of the rollover contribution would be includible in gross income if it were not being rolled over.

(iii) As support for these certifications, Employee A provides the plan administrator of Plan M with two statements from Plan O. The first is a letter from the plan administrator of Plan O, as described in *Example 1,* stating that Plan O has received a determination letter from the Commissioner indicating that Plan O is qualified. The second is the distribution statement that accompanied the distribution check. The distribution statement indicates that the distribution is being made by Plan O to Employee A, indicates the gross amount of the distribution, and indicates the amount withheld as Federal income tax. The amount withheld as Federal income tax is 20 percent of the gross

amount of the distribution. Employee A contributes to Plan M an amount not greater than the gross amount of the distribution stated in the letter from Plan O and the contribution is made within 60 days of the date of the distribution statement from Plan O.

(iv) Based on the certifications and documentation provided by Employee A, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the distribution otherwise satisfies the requirements of section 402(c) for treatment as a rollover contribution.

Example 4. (i) The facts are the same as in *Example 3,* except that, rather than contributing the distribution from Plan O to Plan M, Employee A contributes the distribution from Plan O to IRA P, an individual retirement account described in section 408(a). After the contribution of the distribution from Plan O to IRA P, but before the year in which Employee A attains age 70½, Employee A requests a distribution from IRA P and decides to contribute it to Plan M as a rollover contribution. To make the rollover contribution, Employee A endorses the check received from IRA P as payable to Plan M.

(ii) In addition to providing the certifications described in *Example 3* with respect to the distribution from Plan O, Employee A certifies that, to the best of Employee A's knowledge, the contribution to IRA P was not made more than 60 days after the date Employee A received the distribution from Plan O, no amount other than the distribution from Plan O has been contributed to IRA P, and the distribution from IRA P was received not more than 60 days earlier than the rollover contribution to Plan M.

(iii) As support for these certifications, in addition to the two statements from Plan O described in *Example 3,* Employee A provides copies of statements from IRA P. The statements indicate that the account is identified as an IRA, the account was established within 60 days of the date of the letter from Plan O informing Employee A that an amount had been distributed, and the opening balance in the IRA does not exceed the amount of the distribution described in the letter from Plan O. There is no indication in the statements that any additional contributions have been made to IRA P since the account was opened. The date on the check from IRA P is less than 60 days before the date that Employee A makes the contribution to Plan M.

(iv) Based on the certifications and documentation provided by Employee A, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the contribution by Employee A is a rollover contribution described in section 408(d)(3)(A)(ii) that satisfies the other requirements of section 408(d)(3) for treatment as a rollover contribution.

Q–15: For purposes of applying the plan qualification requirements of section 401(a), is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover a distribution and rollover or is it a transfer of assets and liabilities?

A–15: For purposes of applying the plan qualification requirements of section 401(a), a direct rollover is a distribution and rollover of the eligible rollover distribution and not a transfer of assets and liabilities. For example, if the consent requirements under section 411(a)(11) or sections 401(a)(11) and 417(a)(2) apply to the distribution, they must be satisfied before the eligible rollover distribution may be distributed in a direct rollover. Similarly, the direct rollover is not a transfer of assets and liabilities that must satisfy the requirements of section 414(l). Finally, a direct rollover is not a transfer of benefits for purposes of applying the requirements under section 411(d)(6), as described in § 1.411(d)–4, Q&A–3. Therefore, for example, the eligible retirement plan is not required to provide, with respect to amounts paid to it in a direct rollover, the same optional forms of benefits that were provided under the plan that made the direct rollover. The direct rollover requirements of section 401(a)(31) do not affect the ability of a qualified plan to make an elective or nonelective transfer of assets and liabilities to another qualified plan in accordance with applicable law (such as section 414(l)).

Q–16: Must a direct rollover option be provided for an eligible rollover distribution that is in the form of a plan loan offset amount?

A–16: A plan will not fail to satisfy section 401(a)(31) merely because the plan does not permit a distributee to elect a direct rollover of an eligible rollover distribution in the form of a plan loan offset amount. Section 1.402(c)–2(b), Q&A–9 defines a plan loan offset amount, in general, as a distribution that occurs when, under the terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan. A plan administrator is permitted to allow a direct rollover of a participant note for a plan loan to a qualified trust described in section 401(a) or a qualified annuity

plan described in section 403(a). See § 1.402(c)–2, Q&A–9 for examples illustrating the rules for plan loan offset amounts that are set forth in this Q&A–16. See § 31.3405(c)–1, Q&A–11 of this chapter for guidance concerning special withholding rules that apply to a distribution in the form of a plan loan offset amount.

Q–17: Must a direct rollover option be provided for an eligible rollover distribution from a qualified plan distributed annuity contract?

A–17: Yes. If any amount to be distributed under a qualified plan distributed annuity contract is an eligible rollover distribution (in accordance with § 1.402(c)–2), Q&A–10 the annuity contract must satisfy section 401(a)(31) in the same manner as a qualified plan under section 401(a). Section 1.402(c)–2, Q&A–10 defines a qualified plan distributed annuity contract as an annuity contract purchased for a participant, and distributed to the participant, by a qualified plan. In the case of a qualified plan distributed annuity contract, the payor under the contract is treated as the plan administrator. See § 31.3405(c)–1, Q&A–13 of this chapter concerning the application of mandatory 20-percent withholding requirements to distributions from a qualified plan distributed annuity contract.

Q–18: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution?

A–18: (a) *General rule*. For purposes of section 401(a)(31), a plan administrator may make the assumptions described in paragraphs (b) and (c) of this Q&A–18 in determining the amount of a distribution that is an eligible rollover distribution for which a direct rollover option must be provided. Section 31.3405(c)–1, Q&A–10 of this chapter provides assumptions for purposes of complying with section 3405(c). See § 1.402(c)–2, Q&A–15 concerning the effect of these assumptions for purposes of section 402(c).

(b) *$5,000 death benefit*. A plan administrator is permitted to assume that a distribution from the plan that qualifies for the $5,000 death benefit exclusion under section 101(b) is the only death benefit being paid with respect to a deceased employee that qualifies for that exclusion. Thus, to the extent that such a distribution would be excludible from gross income based on this assumption, the plan administrator is permitted to assume that it is not an eligible rollover distribution.

(c) *Determination of designated beneficiary*. For the purpose of determining the amount of the minimum distribution required to satisfy section 401(a)(9)(A) for any calendar year, the plan administrator is permitted to assume that there is no designated beneficiary.

Q–19: When must a qualified plan be amended to comply with section 401(a)(31)?

A–19: Even though section 401(a)(31) applies to distributions from qualified plans made on or after January 1, 1993, a qualified plan is not required to be amended before the last day by which amendments must be made to comply with the Tax Reform Act of 1986 and related provisions, as permitted in other administrative guidance of general applicability, provided that:

(a) In the interim period between January 1, 1993, and the date on which the plan is amended, the plan is operated in accordance with the requirements of section 401(a)(31); and

(b) The amendment applies retroactively to January 1, 1993.

[T.D. 8619, 60 FR 49204, Sept. 22, 1995, as amended by T.D. 8880, 65 FR 21314, Apr. 21, 2000; 65 FR 34534, May 30, 2000]

§ 1.401(b)–1 Certain retroactive changes in plan.

(a) *General rule*. Under section 401(b) a stock bonus, pension, profit-sharing, annuity, or bond purchase plan which does not satisfy the requirements of section 401(a) on any day solely as a result of a disqualifying provision (as defined in paragraph (b) of this section) shall be considered to have satisfied such requirements on such date if, on or before the last day of the remedial amendment period (as determined under paragraphs (d), (e) and (f) of this section) with respect to such disqualifying provision, all provisions of the plan which are necessary to satisfy all requirements of sections 401(a), 403(a), or 405(a) are in effect and have been made effective for all purposes for the whole of such period. Under some facts

and circumstances, it may not be possible to amend a plan retroactively so that all provisions of the plan which are necessary to satisfy the requirements of section 401(a) are in fact made effective for the whole remedial amendment period. If it is not possible, the requirements of this section will not be satisfied even if the employer adopts a retroactive plan amendment which, in form, appears to satisfy such requirements. Section 401(b) does not permit a plan to be made retroactively effective, for qualification purposes, for a taxable year prior to the taxable year of the employer in which the plan was adopted by such employer.

(b) *Disqualifying provisions.* For purposes of this section, with respect to a plan described in paragraph (a) of this section, the term ''disqualifying provision'' means:

(1) A provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan, which causes such plan to fail to satisfy the requirements of the Code applicable to qualification of such plan as of the date such plan or amendment is first made effective.

(2) A plan provision which results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in such requirements—

(i) Effected by the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 829), hereafter referred to as ''ERISA,'' or the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97–248, 96 Stat. 324), hereafter referred to as ''TEFRA,'' or

(ii) Effective before the first day of the first plan year beginning after December 31, 1989 and that is effected by the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 2489), hereafter referred to as ''TRA '86,'' the Omnibus Budget Reconciliation Act of 1986, (Pub. L. 99–509, 100 Stat. 1874), hereafter referred to as ''OBRA '86,'' or the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100–203, 101 Stat. 1330), hereafter referred to as ''OBRA '87.'' For purposes of this paragraph (b)(2)(ii), a disqualifying provision includes any plan provision that is integral to a qualification requirement changed by TRA '86, OBRA '86, or OBRA '87 or any requirement treated by the Commissioner, directly or indirectly, as if section 1140 of TRA '86 applied to it, but only to the extent such provision is effective before the first day of the first plan year beginning after December 31, 1989. With respect to disqualifying provisions described in this paragraph (b)(2)(ii) effective before the first day of the first plan year which begins after December 31, 1988, there must be compliance with the conditions of section 1140 of TRA '86 (other than the requirement that the plan amendment be made on or before the last day of the first plan year beginning after December 31, 1988), including operation in accordance with the plan provision as of its effective date with respect to the plan.

(3) A plan provision designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision that either—

(i) Results in the failure of the plan to satisfy the qualification requirements of the Internal Revenue Code by reason of a change in those requirements; or

(ii) Is integral to a qualification requirement of the Internal Revenue Code that has been changed.

(c) *Special rules applicable to disqualifying provisions*—(1) *Absence of plan provision.* For purposes of paragraphs (b)(2) and (3) of this section, a disqualifying provision includes the absence from a plan of a provision required by, or, if applicable, integral to the applicable change to the qualification requirements of the Internal Revenue Code, if the plan was in effect on the date the change became effective with respect to the plan.

(2) *Method of designating disqualifying provisions.* The Commissioner may designate a plan provision as a disqualifying provision pursuant to paragraph (b)(3) of this section only in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2) of this chapter.

(3) *Authority to impose limitations.* In the case of a provision that has been designated as a disqualifying provision by the Commissioner pursuant to paragraph (b)(3) of this section, the Commissioner may impose limits and provide additional rules regarding the

amendments that may be made with respect to that disqualifying provision during the remedial amendment period. The Commissioner may provide guidance in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2) of this chapter.

(d) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins:

(i) In the case of a provision of, or absence of a provision from, a new plan, described in paragraph (b)(1) of this section, the date the plan is put into effect,

(ii) In the case of an amendment to an existing plan, described in paragraph (b)(1) of this section, the date the plan amendment is adopted or put into effect (whichever is earlier),

(iii) In the case of a disqualifying provision described in paragraph (b)(2) of this section, the date on which the change effected by ERISA, TEFRA, TRA '86, OBRA '86, OBRA '87, or a qualification requirement that is treated, directly or indirectly, as subject to the conditions of section 1140 of TRA '86 described in paragraph (b)(2) of this section, became effective with respect to such plan or, in the case of a provision, described in paragraph (b)(2)(ii) of this section, that is integral to such qualification requirement, the first day on which the plan was operated in accordance with such provision, or

(iv) In the case of a disqualifying provision described in paragraph (b)(3)(i) of this section, the date on which the change effected by an amendment to the Internal Revenue Code became effective with respect to the plan; or

(v) In the case of a disqualifying provision described in paragraph (b)(3)(ii) of this section, the first day on which the plan was operated in accordance with such provision, as amended, unless another time is specified by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2) of this chapter.

(2) Unless further extended as provided by paragraph (e) of this section, the remedial amendment period ends with the latest of:

(i) In the case of a plan maintained by one employer, the time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the latest of:

(A) The date on which the remedial amendment period begins.

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(ii) In the case of a plan maintained by one employer, the last day of the plan year within which falls the latest of:

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(iii) In the case of a plan maintained by more than one employer, the last day of the tenth month following the last day of the plan year in which falls the latest of:

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date of which a plan amendment described in paragraph (b)(1) of this section is made effective, or

(iv) December 31, 1976, but only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), and only in the case of a remedial amendment period which began on or after September 2, 1974.

(3) For purposes of paragraphs (d)(2)(i), (d)(2)(ii), and (d)(2)(iii) of this section, for any disqualifying provision described in paragraph (b)(2)(ii) of this section, the remedial amendment period shall be deemed to have begun with the first day of the first plan year which begins after December 31, 1988.

(4) For purposes of this paragraph (d)(2) of this section, a master or prototype plan shall not be considered to be a plan maintained by more than one

employer, and whether or not a plan is maintained by more than one employer, shall be determined without regard to section 414 (b) and (c) except that if a plan is maintained solely by an affiliated group of corporations (within the meaning of section 1504) which files a consolidated income tax return pursuant to section 1501 for a taxable year within which falls the latest of the dates described in paragraph (d)(2)(i) of this section, such plan shall be deemed to be maintained by one employer.

(e) *Extensions of remedial amendment period*—(1) *Opinion letter request by sponsoring organization of master or prototype plan*. In the case of an employer who has adopted a master or prototype plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of:

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which:

(A) The opinion letter with respect to the request of the sponsoring organization is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph apply only if the sponsoring organization of such master or prototype plan has, after September 2, 1974, and on or before December 31, 1976, filed a request for an opinion letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this paragraph (e)(1) apply to a master or prototype plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of adoption of the replacement plan.

(2) *Notification letter request by law firm sponsor of district-approved plan*. In the case of an employer who has adopted a pattern plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of:

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which:

(A) The notification letter with respect to the request of the sponsoring law firm is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph shall apply only if the sponsoring law firm of such pattern plan has, on or before December 31, 1976, filed a request for a notification letter with the Internal Revenue Service with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this paragraph (e)(2) apply to a pattern plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of the adoption of the replacement plan.

(3) *Determination letter request by employer or plan administrator*. If on or before the end of a remedial amendment period determined without regard to this paragraph (e), or in a case to which paragraph (e) (1) or (2) of this section applies, on or before the 90th day following the later of the dates described in paragraph (e) (1) or (2) of this section, the employer or plan administrator files a request pursuant to § 601.201(s) of this chapter (Statement of Procedural Rules) for a determination letter with respect to the initial or continuing qualification of the plan, or a trust which is part of such plan, such remedial amendment period shall be extended until the expiration of 91 days after:

(i) The date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, or

(ii) If a petition is timely filed with the United States Tax Court for a declaratory judgment under section 7476 with respect to the final determination (or the failure of the Internal Revenue Service to make a final determination) in response to such request, the date on which the decision of the United States Tax Court in such proceeding becomes final.

(4) *Transitional rule.* In the case of a request for a determination letter described in and filed within the time prescribed in paragraph (e)(3) of this section with respect to which a final determination is issued by the Internal Revenue Service on or before September 28, 1976 the remedial amendment period described in paragraph (d) of this section shall not end prior to the expiration of 150 days beginning on the date of such final determination by the Internal Revenue Service.

(5) *Disqualifying provision prior to September 2, 1974.* If the remedial amendment period with respect to a disqualifying provision described in paragraph (b)(1) of this section began prior to September 2, 1974, and the provisions of paragraphs (e)(5)(i), (ii) and (iii) of this section are satisfied, the remedial amendment period described in paragraph (d) shall not end prior to December 31, 1976. This subparagraph shall apply only if—

(i) A request pursuant to § 601.201 of this chapter for a determination letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan) was filed not later than the later of:

(A) The time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the date on which the remedial amendment period began, or

(B) The date 6 months after the close of such taxable year,

(ii) The employer, either:

(A) While such request for a determination letter is or was under consideration by the Internal Revenue Service or,

(B) Promptly after the date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, adopts or adopted either a plan amendment retroactive to the date on which the remedial amendment period began, or a prospective plan amendment, and

(iii) The amendment described in paragraph (e)(5)(ii) of this section would have resulted in the plan's satisfying the requirements of section 401(a) of the Code from the beginning of the remedial amendment period to the date such amendment was made if this section had been in effect during such period, and in the case of a prospective amendment, if such amendment had been made retroactive to such beginning date.

(f) *Discretionary extensions.* At his discretion, the Commissioner may extend the remedial amendment period or may allow a particular plan to be amended after the expiration of its remedial amendment period and any applicable extension of such period. In determining whether such an extension will be granted, the Commissioner shall consider, among other factors, whether substantial hardship to the employer would result if such an extension were not granted, whether such an extension is in the best interest of plan participants, and whether the granting of the extension is adverse to the interests of the Government. The mere absence of final regulations with respect to issues covered under the Special Reliance Procedure announced by the Internal Revenue Service in Technical Information Release 1416 on November 5, 1975, and as extended by Internal Revenue Service News Release IR–1616 on May 14, 1976, shall not be deemed to satisfy the criteria of this paragraph. With regard to a particular plan, a request for extension of time pursuant to this paragraph shall be submitted prior to the expiration of the remedial amendment period determined without regard to this paragraph, or within such time thereafter as the Internal Revenue Service may consider resonable under the circumstances. The request should be submitted to the appropriate District Director, determined under § 601.201(s)(3)(xii) of this chapter (Statement of Procedural Rules). This subparagraph applies to disqualifying provisions that were adopted or became effective prior to September 2, 1974, as

well as disqualifying provisions adopted or made effective on or after September 2, 1974.

(Secs. 401(b), 7805, Internal Revenue Code of 1954 (88 Stat. 943, 68A Stat. 917; 26 U.S.C. 401(b), 7805))

[T.D. 7437, 41 FR 42653, Sept. 28, 1976, as amended by T.D. 7896, 48 FR 23817, May 27,1983; T.D. 7997, 49 FR 50645, Dec. 31, 1984; T.D. 8217, 53 FR 29662, Aug. 8, 1988; T.D. 8727, 62 FR 41273, 41274, Aug. 1, 1997; T.D. 8871, 65 FR 5433, Feb. 4, 2000]

§ 1.401(e)–1 Definitions relating to plans covering self-employed individuals.

(a) ''*Keogh*'' *or* ''*H.R. 10*'' *plans, in general*—(1) *Introduction and organization of regulations*. Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan. This section contains definitions contained in section 401(c) relating to plans covering self-employed individuals and is applicable to employer taxable years beginning after December 31, 1975, unless otherwise specified.

The provisions of section 401(a) relating to qualification requirements which are generally applicable to all qualified plans, and other provisions relating to the special rules under section 401 (b), (f), (g), (h), and (i), are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements and special rules, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401 (e)–2, (e)–5, and (j)–1 through (j)–5. Section 1.401(e)–2 contains general rules, § 1.401(e)–5 contains a special rule limiting the contribution and benefit base to the first $100,000 of annual compensation, and § 1.401 (j)–1 through (j)–5 contains special rules for defined benefit plans. Section 1.401(e)–3 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of section 401(c)(3). Section 1.401(e)–4 contains rules relating to contributions on behalf of owner-employees for premiums on annuity, etc., contracts and a transitional rule for certain excess contributions made on behalf of owner-employees for employer taxable years beginning before January 1, 1976. The provisions of this section and of §§ 1.401(e)–2 through 1.401(e)–5 are applicable to employer taxable years beginning after December 31, 1975, unless otherwise specified.

(2) [Reserved]

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–2 General rules relating to plans covering self-employed individuals.

(a) ''*Keogh*'' *or* ''*H.R. 10*'' *plans; introduction and organization of regulations*. This section provides certain rules which supplement, and modify, the qualification requirements of section 401(a) and the special rules provided by § 1.401(b)–1 and other special rules under subsections (f), (g), (h), and (i) of section 401 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). Section 1.401(e)–1(a)(1) sets forth other provisions which also supplement, and modify, these requirements and special rules in the case of a plan described in this section. The provisions of this section apply to employer taxable years beginning after December 31, 1975, unless otherwise specified.

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–3 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) ''*Keogh*'' *or* ''*H.R. 10*'' *plans covering owner-employees; introduction and organization of regulations*. This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). These additional requirements are prescribed in section 401(d) and are made applicable to such a trust by section 401(a)(10)(B) and to an annuity plan by section 404(a)(2). However, to the extent that the provisions of §§ 1.401(e)–1 and 1.401(e)–2 are not modified by the provisions of this section such provisions are also applicable to a plan which covers an owner-employee. The provisions

of this section apply to taxable years beginning after December 31, 1975, unless otherwise specified.

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–4 Contributions for premiums on annuity, etc., contracts and transitional rule for certain excess contributions.

(a) *In general.* The provisions of this section prescribe the rules specified in section 401(e) relating to certain contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in section 401(c)(3) and the regulations thereunder) in taxable years of the employer beginning after December 31, 1975. In addition, such plans are also subject to the limitations on contributions and benefits under section 415 for years beginning after December 31, 1975. However, the defined contribution compensation limitation described in section 415(c)(1)(B) will not apply to any contribution described in this section provided that the requirements specified in section 415(c)(7) and § 1.415–6(h) are satisfied. Solely for the purpose of applying section 4972(b) (relating to excise tax on excess contributions for self-employed individuals) to other contributions made by an owner-employee as an employee, the amount of any employer contribution which is not deductible under section 404 for the employer's taxable year but which is described in section 401(e) and this section shall be taken into account as a contribution made by such owner-employee as an employee during the taxable year of his employer in which such contribution is made.

(b) *Contributions described in section 401(e)*—(1) An employer contribution on behalf of an owner-employee is described in section 401(e), if—

(i) Under the provisions of the plan, the contribution is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts on the life of the owner-employee.

(ii) The employer contributions so applied meet the requirements of subparagraphs (2) through (5) of this paragraph.

(iii) The amount of the contribution exceeds the amount deductible under section 404 with respect to contributions made by the employer on behalf of the owner-employee under the plan, and

(iv) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $7,500. For purposes of computing such $7,500 limit, the total employer contributions include amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2)(i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-employee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. For example, a nontransferable face-amount certificate described in

section 401(g) and the regulations thereunder is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4)(i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the amounts deductible under section 404 by such employer on behalf of such owner-employee for the most recent three taxable years of the employer which are described in the succeeding sentence. The three employer taxable years described in the preceding sentence must be years, ending prior to the date the latest contract was entered into or modified to provide additional, benefits, in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the ''average of the amounts deductible'', only so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account.

(iii) For purposes of making the computations described in subdivisions (i) and (ii) of this subparagraph for any taxable year of the employer the average of the amounts deductible under section 404 by the employer on behalf of an owner-employee for the most recent three relevant taxable years of the employer shall be determined as if section 404, as in effect for the taxable year for which the computation is to be made, had been in effect for all three such years.

(5) For any taxable year of an employer in which contributions are made on behalf of an individual as an owner-employee under more than one plan, the amount of contributions described in this section by the employer on behalf of such an owner-employee under all such plans must not exceed $7,500.

(c) *Transitional rule for excess contributions*—(1)(i) The rules of this paragraph are inapplicable to a plan which was not in existence for any taxable year of an employer which begins before January 1, 1976. For taxable years of an employer which begin before January 1, 1976, the rules with respect to excess contributions on behalf of owner-employees set forth in section 401(d) (5) and (8) and in section 401(e), as these sections were in effect on September 1, 1974, prior to their amendment by section 2001(e) of the Employee Retirement Income Security Act of 1974 (hereinafter in this paragraph referred to as the ''Act'') (88 Stat. 954), shall apply except as provided by subparagraph (2) of this paragraph. Section 1.401–13 generally provides the rules for excess contributions on behalf of owner-employees set forth in these sections.

(ii) Notwithstanding the provisions of subdivision (i) of this subparagraph, the rules set forth in such subsections (d) (5) and (8) and (e) of section 401 with respect to excess contributions for such taxable years beginning before January 1, 1976, apply even though the application of those rules affects a subsequent taxable year. Thus, for example, if, in 1975, a nonwillful excess contribution described in section 401(e)(1) (prior to such amendment) is made on behalf of an owner-employee, the plan will not be qualified unless the provisions required by subparagraphs (A) and (B) of such 401(d)(8) are contained in the plan and made applicable to excess contributions made for such taxable years beginning before January 1, 1976. In such case, the effect of such contribution on the plan, the employer, and the owner-employee would be determined under paragraph (2) of section 401(e), as in effect on September 1, 1974. By reason of section 401(e)(2)(F), as in effect

on September 1, 1974, the period for assessing any deficiency by reason of the excess contribution will not expire until the expiration of the 6-month period described in section 401(e)(2)(C), as in effect on September 1, 1974, even if the first day of such 6-month period falls in a taxable year beginning after December 31, 1975. For the rules applicable to a willful excess contribution, which generally divide an owner-employee's interest in a plan into two parts on the basis of employer taxable years beginning before and after December 31, 1975, see §1.72–17A(e)(2)(v). In the case of a willful excess contribution, the rule specified in section 401(e)(2)(E)(iii), as in effect on September 1, 1974, shall not apply to any taxable year of an employer beginning on or after January 1, 1976. Thus, for example, if a willful excess contribution was made to a plan on behalf of an owner-employee with respect to his employer's taxable year beginning January 1, 1975, the plan would not meet, for purposes of section 404, the requirements of section 401(d) with respect to that owner-employee for such year, but the 5 taxable years following such year would be unaffected because those years begin on or after January 1, 1976.

(2)(i) For purposes of applying the excess contribution rules with respect to the employer taxable years specified in subparagraph (1) of this paragraph for such an employer taxable year which begins after December 31, 1973, see section 404(e) and §1.404(e)–1A for rules increasing the limitation on the amount of allowable employer deductions on behalf of owner-employees under section 404. For purposes of applying subparagraphs (A) and (B)(i) of section 401(e)(1) prior to the amendment made by section 2001(e)(3) of the Act (88 Stat. 954), the employer deduction allowable by section 404(e)(4) with respect to an owner-employee in a defined contribution plan shall be deemed not to be an excess contribution (see §1.404(e)–1A(c)(4)).

(ii) For purposes of applying the excess contribution rules with respect to the employer taxable years specified in subparagraph (1) of this paragraph to an employer's plan which was not in existence on January 1, 1974, or to a plan in existence on January 1, 1974, which elects under section 1017(d) of the Act (88 Stat. 934), in accordance with regulations, to have the funding provisions of section 412 apply to such an existing plan, see section 404 (a) (1), (a)(6), and (a)(7), as amended by section 1013(c)(1), (2), and (3) of the Act (88 Stat. 922 and 923) for rules modifying the amount of employer deductions on behalf of owner-employees.

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§1.401(e)–5 Limitation of contribution and benefit bases to first $100,000 of annual compensation in case of plans covering self-employed individuals.

(a) *General rules—General rule.* (1) Under section 401(a)(17), a plan maintained by an employer which provided contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) is a qualified plan only if the annual compensation of each employee taken into account under the plan does not exceed the first $100,000 of such compensation. For purposes of applying section 401(a)(17) and the preceding sentence, all plans maintained by such an employer with respect to the same trade or business shall be treated as a single plan. See also sections 401(d)(9) and (10) (relating to controlled trades or businesses where a plan covers an owner-employee who controls more than one trade or business); section 404(e) (relating to special limitations for self-employed individuals); section 413(b)(7) (relating to determination of limitations provided by section 404(a) in the case of certain plans maintained pursuant to a collective bargaining agreement); and section 413(c)(6) (relating to determination of limitations provided by section 404(a) in the case of certain plans maintained by more than one employer).

(2) *Special section 414(b), (c) rule.* This subparagraph (2) applies to plans maintained by employers that are trades or businesses (whether or not incorporated) that are under common control within the meaning of section 414(c). All such plans that are described in paragraph (a)(1) and §1.401(e)–6(a) (so called ''Subchapter S plans'') shall be treated as a single plan in applying the limitation of paragraph (a)(1).

(b) *Integrated plans.* (1) In the case of a qualified plan, other than a plan described in section 414(j), which is integrated with the Social Security Act (chapter 21 of the Code), or with contributions or benefits under chapter 2 of the Code (relating to tax on self-employment income) or under any other Federal of State law, the $100,000 limitation described in subparagraph (a) shall be determined without regard to any adjustments to contributions or benefits under the plan on account of such integration. See also subsections (a)(5), (a)(15), and (d)(6) of section 401 and the regulations thereunder for other rules with respect to plans which are integrated.

(2) In the case of a qualified defined benefit plan described in section 414(j), see section 401(j)(4) for a special prohibition against integration.

(c) *Application of nondiscrimination requirement.* (1) This paragraph shall apply—

(i) In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) and

(ii) For a year in which the compensation of any employee covered by the plan exceeds $100,000. In the case of an employee who is an employee within the meaning of section 401(c)(1), compensation includes earned income within the meaning of section 401(c)(2).

(2) In applying section 401(a)(4) under the circumstances described in subparagraph (1) of this paragraph, the determination whether the rate of contributions or benefits under the plan discriminates in favor of highly compensated employees shall be made as if the compensation for the year of each employee described in the first sentence of subparagraph (1)(ii) of this paragraph were $100,000, rather than the compensation actually received by him for such year.

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). A, a self-employed individual, has established the P Profit-Sharing Plan, which covers A and his two commonlaw employees, B and C. A's taxable year and the plan's plan year are both the calendar year. For 1976, A has earned income of $150,000, and B and C each receive compensation of less than $100,000 from A. If he wishes to contribute $7,500 to the plan on his behalf for 1976, A must also contribute to the accounts of B and C under the plan amounts at least equal to 7½ percent of their respective compensation for 1976.

Example (2). D, an owner-employee within the meaning of section 401(c)(3), is a participant in the Q Qualified Defined Contribution Plan, which, in 1975, satisfies the requirements of section 401(d)(6) and all other integration requirements applicable to qualified defined contribution plans. The taxable years of D, the employer of D within the meaning of section 401(c)(4), and the plan are all calendar years. The plan provides for an integration level of $13,200 and a contribution rate of 5 percent of compensation in excess of $13,200. For 1975, D has earned income of $115,000. The maximum amount of earned income upon which D's contribution can be determined is $86,800, and the contribution based upon this maximum amount of earned income is $4,340, computed as follows:

Maximum annual compensation which may be taken into account	$100,000
Less: Social Security Act integration level	13,200
Plan contribution base	$86,800
Multiplied by: Contribution rate (percent)	5
Total	$4,340

(e) *Years to which section applies.* This section applies to taxable years of an employer beginning after December 31, 1975. However, if employer contributions made under a plan for any employee for taxable years of an employer beginning after December 31, 1973, exceed the amounts permitted to be deducted for that employee under section 404(e), as in effect on September 1, 1974, this section applies to such taxable years of an employer.

Thus, for example, a plan of a calendar year employer which was adopted on January 1, 1974, would be subject to this section in 1974, if the employer made a contribution on behalf of any employee within the meaning of section 401(c)(1) for such year in excess of the $2,500 or 10 percent earned income limit, whichever is applicable to that employee, specified in section 404(e)(1) as in effect prior to the amendment to such Code section made by section 2001(a)(1)(A) of the Employee Retirement Income Security Act of 1974 (88 Stat. 952). The plan described in the proceeding sentence would also be subject to this section in 1974, if the employer made a contribution on behalf of

any employee within the meaning of section 401(c)(1) which is allowable as a deduction only because of the addition of paragraph (4) to Code section 404(e) made by section 2001(a)(3) of such Act (88 Stat. 952).

(b) [Reserved]

[T.D. 7636, 44 FR 47055, Aug. 10, 1979; T.D. 7636, 60 FR 21435, May 2, 1995]

§ 1.401(e)–6 Special rules for shareholder-employees.

(a) *Limitation of contributions and benefit bases to first $100,000 of annual compensation in case of plans covering shareholder-employees.* (1) Under section 401(a)(17), a plan which provides contributions or benefits for employees, some or all of whom are shareholder-employees within the meaning of section 1379(d), is subject to the same limitation on annual compensation as a plan which provides such contributions or benefits for employees some or all of whom are self-employed individuals within the meaning of section 401(c)(1). Thus, a plan which provides contributions or benefits for such shareholder-employees is subject to the rules provided by § 1.401(e)–5, unless otherwise specified. See also section 1379. In the case of plans maintained by employers that are corporations described in section 414(b) and that are described in this subparagraph (1), the same rule described in § 1.401(e)–5(a)(2) shall apply.

(2) Subparagraph (1) applies to taxable years of an electing small business corporation beginning after December 31, 1975. However, if corporate contributions made under a plan on behalf of any shareholder-employee for corporate taxable years beginning after December 31, 1973, exceed the lesser of the amount of contributions specified in section 1379(b)(1) (A) or (B), as in effect on September 1, 1974, for that shareholder-employee, subparagraph (1) applies to such corporate taxable years. Thus, for example if an electing small business corporation whose taxable year is the calendar year adopted a plan on January 1, 1974, the plan would be subject to the provisions of subparagraph (1) of this section in 1974, if the corporation made a contribution in excess of $2,500 on behalf of any shareholder-employee for such year.

(b) [Reserved]

[T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.401(f)–1 Certain custodial accounts and annuity contracts.

(a) *Treatment of a custodial account or an annuity contract as a qualified trust.* Beginning on January 1, 1974, a custodial account or an annuity contract may be used, in lieu of a trust, under any qualified pension, profitsharing, or stock bonus plan if the requirements of paragraph (b) of this section are met. A custodial account or an annuity contract may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account or annuity contract as part of a plan does not preclude the use of a trust or another custodial account or another annuity contract as part of the same plan. A plan under which a custodial account or an annuity contract is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied. For regulations relating to the period before January 1, 1974, see § 1.401–8.

(b) *Rules applicable to custodial accounts and annuity contracts.* (1) Beginning on January 1, 1974, a custodial account or an annuity contract is treated as a qualified trust under section 401 if the following requirements are met:

(i) The custodial account or annuity contract would, except for that fact that it is not a trust, constitute a qualified trust under section 401; and

(ii) In the case of a custodial account, the custodian either is a bank or is another person who demonstrates, to the satisfaction of the Commissioner, that the manner in which he will hold the assets will be consistent with the requirements of section 401. This demonstration must be made in the same manner as the demonstration required by § 1.408–2(e).

(2) If a custodial account would, except for the fact that it is not a trust, constitute a qualified trust under section 401, it must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms

of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan. For any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries as provided for in the plan (see paragraph (a) of § 1.401–2).

(3) An annuity contract would, except for the fact that it is not a trust, constitute a qualified trust under section 401 if it is purchased by an employer for an employee under a plan which meets the requirements of section 404(a)(2) and the regulations thereunder, except that the plan may be either a pension or a profit-sharing plan.

(c) *Effect of this section.* (1)(i) Any custodial account or annuity contract which satisfies the requirements of paragraph (b) of this section is treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Such a custodial account or annuity contract is treated as a separate legal person which is exempt from the income tax under section 501(a). In addition, the person holding the assets of such account or holding such contract is treated as the trustee thereof. Accordingly, such person is required to file the returns described in sections 6033 and 6047 and to supply any other information which the trustee of a qualified trust is required to furnish.

(ii) Any procedure which has the effect of merely substituting one custodian for another shall not be considered as terminating or interrupting the legal existence of a custodial account which otherwise satisfies the requirements of paragraph (b) of this section.

(2)(i) The beneficiary of a custodial account which satisfies the requirements of paragraph (b) of this section is taxed in accordance with section 402. In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(ii) If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available within the meaning of section 402(a)(1) to the employees for whom they are held.

(3) The beneficiary of an annuity contract which satisfies the requirements of paragraph (b) of this section is taxed as if he were the beneficiary of an annuity contract described in section 403(a).

(d) *Definitions.* For purposes of this section—

(1) The term *bank* means a bank as defined in section 408(n).

(2) The term *annuity* means an annuity as defined in section 401(g). Thus, any contract or certificate issued after December 31, 1962, which is transferable is not treated as a qualified trust under this section.

(e) *Other contracts.* For purposes of this section, other than the non-transferability restriction of paragraph (d)(2), a contract issued by an insurance company qualified to do business in a state shall be treated as an annuity contract. For purposes of the preceding sentence, the contract does not include a life, health or accident, property, casualty or liability insurance contract. For purposes of this paragraph, a contract which is issued by an insurance company will not be considered a life insurance contract merely because the contract provides incidental life insurance protection. The provisions of this paragraph are effective for taxable years beginning after December 31, 1975.

(f) *Cross reference.* For the requirement that the assets of an employee benefit plan be placed in trust, and exceptions thereto, see section 403 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1103, and the regulations prescribed thereunder by the Secretary of Labor.

(Secs. 401(f)(2), 7805, Internal Revenue Code of 1954 (88 Stat. 939 and 68A Stat. 917; 26 U.S.C. 401(f)(2), 7805))

[43 FR 41204, Sept. 15, 1978. Redesignated and amended by T.D. 7748, 46 FR 1695–1696, Jan. 7, 1981; T.D. 8635, 60 FR 65549, Dec. 20, 1995]

§ 1.401(k)–0 Certain cash or deferred arrangements, table of contents.

This section contains the captions that appear in § 1.401(k)–1.

§ 1.401(k)–1 Certain cash or deferred arrangements.

(a) General rules.
(1) Certain plans permitted to include cash or deferred arrangements.
(2) Rules applicable to cash or deferred arrangements generally.
(i) Definition of cash or deferred arrangement.
(ii) Treatment of after-tax employee contributions.
(iii) Treatment of elective contributions as plan assets.
(3) Rules applicable to cash or deferred elections generally.
(i) Definition of cash or deferred election.
(ii) Requirement that amounts not be currently available.
(iii) Amounts currently available.
(iv) Certain one-time elections not treated as cash or deferred elections.
(v) Tax treatment of employees.
(vi) Examples.
(4) Rules applicable to qualified cash or deferred arrangements.
(i) Definition of qualified cash or deferred arrangement.
(ii) Treatment of elective contributions as employer contributions.
(iii) Tax treatment of employees.
(iv) Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement.
(5) Rules applicable to nonqualified cash or deferred arrangements.
(i) Definition of nonqualified cash or deferred arrangement.
(ii) Treatment of elective contributions as employer contributions.
(iii) Tax treatment of employees.
(iv) Qualification of plan that includes a nonqualified cash or deferred arrangement.
(6) Rules applicable to partnership cash or deferred arrangements.
(i) Application of general rules.
(ii) Definition of partnership cash or deferred arrangement.
(A) General rule.
(B) Timing of partner's cash or deferred election.
(C) Transition rule for partnership cash or deferred elections.
(iii) Treatment of certain matching contributions as elective contributions.
(7) Rules applicable to collectively bargained plans.
(i) In general.
(ii) Example
(b) Coverage and nondiscrimination requirements.
(1) In general.
(2) Actual deferral percentage test.
(i) General rule.
(ii) Rule for plan years beginning after 1979 and before 1987.
(iii) Plan provision requirement.
(3) Aggregation.
(i) Aggregation of arrangements and plans.
(ii) Restructuring and Permissive Aggregation.
(4) Elective contributions taken into account under the actual deferral percentage test.
(i) General rule.
(ii) Elective contributions and qualified nonelective contributions used to satisfy actual contribution percentage test.
(iii) Elective contributions for partners.
(iv) Elective contributions not taken into account.
(5) Qualified nonelective contributions and qualified matching contributions that may be taken into account under the actual deferral percentage test.
(6) Examples.
(c) Nonforfeitability requirement.
(1) General rule.
(2) Example.
(d) Distribution limitation.
(1) General rule.
(2) Rules applicable to hardship distributions.
(i) Distribution must be on account of hardship.
(ii) Limit on distributable amount.
(iii) General hardship distribution standards.
(A) Immediate and heavy financial need.
(B) Distribution necessary to satisfy financial need.
(iv) Deemed hardship distribution standards.
(A) Deemed immediate and heavy financial need.
(B) Distribution deemed necessary to satisfy financial need.
(C) Commissioner may expand standards.
(3) Rules applicable to distributions upon plan termination.
(4) Rules applicable to distributions upon sale of assets or subsidiary.
(i) Seller must maintain the plan.
(ii) Employee must continue employment.
(iii) Distribution must be in connection with disposition of assets or subsidiary.
(iv) Definitions.
(A) Substantially all.
(B) Unrelated employer.
(5) Lump sum requirement for certain distributions.
(6) Rules applicable to all distributions.
(i) Impermissible distributions.
(ii) Deemed distributions.
(iii) ESOP dividend distributions.
(iv) Limitations apply after transfer.
(v) Required consent.
(7) Examples.

(e) Additional requirements for qualified cash or deferred arrangements.
(1) Qualified profit-sharinq, stock bonus, pre-ERISA money purchase or rural cooperative plan requirement.
(2) Cash availability requirement.
(3) Separate accounting requirement.
(i) General rule.
(ii) Failure to satisfy separate accounting requirement.
(4) Limitations on cash or deferred arrangements of state and local governments and tax-exempt organizations.
(5) One-year eligibility requirement.
(6) Other benefits not contingent upon elective contributions.
(i) General rule.
(ii) Definition of other benefits.
(iii) Effect of certain statutory limits.
(iv) Nonqualified deferred compensation.
(v) Plan loans and distributions.
(vi) Examples.
(7) Coordination with other plans.
(8) Recordkeeping requirements.
(9) Consistent application of separate lines of business rules.
(f) Correction of excess contributions.
(1) General rule.
(i) Permissible correction methods.
(ii) Combination of correction methods.
(iii) Impermissible correction methods.
(iv) Partial distributions.
(2) Amount of excess contributions.
(3) Recharacterization of excess contributions.
(i) General rule.
(ii) Treatment of recharacterized excess contributions.
(iii) Additional rules.
(A) Time of recharacterization.
(B) Employee contributions must be permitted under plan.
(C) Plans under which excess contributions may be recharacterized.
(iv) Transition rules.
(v) Example.
(4) Corrective distribution of excess contributions (and income).
(i) General rule.
(ii) Income allocable to excess contributions.
(A) General rule.
(B) Method of allocating income.
(C) Alternative method of allocating income.
(D) Safe harbor method of allocating gap period income.
(iii) No employee or spousal consent required.
(iv) Treatment of corrective distributions as employer contributions.
(v) Tax treatment of corrective distributions.
(A) General rule.
(B) Rule for de minimis distributions.
(C) Rule for certain 1987 and 1988 excess contributions.
(vi) No reduction of required minimum distribution.
(5) Rules applicable to all corrections.
(i) Coordination with distribution of excess deferrals.
(A) In general.
(B) Treatment of excess contributions that reduce excess deferrals.
(ii) Correction of family members.
(iii) Matching contributions forfeited because of excess deferral or contribution.
(6) Failure to correct.
(i) Failure to correct within 2½ months after end of plan year.
(ii) Failure to correct within 12 months after end of plan year.
(7) Examples.
(g) Definitions.
(1) Actual deferral percentage.
(i) General rule.
(ii) Actual deferral ratio.
(A) General rule.
(B) Employee eligible under more than one arrangement.
(*1*) Highly compensated employees.
(*2*) Nonhighly compensated employees.
(*3*) Treatment of plans with different plan years.
(C) Employees subject to family aggregation rules.
(*1*) Aggregation of elective contributions and other amounts.
(*2*) Effect on actual deferral percentage of nonhighly compensated employees.
(*3*) Multiple family groups.
(2) Compensation.
(i) Years beginning after December 31, 1986.
(ii) Years beginning before January 1, 1987.
(A) General rule.
(B) Nondiscrimination requirement.
(3) Elective contributions.
(4) Eligible employee.
(i) General rule.
(ii) Certain one-time elections.
(5) Employee.
(6) Employer.
(7) Excess contributions and excess deferrals.
(i) Excess contributions.
(ii) Excess deferrals.
(8) Highly compensated employees.
(i) Plan years beginning after December 31, 1986.
(ii) Plan years beginning after December 31, 1979 and before January 1, 1987.
(9) Matching contributions.
(10) Nonelective contributions.
(11) Plan.
(i) Application of section 410(b) rules.
(ii) Modifications to section 410(b) rules.
(A) In general.
(B) Plans benefiting collective bargaining unit employees.
(C) Multiemployer plans.
(12) Pre-ERISA money purchase pension plan.

(13) Qualified matching contributions and qualified nonelective contributions.
(i) Qualified matching contributions.
(ii) Qualified nonelective contributions.
(iii) Additional requirements.
(14) Rural cooperative plan.
(15) Section 401(k) plan.
(16) Section 401(m) plan.
(h) Effective dates.
(1) General rule.
(2) Collectively bargained plans.
(3) Transition rules.
(i) Cash or deferred arrangements in existence on June 27, 1974.
(ii) Plan years beginning after December 31, 1979, and before January 1, 1992.
(iii) Restructuring.
(A) General rule.
(B) Identification of component plans.
(*1*) Minimum coverage requirement.
(*2*) Commonality requirement.
(4) State and local government plans.
(i) Plans adopted before May 6, 1986.
(ii) Plan years beginning before January 1, 1996.
(iii) Collectively bargained plans.

[T.D. 8357, 56 FR 40516, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63431, Dec. 4, 1991; T.D. 8581, 59 FR 66169, Dec. 23, 1994]

§ 1.401(k)–1 Certain cash or deferred arrangements.

(a) *General rules*—(1) *Certain plans permitted to include cash or deferred arrangements.* A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

(2) *Rules applicable to cash or deferred arrangements generally*—(i) *Definition of cash or deferred arrangement.* Except as provided in paragraph (a)(2)(ii) of this section, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a)).

(ii) *Treatment of after-tax employee contributions.* A cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions (e.g., by reporting the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). This is the case even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(iii) *Treatment of elective contributions as plan assets.* The extent to which elective contributions under a cash or deferred arrangement constitute plan assets for purposes of the prohibited transaction provisions of section 4975 of the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 is determined in accordance with regulations and rulings issued by the Department of Labor.

(3) *Rules applicable to cash or deferred elections generally*—(i) *Definition of cash or deferred election.* A cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either—

(A) Provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or

(B) Contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

(ii) *Requirement that amounts not be currently available.* A cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date

of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

(iii) *Amounts currently available.* Cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(iv) *Certain one-time elections not treated as cash or deferred elections.* A cash or deferred election does not include a one-time irrevocable election upon an employee's commencement of employment with the employer or upon the employee's first becoming eligible under any plan of the employer, to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and to any other plan of the employer (including plans not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under such plans. Thus, for example, employer contributions pursuant to a one-time irrevocable election described in this paragraph are not treated as having been made pursuant to a cash or deferred election and are not includible in an employee's gross income by reason of § 1.402(a)–1(d). In no event is an election made after December 23, 1994 treated as one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer. See paragraph (a)(6)(ii)(C) of this section for an additional one-time election permitted under a cash or deferred arrangement in which partners may participate.

(v) *Tax treatment of employees.* An amount generally is includible in an employee's gross income for the taxable year in which the employee actually or constructively receives the amount. But for section 402(e)(3) and section 401(k), an employee is treated as having received an amount that is contributed to a plan pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which the amount is earned, or before the amount is currently available. See § 1.402(a)–1(d).

(vi) *Examples.* The provisions of this paragraph (a)(3) are illustrated by the following examples:

Example 1. An employer maintains a profit-sharing plan under which each eligible employee has an election to defer an annual bonus payable on January 30 each year. The bonus equals 10 percent of compensation during the previous calendar year. Deferred amounts are not treated as after-tax employee contributions. The bonus is currently available on January 30. An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election, and the bonus deferral arrangement is a cash or deferred arrangement.

Example 2. An employer maintains a profit-sharing plan under which each eligible employee may elect to defer up to 10 percent of compensation for each payroll period during the plan year. An election to defer compensation for a payroll period is a cash or deferred election if the election is made prior to the date on which the compensation is to be paid to the employee and if the deferred amount is not treated as an after-tax employee contribution at the time of deferral.

Example 3. (i) Employer A establishes a qualified money purchase pension plan in 1986. This is the first qualified plan established by Employer A. All salaried employees are eligible to participate under the plan. Hourly-paid employees are not eligible to participate under the plan. In 1996, Employer A establishes a profit-sharing plan under which all employees (both salaried and hourly) are eligible. Employer A permits all employees on the effective date of the profit-

sharing plan to make a one-time irrevocable election to have Employer A contribute five percent of compensation on their behalf to the plan and to any other plan of Employer A (including plans not yet established) for the duration of the employee's employment with Employer A, and have their salaries reduced by five percent.

(ii) The election provided under the profit-sharing plan is not a one-time irrevocable election within the meaning of §1.401(k)–1(a)(3)(iv) with respect to the salaried employees of Employer A who, at any time before becoming eligible to participate under the profit-sharing plan, became eligible to participate under the money purchase pension plan. The election under the profit-sharing plan is a one-time irrevocable election within the meaning of §1.401(k)– 1(a)(3)(iv) with respect to the hourly employees, because they were not previously eligible to participate under another plan of the employer.

(4) *Rules applicable to qualified cash or deferred arrangements*—(i) *Definition of qualified cash or deferred arrangement.* A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section and that is part of a plan that otherwise satisfies the requirements of section 401(a).

(ii) *Treatment of elective contributions as employer contributions.* Except as provided in paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are treated as employer contributions. Thus, for example, elective contributions are treated as employer contributions for purposes of sections 401(a) and 401(k), 402, 404, 409, 411, 412, 415, 416, and 417.

(iii) *Tax treatment of employees.* Except as provided in section 402(g) and paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash or other taxable amounts would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan. See §1.402(a)–1(d)(2)(i).

(iv) *Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement.* A plan that includes a qualified cash or deferred arrangement must satisfy the requirements of sections 401(a)(4) and 410(b). Thus, for example, the plan must satisfy section 401(a)(4) with respect to the amount of contributions or benefits and the availability of benefits, rights and features under the plan. See §1.401(a)(4)–1(b)(3). The right to make each level of elective contributions under a cash or deferred arrangement is a benefit, right or feature subject to this requirement, and each of these rights must therefore generally be available to a group of employees that satisfies section 410(b). See §1.401(a)(4)–4(e)(3)(i) and (iii)(D). Thus, for example, if all employees are eligible to make a stated level of elective contributions under a cash or deferred arrangement, but that level of contributions can only be made from compensation in excess of a stated amount, such as the Social Security taxable wage base, the arrangement will generally favor highly compensated employees with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4). For plan years beginning after December 31, 1984, the amount of elective contributions under a qualified cash or deferred arrangement satisfies the requirements of section 401(a)(4) only if the amount of elective contributions satisfies the special nondiscrimination test of section 401(k)(3) and paragraph (b)(2) of this section. See §1.401(a)(4)–1(b)(2)(ii)(B). See also §1.401(a)(4)– 11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(5) *Rules applicable to nonqualified cash or deferred arrangements*—(i) *Definition of nonqualified cash or deferred arrangement.* A nonqualified cash or deferred arrangement is a cash or deferred arrangement that is not a qualified cash or deferred arrangement. Thus, if a cash or deferred arrangement fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section, the arrangement is a nonqualified cash or deferred arrangement.

(ii) *Treatment of elective contributions as employer contributions.* Except as specifically provided otherwise, elective contributions under a nonqualified

cash or deferred arrangement are treated as nonelective employer contributions. Thus, for example, the elective contributions are treated as nonelective employer contributions for purposes of sections 401(a) (including section 401(a)(4)) and 401(k), 404, 409, 411, 412, 415, 416, and 417 and are not subject to the requirements of section 401(m).

(iii) *Tax treatment of employees.* Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the cash or other taxable amount that the employee would have received (but for the cash or deferred election) would have been includible in the employee's gross income. See §1.402(a)–1(d)(1).

(iv) *Qualification of plan that includes a nonqualified cash or deferred arrangement.* A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a nonqualified cash or deferred arrangement. In determining whether the plan satisfies the requirements of section 401(a)(4), the special nondiscrimination tests of sections 401(k)(3) and 401(m)(2) may not be used. See §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–9 (definition of section 401(k) plan).

(6) *Rules applicable to partnership cash or deferred arrangements*—(i) *Application of general rules.* A partnership may maintain a cash or deferred arrangement, and individual partners may make cash or deferred elections with respect to compensation attributable to services rendered to the partnership. Generally, the same rules apply to partnership cash or deferred arrangements as apply to other cash or deferred arrangements. Thus, a partnership cash or deferred arrangement is not a qualified cash or deferred arrangement unless the requirements of section 401(k) and this section are satisfied. For example, any contributions made on behalf of an individual partner pursuant to a partnership cash or deferred arrangement are elective contributions unless they are designated or treated as after-tax employee contributions. Consistent with §1.402(a)–1(d), the elective contributions are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement. Also, even if the arrangement is a qualified cash or deferred arrangement, the elective contributions are includible in gross income and are not deductible under section 404(a) to the extent they exceed the applicable limit under section 402(g). See also §1.401(a)–30.

(ii) *Definition of partnership cash or deferred arrangement*—(A) *General rule.* Effective for contributions made for plan years beginning after December 31, 1988, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

(B) *Timing of partner's cash or deferred election.* For purposes of paragraph (a)(3)(ii) of this section, 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. A partner's compensation for a partnership taxable year ending with or within a plan year beginning before January 1, 1992, is, however, deemed not to be currently available until the due date, including extensions, for filing the partnership's federal income tax return for its taxable year ending with or within the plan year. See §1.401(k)–1(b)(4)(iii) for the rules regarding when contributions are treated as allocated.

(C) *Transition rule for partnership cash or deferred elections.* A one-time irrevocable election to participate or not to participate in a plan in which partners may participate is not a cash or deferred election if the election was made on or before the later of the first day of the first plan year beginning after December 31, 1988, or March 31, 1989. This election may be made after the commencement of employment or after the employee's first becoming eligible under any plan of the employer. In no event, however, may the election be made after December 23, 1994. The election may be made even if the one-time

irrevocable election in §1.401(k)–1(a)(3)(iv) was previously made.

(iii) *Treatment of certain matching contributions as elective contributions.* If a partnership makes matching contributions with respect to an individual partner's elective contributions or employee contributions, then the matching contributions are treated as elective contributions made on behalf of the partner. In the case of a plan that, on August 8, 1988, did not treat matching contributions as elective contributions, the preceding sentence applies only to plan years beginning after August 8, 1988. See also §§1.401(m)–1(f)(12) and 1.404(e)–1A(f).

(7) *Rules applicable to collectively bargained plans*—(i) *In general.* The amount of employer contributions under a nonqualified cash or deferred arrangement is treated as satisfying section 401(a)(4) if the arrangement is part of a collectively bargained plan (including a plan adopted by a state or local government before May 6, 1986) that automatically satisfies the requirements of section 410(b). See §§1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7). Except as specifically provided otherwise, elective contributions under the arrangement are treated as employer contributions. See §1.401(k)–1(a)(5)(ii). However, elective contributions under the nonqualified cash or deferred arrangement are treated as employee contributions for purposes of section 402(a) for plan years beginning after December 31, 1992, and are therefore not excludable from gross income under section 402(e)(3). See §1.402(a)–1(d)(3)(iv).

(ii) *Example.* The provisions of this paragraph (a)(7) are illustrated by the following example:

Example. For the 1994 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement not satisfy the actual deferral percentage test of section 401(k)(3) and paragraph (b) of this section. Therefore, the arrangement is a nonqualified cash or deferred arrangement. The employer contributions under the cash or deferred arrangement are considered to be nondiscriminatory under section 401(a)(4), and the elective contributions are generally treated as employer contributions. Under §1.402(a)–1(d)(1), however, elective contributions are includible in an employee's gross income.

(b) *Coverage and nondiscrimination requirements*—(1) *In general.* A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(i) The group of eligible employees under the section 401(k) plan and the group of employees benefiting under the plan to which the nonelective employer contributions are made separately satisfy the requirements of section 410(b) (including the average benefit percentage test, if applicable). For special rules governing the application of section 410(b) to a cash or deferred arrangement, see §§1.410(b)–7(c)(1) and 1.410(b)–8(a)(1). See also §1.401(a)(4)–11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(ii) The cash or deferred arrangement satisfies the actual deferral percentage test described in paragraph (b)(2) of this section. This is the exclusive nondiscrimination test applicable to the amount of elective contributions under a qualified cash or deferred arrangement. See §1.401(a)(4)–1(b)(2)(ii)(B).

(2) *Actual deferral percentage test*—(i) *General rule.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(A) The actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by 1.25; or

(B) The excess of the actual deferral percentage for the group of eligible highly compensated employees over the actual deferral percentage for the group of all other eligible employees is not more than two percentage points, and the actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by two.

An arrangement does not fail to satisfy the requirements of this paragraph (b)(2) merely because all of the eligible employees under an arrangement for a year are highly compensated employees.

(ii) *Rule for plan years beginning after 1979 and before 1987.* For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(A) The actual deferral percentage for the group of eligible highly compensated employees (top one-third) is not more than the actual deferral percentage for the group of all other eligible employees (lower two-thirds) multiplied by 1.5; or

(B) The excess of the actual deferral percentage for the top one-third over the actual deferral percentage for the lower two-thirds is not more than three percentage points, and the actual deferral percentage for the top one-third is not more than the actual deferral percentage for the lower two-thirds multiplied by 2.5.

(iii) *Plan provision requirement.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a plan that includes a cash or deferred arrangement does not satisfy the requirements of section 401(a) unless it provides that the actual deferral percentage test of section 401(k)(3) will be met. For purposes of this paragraph (b)(2)(iii), the plan may incorporate by reference the provisions of section 401(k)(3), this paragraph (b), and if applicable, section 401(m)(9) and §1.401(m)–2.

(3) *Aggregation*—(i) *Aggregation of arrangements and plans.* Except as otherwise specifically provided in this paragraph (b)(3), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, the two cash or deferred arrangements are treated as a single cash or deferred arrangement, even if they have significantly different features, such as significantly different limits on elective contributions. See §1.401(k)–1(g)(11) for the definition of plan used for purposes of this section. That definition contains the exclusive rules for aggregation and disaggregation of plans for purposes of this section. See also paragraph (g)(1)(ii) of this section for rules requiring the aggregation of elective contributions under two or more plans in computing the actual deferral ratios of certain employees.

(ii) *Restructuring and Permissive Aggregation.* Effective for plan years beginning after December 31, 1991, restructuring under §1.401(a)(4)–9(c) may not be used to demonstrate compliance with the requirements of section 401(k). See §1.401(a)(4)–9(c)(3)(ii). For plan years beginning before January 1, 1992, see §1.401(k)– 1(h)(3)(iii). An employer may, however, treat a plan benefiting otherwise excludable employees as two separate plans for purposes of sections 401(k) and 410(b) in accordance with §§1.410(b)–6(b)(3) and 1.410(b)–7(c)(3).

(4) *Elective contributions taken into account under the actual deferral percentage test*—(i) *General rule.* An elective contribution is taken into account under paragraph (b)(2) of this section for a plan year only if each of the following requirements is satisfied:

(A) The elective contribution is allocated to the employee's account under the plan as of a date within that plan year. For purposes of this rule, an elective contribution is considered allocated as of a date within a plan year only if—

(*1*) The allocation is not contingent upon the employee's participation in the plan or performance of services on any date subsequent to that date, and

(*2*) The elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the plan year to which the contribution relates.

(B) The elective contribution relates to compensation that either—

(*1*) Would have been received by the employee in the plan year but for the employee's election to defer under the arrangement, or

(*2*) Is attributable to services performed by the employee in the plan year and, but for the employee's election to defer, would have been received by the employee within two and one-half months after the close of the plan year.

(ii) *Elective contributions and qualified nonelective contributions used to satisfy*

actual contribution percentage test. Except as provided in §1.401(m)–1(b)(5)(iii), elective contributions treated as matching contributions must satisfy the actual contribution percentage test of section 401(m)(2) and are not taken into account under paragraph (b)(2) of this section. A qualified nonelective contribution that is treated as a matching contribution is subject to the actual contribution percentage test of section 401(m)(2) and is not taken into account as an elective contribution under paragraph (b)(2) or (5) of this section.

(iii) *Elective contributions for partners.* For purposes of paragraph (b)(2) of this section, a partner's distributive share of partnership income is treated as received on the last day of the partnership taxable year. Thus, an elective contribution made on behalf of a partner is treated as allocated to the partner's account for the plan year that includes the last day of the partnership taxable year, provided the requirements of paragraph (b)(4)(i)(A) of this section are met.

(iv) *Elective contributions not taken into account.* Elective contributions that do not satisfy the requirements of paragraph (b)(4)(i) of this section may not use the special nondiscrimination rule of section 401(k)(3) and paragraph (b)(2) of this section for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the elective contributions must satisfy the requirements of section 401(a)(4) (without regard to the special nondiscrimination test in section 401(k)(3) and paragraph (b)(2) of this section) for the plan year in which they are allocated under the plan as if they were nonelective employer contributions and were the only nonelective employer contributions for the year. See §§1.401(a)(4)–1(b)(2)(ii)(B); 1.410(b)–7(c)(1).

(5) *Qualified nonelective contributions and qualified matching contributions that may be taken into account under the actual deferral percentage test.* Except as specifically provided otherwise, for purposes of paragraph (b)(2) of this section, all or part of the qualified nonelective contributions and qualified matching contributions made with respect to any or all employees who are eligible employees under the cash or deferred arrangement being tested may be treated as elective contributions under the arrangement, provided that each of the following requirements (to the extent applicable) is satisfied:

(i) The amount of nonelective contributions, including those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2).

(ii) The amount of nonelective contributions, excluding those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test and those qualified nonelective contributions treated as matching contributions under §1.401(m)–1(b)(5) for purposes of the actual contribution percentage test, satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2).

(iii) For plan years beginning before January 1, 1987, or such later date provided in paragraph (h) of this section, the matching contributions, including those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(iv) For plan years beginning before January 1, 1987, or such later date provided in paragraph (h) of this section, the matching contributions, excluding those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(v) The qualified nonelective contributions and qualified matching contributions satisfy the requirements of paragraph (b)(4)(i)(A) of this section for the plan year as if the contributions were elective contributions.

(vi) For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, the section 401(k) plan and the plan or plans to which the qualified nonelective contributions and qualified matching contributions are made, could be aggregated under §1.410(b)–7(d) after application of the mandatory disaggregation rules of §1.410(b)–7(c), as

modified in §1.401(k)–1(g)(11). If the plan year of the section 401(k) plan is changed to satisfy the requirement under §1.410(b)–7(d)(5) that aggregated plans have the same plan year, the qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if the contributions satisfy the requirements of paragraph (b)(4)(i) of this section with respect to the short year as if the contributions were elective contributions and the aggregated plans could otherwise be aggregated for purposes of section 410(b).

(6) *Examples*. The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. (i) Employees A, B, and C are eligible employees who earn $30,000, $15,000, and $10,000, respectively, in 1989. In addition, their employer, X, contributes a bonus of up to 10 percent of their regular compensation to a trust under a profit-sharing plan that includes a cash or deferred arrangement. Under the arrangement, each eligible employee may elect to receive none, all, or any part of the 10 percent in cash. The employer contributes the remainder to the trust. The cash portion of the bonus, if any, is paid after the end of the plan year. The 10 percent is therefore not included in compensation until the year paid. Employee A is highly compensated. For the 1989 plan year, A, B, and C make the following elections:

Employee	Compensation	Elective contribution
A	$30,000	$1,780
B	15,000	750
C	10,000	450

(ii) The ratios of employer contributions to the trust on behalf of each eligible employee to the employee's compensation for the plan year (calculated separately for each employee) are:

Employee	Ratio of elective contribution to compensation	Actual deferral ratio (percent)
A	$1,780/30,000	5.93
B	750/15,000	5.00
C	450/10,000	4.50

(iii) The actual deferral percentage for the highly compensated group (Employee A) is 5.93 percent. The actual deferral percentage for the nonhighly compensated group is 4.75 percent ((5%+4.5%)/2)). Because 5.93 percent is less than 5.94 percent (4.75% multiplied by 1.25), the first percentage test is satisfied.

Example 2. (i) The facts are the same as in *Example 1*, except that elective contributions are made pursuant to a salary reduction agreement and no bonuses are paid. Employer X includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). See §1.401(k)–1(g)(2)(i). In addition, A defers $2,025. Thus, the compensation and elective contributions for A, B, and C are:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
A	$30,000	$2,025	6.75
B	15,000	750	5.00
C	10,000	450	4.50

(ii) The actual deferral percentage for the highly compensated group (Employee A) is 6.75 percent. The actual deferral percentage for the nonhighly compensated group is 4.75 percent ((5.00%+4.50%)/2). Because 6.75 percent exceeds 5.94 percent (4.75×1.25), the first percentage test is not satisfied. However, since the actual deferral percentage equals the maximum percentage allowed under the second percentage test, (4.75+2=6.75), the second percentage test is satisfied.

Example 3. (i) Employees D through L are eligible employees in Employer A's profit-sharing plan that contains a cash or deferred arrangement. Employer A includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). Each eligible employee may elect to defer up to six percent of compensation under the cash or deferred arrangement. Employees D and E are highly compensated. The compensation, elective contributions, and actual deferral ratios of these employees for the 1989 plan year are shown below:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
D	$100,000	$6,000	6
E	80,000	4,000	5
F	60,000	3,600	6
G	40,000	1,600	4
H	30,000	1,200	4
I	20,000	600	3
J	20,000	600	3
K	10,000	300	3
L	5,000	150	3

(ii) The actual deferral percentage for the highly compensated group is 5.5 percent. The actual deferral percentage for the nonhighly compensated group is 3.71 percent. Because 5.5 percent is greater than 4.64 percent (3.71%×1.25), the first percentage test is not satisfied. However, because 5.5 percent is less than 5.71 percent (the lesser of 3.71%+2 or 3.71%×2), the second percentage test is satisfied.

Example 4. (i) Employer D maintains a profit-sharing plan that contains a cash or deferred arrangement. Employer D includes

elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). The following amounts are contributed under the plan:

(A) Six percent of each employee's compensation. These contributions are not qualified nonelective contributions (QNCs).

(B) Two percent of each employee's compensation. These contributions are QNCs.

(C) Three percent of each employee's compensation that the employee may elect to receive as cash or to defer under the plan.

(ii) For the 1990 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S were:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
M	$100,000	$3,000	3
N	80,000	1,600	2
O	60,000	1,800	3
P	40,000	0	0
Q	30,000	0	0
R	20,000	0	0
S	20,000	0	0

(iii) Both types of nonelective contributions are made for all employees. Thus, both the six percent and the two percent employer contributions satisfy the requirements of section 401(a)(4) and paragraph (b)(5)(i) of this section.

(iv) The elective contributions alone do not satisfy the special rules in paragraph (b)(4) of this section because the actual deferral percentage for the highly compensated group, consisting of employees M and N, is 2.5 percent and the actual deferral percentage for the nonhighly compensated group is 0.6 percent. However, the two percent QNCs may be taken into account in applying the special rules. The six percent nonelective contributions may not be taken into account because they are not QNCs.

(v) If the two percent QNCs are taken into account, the actual deferral percentage for the highly compensated group is 4.5 percent, and the actual deferral percentage for the nonhighly compensated group is 2.6 percent. Because 4.5 percent is not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the actual deferral percentage test of section 401(k)(3) and paragraph (b)(2) of this section is satisfied. Thus, the plan satisfies this paragraph (b).

Example 5. (i) Employer N maintains a plan that contains a cash or deferred arrangement. The plan year and the employer's taxable year are the calendar year. The plan provides for employee contributions, elective contributions, matching contributions, and qualified nonelective contributions (QNCs), all of which meet the applicable requirements of section 401(a)(4). Matching contributions on behalf of nonhighly compensated employees are qualified matching contributions (QMACs). Matching contributions on behalf of highly compensated employees are not QMACs. For the 1988 plan year, elective contributions and matching contributions with respect to highly compensated and nonhighly compensated employees are shown in the following chart.

	Elective contributions (including QNCs) (percent)	Total matching contributions (percent)	QMACs (percent)
Highly compensated	15	5	0
Nonhighly compensated	11	5	5

(ii) The plan fails to meet the requirements of section 401(k)(3)(A) because 15 percent is more than 125 percent of, and more than two percentage points greater than, 11 percent. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) to the extent needed under that section. Under this provision, the plan takes QMACs of one percent of compensation into account for each nonhighly compensated employee in applying the actual deferral percentage test. After this adjustment, the actual deferral and actual contribution percentages are as follows:

	Actual deferral percentage	Actual contribution percentage
Highly compensated	15	5
Nonhighly compensated	12	4

(iii) The elective contributions and QMACs taken into account under section 401(k) meet the requirements of section 401(k)(3)(A)(ii) because 15 percent is 125 percent of 12 percent. The remaining matching contributions meet the requirements of section 401(m) because five percent is 125 percent of four percent.

(c) *Nonforfeitability requirement*—(1) *General rule.* A cash or deferred arrangement satisfies this paragraph (c) only if the elective contributions meet each of the following requirements:

(i) Each employee's right to the amount attributable to elective contributions is immediately nonforfeitable within the meaning of section 411, and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date. A contribution that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(ii) The contributions are disregarded for purposes of applying section 411(a) to other contributions or benefits.

(iii) The contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) *Example*. The provisions of this paragraph (c) are illustrated by the following example:

Example. (i) Employees B and C are covered by Employer Y's stock bonus plan, which includes a cash or deferred arrangement. Under the plan, Employer Y makes a nonelective contribution on behalf of each employee equal to four percent of compensation. All employees participating in the plan have a nonforfeitable right to a percentage of their accrued benefit derived from this contribution as shown in the following table:

Years of service	Nonforfeitable percentage
Less than 1	0
1	20
2	40
3	60
4	80
5 or more	100

(ii) B and C have three and six years of service, respectively. Employer Y also permits employees to elect to defer up to 6 percent of compensation through salary reduction agreements. Amounts deferred under these agreements are nonforfeitable at all times. In accordance with paragraph (c)(1)(i) of this section, the nonforfeitable percentage of Employer Y's nonelective contribution on behalf of B and C may not be treated as a qualified nonelective contribution under paragraph (b)(3) of this section, because these amounts are nonforfeitable by reason of the completion by B and C of a stated number of years of service, and not regardless of the age and service of B and C.

(d) *Distribution limitation*—(1) *General rule*. A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also satisfy the requirements of paragraphs (d)(2) through (6) of this section (to the extent applicable):

(i) The employee's retirement, death, disability, or separation from service.

(ii) In the case of a profit-sharing or stock bonus plan, the employee's attainment of age 59½, or the employee's hardship.

(iii) For plan years beginning after December 31, 1984, the termination of the plan.

(iv) For plan years beginning after December 31, 1984, the date of the sale or other disposition by a corporation of substantially all the assets (within the meaning of section 409(d)(2)) used by the corporation in a trade or business of the corporation to an unrelated corporation.

(v) For plan years beginning after December 31, 1984, the date of the sale or other disposition by a corporation of its interest in a subsidiary (within the meaning of section 409(d)(3)) to an unrelated entity or individual.

(2) *Rules applicable to hardship distributions*—(i) *Distribution must be on account of hardship*. A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan. See section 411(d)(6) and the regulations thereunder.

(ii) *Limit on distributable amount*. For plan years beginning after December 31, 1988, a distribution on account of hardship must be limited to the distributable amount. The distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions on account of hardship. If the plan so provides, the employee's total elective contributions used in determining the distributable amount may be increased by income allocable to elective contributions, by amounts treated as elective contributions under paragraph (b)(5) of this section, and by income allocable to amounts treated as elective contributions. The distributable amount may only include amounts that were credited to the employee's

account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or such later date provided in paragraph (h) of this section).

(iii) *General hardship distribution standards*—(A) *Immediate and heavy financial need.* Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) *Distribution necessary to satisfy financial need.* A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all relevant facts and circumstances. For purposes of this paragraph, the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not treated as a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution. A distribution generally may be treated as necessary to satisfy a financial need if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

(*1*) Through reimbursement or compensation by insurance or otherwise;

(*2*) By liquidation of the employee's assets;

(*3*) By cessation of elective contributions or employee contributions under the plan; or

(*4*) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms, in an amount sufficient to satisfy the need.

For purposes of this paragraph (d)(2)(iii)(B), a need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(iv) *Deemed hardship distribution standards*—(A) *Deemed immediate and heavy financial need.* A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

(*1*) Expenses for medical care described in section 213(d) previously incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in section 152) or necessary for these persons to obtain medical care described in section 213(d);

(*2*) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(*3*) Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152); or

(*4*) Payments necessary to prevent the eviction of the employee from the

employee's principal residence or foreclosure on the mortgage on that residence.

(B) *Distribution deemed necessary to satisfy financial need.* A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

(*1*) The distribution is not in excess of the amount of the immediate and heavy financial need of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(*2*) The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer.

(*3*) The plan and all other plans maintained by the employer limit the employee's elective contributions for the next taxable year to the applicable limit under section 402(g) for that year minus the employee's elective contributions for the year of the hardship distribution.

(*4*) 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 12 months after receipt of the hardship distribution. For this purpose the phrase ''all other plans maintained by the employer'' means all qualified and nonqualified plans of deferred compensation maintained by the employer. The phrase includes a stock option, stock purchase, or similar plan, or a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan. It also does not include a health or welfare benefit plan, including one that is part of a cafeteria plan within the meaning of section 125. See §1.401(k)–1(g)(4)(i) for the continued treatment of suspended employees as eligible employees.

(C) *Commissioner may expand standards.* The Commissioner may expand the list of deemed immediate and heavy financial needs and may prescribe additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need only in revenue rulings, notices, and other documents of general applicability, and not on an individual basis.

(3) *Rules applicable to distributions upon plan termination.* A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains a successor plan. For purposes of this rule, the definition of the term ''employer'' contained in paragraph (g)(6) of this section is applied as of the date of plan termination, and a successor plan is any other defined contribution plan maintained by the same employer. However, if at all times during the 24-month period beginning 12 months before the termination, fewer than two percent of the employees who were eligible under the defined contribution plan that includes the cash or deferred arrangement as of the date of plan termination are eligible under the other defined contribution plan, the other plan is not a successor plan. The term ''defined contribution plan'' means a plan that is a defined contribution plan as defined in section 414(i), but does not include an employee stock ownership plan as defined in section 4975(e) or 409(a) or a simplified employee pension as defined in section 408(k). A plan is a successor plan only if it exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan.

(4) *Rules applicable to distributions upon sale of assets or subsidiary*—(i) *Seller must maintain the plan.* A distribution may be made under section 401(k)(10) and paragraph (d)(1) (iv) or (v) of this section only from a plan that the seller continues to maintain after the disposition. This requirement is satisfied if and only if the purchaser does not maintain the plan after the disposition. A purchaser maintains the plan of the seller if it adopts the plan or otherwise becomes an employer whose employees accrue benefits under the plan. A purchaser also maintains

the plan if the plan is merged or consolidated with, or any assets or liabilities are transferred from the plan to a plan maintained by the purchaser in a transaction subject to section 414(*l*)(1). A purchaser is not treated as maintaining the plan merely because a plan that it maintains accepts elective transfers described in § 1.411(d)–4, Q&A–3(b)(1), or rollover contributions of amounts distributed by the plan (including distributions that the recipient elects, under section 401(a)(31), to have paid in a direct rollover to the plan of the purchaser).

(ii) *Employee must continue employment*. A distribution may be made under paragraph (d)(1) (iv) or (v) of this section only to an employee who continues employment with the purchaser of assets or with the subsidiary, whichever is applicable.

(iii) *Distribution must be in connection with disposition of assets or subsidiary*. Elective contributions may not be distributed under paragraph (d)(1) (iv) or (v) of this section except in connection with the disposition that results in the employee's transfer to the purchaser. Whether a distribution is made in connection with the disposition of assets or a subsidiary depends on all of the facts and circumstances. Except in unusual circumstances, however, a distribution will not be treated as having been made in connection with a disposition unless it was made by the end of the second calendar year after the calendar year in which the disposition occurred.

(iv) *Definitions*—(A) *Substantially all*. For purposes of paragraph (d)(1)(iv) of this section, the sale of ''substantially all'' the assets used in a trade or business means the sale of at least 85 percent of the assets.

(B) *Unrelated employer*. For purposes of paragraph (d)(1) (iv) and (v) of this section, an ''unrelated'' entity or individual is one that is not required to be aggregated with the seller under section 414 (b), (c), (m), or (o) after the sale or other disposition.

(5) *Lump sum requirement for certain distributions*. After March 31, 1988, a distribution may be made under paragraph (d)(1) (iii), (iv), or (v) of this section only if it is a lump sum distribution. The term *lump sum distribution* has the meaning provided in section 402(d)(4), without regard to subparagraphs (A) (i) through (iv), (B), and (F) of that section.

(6) *Rules applicable to all distributions*—(i) *Impermissible distributions*. Amounts attributable to elective contributions may not be distributed on account of any event not described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years. For example, if excess deferrals (and income) for an employee's taxable year are not distributed within the time prescribed in § 1.402(g)–1(e) (2) or (3), the amounts may be distributed only on account of an event described in this paragraph (d).

(ii) *Deemed distributions*. The cost of life insurance (P.S. 58 costs) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph. The making of a loan is not treated as a distribution, even if the loan is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(iii) *ESOP dividend distributions*. A plan does not fail to satisfy the requirements of this paragraph (d) merely by reason of a dividend distribution described in section 404(k)(2).

(iv) *Limitations apply after transfer*. The limitations of this paraqraph (d) generally continue to apply to amounts attributable to elective contributions (including amounts treated as elective contributions) that are transferred to another qualified plan of the same or another employer. Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in this paragraph (d). The limitations of paragraph (d) of this section cease to apply after the transfer, however, if the amounts could have been distributed at the time of the transfer (other than on account of hardship), and the transfer is an elective transfer described in § 1.411(d)–4, Q&A–3(b)(1). The limitations of paragraph (d) of this section

also do not apply to amounts distributed from another plan that the recipient elects under section 401(a)(31) to have paid in a direct rollover to the plan.

(v) *Required consent.* A distribution may be made under this paragraph (d) only if any consent or election required under section 411(a)(11) or 417 is obtained.

(7) *Examples.* The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. Employer C maintains a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the plan includes a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

Example 2. Employer D maintains a pre-ERISA money purchase plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be distributed to an employee on account of hardship. Under paragraph (d)(1) of this section, hardship is a distribution event only in a profit-sharing or stock bonus plan. Since elective contributions under the arrangement may be distributed before a distribution event occurs, the cash or deferred arrangement does not satisfy this paragraph (d), and is not a qualified cash or deferred arrangement. Moreover, the plan is not a qualified plan because a pension plan may not provide for payment of benefits upon hardship. See §1.401–1(b)(1)(i).

(e) *Additional requirements for qualified cash or deferred arrangements*—(1) *Qualified profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the plan of which it is a part is a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan that otherwise satisfies the requirements of section 401(a) (taking into account the cash or deferred arrangement). A plan that includes a cash or deferred arrangement may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. See paragraph (e)(7) of this section, however, for limitations on the extent to which elective contributions under a cash or deferred arrangement may be taken into account in determining whether the other contributions satisfy the requirements of section 401(a).

(2) *Cash availability requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or to have the employer contribute an amount in excess of the specified cash amount to a profit-sharing plan on the employee's behalf, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(3) *Separate accounting requirement*—(i) *General rule.* A cash or deferred arrangement satisfies this paragraph (e) only if the portion of an employee's benefit subject to the requirements of paragraphs (c) and (d) of this section is determined by an acceptable separate accounting between that portion and any other benefits. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts subject to the requirements of paragraphs (c) and (d) of this section and to other accounts. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section.

(ii) *Failure to satisfy separate accounting requirement.* The requirements of

paragraph (e)(3)(i) of this section are treated as satisfied if all amounts held under a plan that includes a cash or deferred arrangement or under another plan, contributions under which are taken into account under the arrangement for purposes of paragraph (b) of this section are treated as attributable to elective contributions subject to the requirements of paragraphs (c) and (d) of this section.

(4) *Limitations on cash or deferred arrangements of state and local governments and tax-exempt organizations*—(i) A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted:

(A) After May 6, 1986, by a state or local government or political subdivision thereof, or any agency or instrumentality thereof (''a governmental unit''), or

(B) After July 1, 1986, by any organization exempt from tax under subtitle A of the Internal Revenue Code.

For purposes of paragraph (e)(4) of this section, whether an organization is exempt from tax under subtitle A of the Internal Revenue Code is determined without regard to section 414 (b), (c), (m) or (o).

(ii) A cash or deferred arrangement is treated as adopted after the dates described in paragraph (e)(4)(i) of this section with respect to all employees of any employer that adopts the arrangement after such dates. If an employer adopted an arrangement prior to such dates, all employees of the employer may participate in the arrangement.

(iii) For purposes of this paragraph (e)(4), an employer that has made a legally binding commitment to adopt a cash or deferred arrangement is treated as having adopted the arrangement on that date.

(iv) If a governmental unit adopted a cash or deferred arrangement before May 7, 1986, then any cash or deferred arrangement adopted by the unit at any time is treated as adopted before that date.

(v) This paragraph (e)(4) does not apply to a rural cooperative plan.

(vi) For purposes of this paragraph (e)(4), an employee representative is treated as an employee of a tax exempt employer even if the employee could be treated as an employee by another employer under § 1.413–1(i)(1).

(5) *One-year eligibility requirement*. For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no employee is required to complete a period of service greater than one year (determined without regard to section 410(a)(1)(B)(i)) with the employer maintaining the plan to be eligible to make an election under the arrangement.

(6) *Other benefits not contingent upon elective contributions*—(i) *General rule*. For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not to make elective contributions under the arrangement. The preceding sentence does not apply to any matching contribution (as defined in section 401(m)) made by reason of such an election or to any benefit that is provided at the employee's election under a plan described in section 125(d) in lieu of an elective contribution under a qualified cash or deferred arrangement.

(ii) *Definition of other benefits*. Other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective employer contributions under a defined contribution plan; the availability, cost, or amount of health benefits; vacations or vacation pay; life insurance; dental plans; legal services plans; loans (including plan loans); financial planning services; subsidized retirement benefits; stock options; property subject to section 83; and dependent care assistance. Also, increases in salary and bonuses (other than those actually subject to the cash or deferred election) are benefits for purposes of this paragraph (e)(6). The ability to make after-tax employee contributions is a benefit, but that benefit is not contingent upon an employee's electing to make or not make elective contributions under the arrangement merely because the amount of elective contributions reduces dollar-for-dollar the amount of after-tax employee contributions that may be

made. Benefits under any other plan or arrangement (whether or not qualified) are not contingent upon an employee's electing to make or not to make elective contributions under a cash or deferred arrangement merely because the elective contributions are or are not taken into account as compensation under the other plan or arrangement for purposes of determining benefits.

(iii) *Effect of certain statutory limits.* A benefit under a defined benefit plan that is contingent upon elective contributions solely by reason of the combined plan fraction of section 415(e) is not treated as contingent for purposes of this paragraph (e)(6). Similarly, any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of 1974 that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent.

(iv) *Nonqualified deferred compensation.* Participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) only to the extent that an employee may receive additional deferred compensation under the nonqualified plan to the extent the employee makes or does not make elective contributions. Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.

(v) *Plan loans and distributions.* A loan or distribution of elective contributions is not a benefit conditioned on an employee's electing to make or not make elective contributions under the arrangement merely because the amount of the loan or distribution is based on the amount of the employee's account balance.

(vi) *Examples.* The provisions of this paragraph (e)(6) are illustrated by the following examples.

Example 1. Employer T maintains a cash or deferred arrangement for all of its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the nonqualified deferred compensation plan, R and C are eligible to participate only if they do not make elective contributions under the cash or deferred arrangement. Participation in the nonqualified plan is a contingent benefit for purposes of this paragraph (e)(6), because R's and C's participation is conditioned on their electing not to make elective contributions under the cash or deferred arrangement.

Example 2. Employer T maintains a cash or deferred arrangement for all its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the arrangements, Employees R and C may defer a maximum of 10 percent of their compensation, and may allocate their deferral between the cash or deferred arrangement and the nonqualified deferred compensation plan in any way they choose (subject to the overall 10 percent maximum). Because the maximum deferral available under the nonqualified deferred compensation plan depends on the elective deferrals made under the cash or deferred arrangement, the right to participate in the nonqualified plan is a contingent benefit for purposes of paragraph (e)(6).

(7) *Coordination with other plans.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no elective contributions (or qualified matching contributions treated as elective contributions under paragraph (b)(5) of this section) under the arrangement are taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the elective contributions are made) satisfy the requirements of section 401(a). Indeed, the portion of a plan that consists of elective contributions is treated as a separate plan for purposes of sections 401(a)(4) and 410(b). See §1.410(b)–7(c)(1). Similarly, elective contributions under a cash or deferred arrangement generally may not be taken into account in determining whether a plan satisfies the minimum contribution or benefit requirements of section 416. See §1.416–1, M–20. However, qualified nonelective contributions that are treated as elective contributions for purposes of section 401(k)(3) under paragraph (b)(5) of this section may be used to enable a

plan to satisfy the minimum contribution or benefit requirements under section 416. See §1.416–1, M–18. This paragraph (e) does not apply for purposes of determining whether a plan satisfies the average benefit percentage requirement of section 410(b)(2)(A)(ii). See also §1.401(m)–1(b)(5) for circumstances under which elective contributions may be used to determine whether a plan satisfies the requirements of section 401(m).

(8) *Recordkeeping requirements.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if the employer maintains the records necessary to demonstrate compliance with the applicable nondiscrimination requirements of paragraph (b) of this section, including the extent to which qualified nonelective contributions and qualified matching contributions are taken into account.

(9) *Consistent application of separate line of business rules.* If an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b), and applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of the plan that consists of contributions under the cash or deferred arrangement, then the requirements of section 401(k) and this section must be applied on an employer-wide rather than a qualified-separate-line-of-business basis to all of the plans or portions of plans taken into account in determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement, regardless of whether those plans or portions of plans also satisfy the requirements necessary to apply the special rule in §1.414(r)–1(c)(2)(ii). Conversely, if an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b), and does not apply the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of the plan that consists of contributions under the cash or deferred arrangement, then the requirements of section 401(k) and this section must be applied on a qualified-separate-line-of-business rather than an employer-wide basis to all of the plans or portions of plans taken into account in determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement, regardless of whether one or more of those plans or portions of plans is tested under the special rule §1.414(r)–1(c)(2)(ii). This requirement applies solely for purposes of determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement under section 401(k) and this section. The rules of this paragraph are illustrated by the following example.

Example. (i) Employer A maintains a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b). However, Employer A applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of its profit-sharing plan that consists of elective contributions under the cash or deferred arrangement (and to no other plans or portions of plans). Employer A makes qualified nonelective contributions to the profit-sharing plan for the 1995 plan year, and the profit-sharing plan provides that these qualified nonelective contributions may be used to satisfy the actual deferral percentage test.

(ii) Under these facts, the requirements of sections 401(a)(4) and 410(b) must be applied on an employer-wide rather than a qualified-separate-line-of-business basis in determining whether the qualified nonelective contributions made to the profit-sharing plan satisfy the requirements of §1.401(k)–1(b)(5), and thus whether they may be taken into account under the actual deferral percentage test. Therefore, in order for the nonelective contributions to be used to satisfy the actual deferral percentage test, both (1) the total amount of nonelective contributions under the profit-sharing plan, including the qualified nonelective contributions to be used to satisfy the actual deferral percentage test, and (2) the total amount of nonelective contributions under the profit-sharing plan, excluding the qualified nonelective contributions to be used to satisfy the actual deferral percentage test, must satisfy the requirements of section 401(a)(4) on an employer-wide basis. Of course, in order for the profit-sharing plan to satisfy section 401(a), it must still satisfy sections

410(b) and 401(a)(4) on a qualified-separate-line-of-business basis.

(f) *Correction of excess contributions*—(1) *General rule*—(i) *Permissible correction methods.* A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section with respect to the amount of elective contributions under the arrangement if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement and paragraph (b)(5) of this section, makes qualified nonelective contributions or qualified matching contributions that are treated as elective contributions under the arrangement and that, in combination with the elective contributions, satisfy the requirements of paragraph (b)(2) of this section. In addition, a cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section for a plan year with respect to the amount of the elective contributions under the arrangement if, in accordance with the terms of the plan that includes the cash or deferred arrangement, excess contributions are recharacterized in accordance with paragraph (f)(3) of this section, or excess contributions (and income allocable thereto) are distributed in accordance with paragraph (f)(4) of this section.

(ii) *Combination of correction methods.* A plan may use any of the correction methods described in paragraph (f)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. Thus, for example, a portion of the excess contributions for a highly compensated employee may be recharacterized under paragraph (f)(3) of this section, and the remaining portion of the excess contributions may be distributed under paragraph (f)(4) of this section. A plan may require or permit a highly compensated employee to elect whether any excess contributions are to be recharacterized or distributed.

(iii) *Impermissible correction methods.* Excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5). See paragraph (f)(6) of this section for the effects of a failure to correct excess contributions.

(iv) *Partial distributions.* Any distribution of less than the entire amount of excess contributions with respect to any highly compensated employee is treated as a pro rata distribution of excess contributions and allocable income or loss.

(2) *Amount of excess contributions.* The amount of excess contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's elective contributions must be reduced for the employee's actual deferral ratio to equal the highest permitted actual deferral ratio under the plan. To calculate the highest permitted actual deferral ratio under a plan, the actual deferral ratio of the highly compensated employee with the highest actual deferral ratio is reduced by the amount required to cause the employee's actual deferral ratio to equal the ratio of the highly compensated employee with the next highest actual deferral ratio. If a lesser reduction would enable the arrangement to satisfy the actual deferral percentage test, only this lesser reduction may be made. This process must be repeated until the cash or deferred arrangement satisfies the actual deferral percentage test. The highest actual deferral ratio remaining under the plan after leveling is the highest permitted actual deferral ratio. Thus, for each highly compensated employee, the amount of excess contributions for a plan year is equal to the employee's elective contributions, plus qualified nonelective contributions and qualified matching contributions taken into account in determining the employee's actual deferral ratio under paragraph (g)(1) of this section, minus the amount determined by multiplying the employee's actual deferral ratio (determined after application of this paragraph (f)(2)) by the compensation used in determining the ratio. In no case may the amount of excess contributions to be recharacterized or distributed for a

plan year with respect to any highly compensated employee exceed the amount of elective contributions made on behalf of the highly compensated employee for the plan year.

(3) *Recharacterization of excess contributions*—(i) *General rule*. Excess contributions are recharacterized in accordance with this paragraph (f)(3) only if the excess contributions are treated as described in paragraph (f)(3)(ii) of this section, and all of the conditions set forth in paragraph (f)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions*.

(A) Excess contributions recharacterized under this paragraph (f)(3) are includable in the employee's gross income on the earliest dates any elective contribution made on behalf of the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash, or on such later date permitted in paragraph (f)(3)(iv) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, section 401(a)(4) and 401(m), and paragraphs (b) and (d) of this section. This requirement is not treated as satisfied unless:

(*1*) The payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by—

(*i*) Timely providing such forms as the Commissioner may designate to the employer and to employees whose excess contributions are recharacterized under this paragraph (f)(3); and

(*ii*) Timely taking such other action as the Commissioner may require; and

(*2*) The plan administrator accounts for the amounts as contributions by the employee for purposes of sections 72 and 6047.

(B) Recharacterized excess contributions continue to be treated as employer contributions that are elective contributions for all other purposes under the Internal Revenue Code, including sections 401(a) (other than 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of paragraph (c) of this section; must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and §1.415–6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(l) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. See §1.414(s)–1(c)(4)(i). Recharacterized excess contributions that relate to plan years ending on or before October 24, 1988, may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section. The amount of excess contributions included in an employee's gross income is reduced as provided under paragraph (f)(5)(i)(B) of this section.

(iii) *Additional rules*—(A) *Time of recharacterization*. Excess contributions may not be recharacterized under this paragraph (f)(3) after the later of October 24, 1988, or 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii)(A) of this section. The Commissioner may designate the means by which this notification is to be provided.

(B) *Employee contributions must be permitted under plan*. The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the highly compensated employee, may not exceed the maximum amount of employee contributions (determined without regard to the actual contribution percentage test of section 401(m)(2)) that the highly compensated employee could have made under the provisions of the plan in effect on the first day of the plan year in the absence of recharacterization. See §1.401(m)–1(a)(2) for requirements relating to the availability of employee contributions.

(C) *Plans under which excess contributions may be recharacterized*. For plan

years beginning after December 31, 1991, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with which that plan could be aggregated under § 1.410(b)–7(d) after application of the mandatory disaggregation rules of § 1.410(b)–7(c), as modified in § 1.401(k)–1(g)(11). For plan years beginning before that date and after December 31, 1988, or such later date provided under paragraph (h) of this section, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with the same plan year as that plan.

(iv) *Transition rules*. If amounts recharacterized for any plan year were not previously included in income, they must be treated as received by employees for income tax purposes on the first day of the first plan year ending after 1987. If notice of recharacterization was provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this paragraph (f)(3)(iv) are effective only for plan years ending before August 9, 1988.

(v) *Example*. The provisions of this paragraph (f)(3) are illustrated by the following example:

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under Plan Y, each eligible employee may elect to defer up to 10 percent of compensation under a salary reduction agreement. An eligible employee may also make employee contributions of up to 10 percent of compensation. X pays the amounts deferred to the trust on the last day of each month. Employer X includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). Salaries are paid on the same date.

(ii) (A) In January 1989, X determines that during 1988 the compensation and actual deferral ratios (ADRs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADR (%)(B/A)
A	$70,000	$7,000	10.00
B	60,000	4,500	7.50
C	20,000	1,000	5.00
D	15,000	0	0
E	10,000	350	3.50
F	10,000	350	3.50

(B) The average deferral percentage (ADP) for X's highly compensated group, A and B, is 8.75 percent ((10.00%+7.50%)/2). The ADP for X's other employees is 3 percent ((5.00%+0% + 3.50% + 3.50%)/4). Because 8.75 percent is more than 2 times 3 percent and more than 3 percent plus 2 percentage points, the plan fails to satisfy paragraph (b)(2) of this section. Neither A nor B made any employee contributions for the year.

(iii) Plan Y provides that each highly compensated participant will have excess contributions, as defined in paragraph (g)(7) of this section, recharacterized. The amount to be recharacterized will be determined according to the method described in paragraph (f)(2) of this section.

(iv) In order to satisfy paragraph (b)(2) of this section, Plan Y must reduce the ADP for X's highly compensated employees to not more than 5 percent. This will satisfy the test described in paragraph (b)(2) of this section, because 5 percent is not more than 2 times 3 percent and is not more than 2 percentage points greater than 3 percent. Plan Y first reduces A's ADR to 7.5 percent (the ADR of the highly compensated employee having the next highest ADR). Since this is not sufficient to satisfy the ADP test in paragraph (b)(2) of this section, the ADR of both A and B must be reduced to 5 percent.

(v) The maximum dollar amount that may be deferred by each employee is determined by using the formula D=(ADR×S) where D is the maximum allowable deferral, ADR is the reduced ADR, and S is the compensation. Thus, A's maximum allowable deferral is $3,500 (.05×$70,000), and B's maximum allowable deferral is $3,000 (.05×$60,000). The balance of the original deferrals by A and B ($3,500 and $1,500 respectively) must be included in their taxable wages for 2988, the year in which X would have paid cash to A and B.

(vi) A deferred $583.33 per month, except for January, February, March, and April, when A deferred $583.34. Pursuant to the first-in, first-out rule in paragraph (f)(3)(ii) of this section, the deferrals made in January, February, March, April, and May, as well as $583.31 of the deferral made in June, are treated as employee contributions. A similar procedure is undertaken with respect to B. X and the plan administrator provide A and B with the forms and notices that the Commissioner requires. If A and B had already filed income tax returns for 1988, they must file amended returns. If Plan Y had a plan year ending November 30, 1987, and A and B had made elective deferrals in December 1987,

they would also have to file amended returns for 1987. In addition, the plan administrator must satisfy paragraph (f)(3)(ii)(B) of this section. Of course, the actual contribution percentage test of section 401(m)(2) must be satisfied for 1988, taking the recharacterized amounts into account.

(4) *Corrective distribution of excess contributions (and income)*—(i) *General rule.* Excess contributions (and income allocable thereto) are distributed in accordance with this paragraph (f)(4) only if the excess contributions and allocable income are designated by the employer as a distribution of excess contributions (and income), and are distributed to the appropriate highly compensated employees after the close of the plan year in which the excess contributions arose and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which an excess contribution arose, the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess contributions*—(A) *General rule.* The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the ''gap period'').

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating income.* A plan may allocate income to excess contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to elective contributions and amounts treated as elective contributions by a fraction. The numerator of the fraction is the excess contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(*1*) The total account balance of the employee attributable to elective contributions and amounts treated as elective contributions as of the beginning of the plan year; plus

(*2*) The employee's elective contributions and amounts treated as elective contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess contributions for the gap period is equal to 10 percent of the income allocable to excess contributions for the plan year (calculated under the method described in paragraph (f)(4)(ii)(C)) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(iii) *No employee or spousal consent required.* A corrective distribution of excess contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions as employer contributions.* Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(v) *Tax treatment of corrective distributions*—(A) *General rule.* Except as provided in paragraph (f)(4)(v) (B) or (C) of this section, a corrective distribution of excess contributions (and income)

that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the earliest dates any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (f)(5)(i)(B) of this section for rules relating to the taxation of excess contributions that reduce excess deferrals. See paragraph (f)(6)(i) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions.* If the total amount of excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess contributions (and income) is includible in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess contributions.* Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (f)(4)(v)(A) of this section, or in the year described in paragraph (f)(4)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but in no event later than April 17, 1989.

(vi) *No reduction of required minimum distribution.* A distribution of excess contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(5) *Rules applicable to all corrections*—(i) *Coordination with distribution of excess deferrals*—(A) *In general.* The amount of excess contributions to be recharacterized under paragraph (f)(3) of this section or distributed under paragraph (f)(4) of this section with respect to an employee for a plan year, is reduced by any excess deferrals previously distributed to the employee for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) *Treatment of excess contributions that reduce excess deferrals.* Under §1.402(g)–1(e), the amount of excess deferrals that may be distributed with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payor or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under §1.402(g)–1(e)(6).

(ii) *Correction of family members.* The determination and correction of excess contributions of a highly compensated employee whose actual deferral ratio is determined under the family aggregation rules of paragraph (g)(1)(ii)(C) of this section is accomplished by reducing the actual deferral ratio as required under paragraph (f)(2) of this section and allocating the excess contributions for the family group among the family members in proportion to the elective contribution of each family member that is combined to determine the actual deferral ratio.

(iii) *Matching contributions forfeited because of excess deferral or contribution.* For purposes of section 401(k)(2)(C) and paragraph (c)(1) of this section, a qualified matching contribution is not treated as forfeitable merely because under the plan it is forfeited if the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(6) *Failure to correct*—(i) *Failure to correct within 2½ months after end of plan year*. If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10-percent excise tax on the amount of the excess contributions. See section 4979 and § 54.4979–1. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year*. If excess contributions are not corrected within 12 months after close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

(7) *Examples*. The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. (i) The Y corporation maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of Y's employees are eligible to participate in the cash or deferred arrangement. The Y corporation includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). The employees' compensation, elective contributions, and actual deferral ratios are shown in the following table:

Employee	Compensation	Elective contributions	Actual deferral ratio (ADR) (percent)
A	$160,000	$6,400	4.0
B	140,000	7,000	5.0
C	70,000	7,000	10.0
D	65,000	6,500	10.0
E	42,000	2,100	5.0
F	35,000	3,500	10.0
G	28,000	2,800	10.0
H	21,000	700	3.33
I	21,000	0	0
J	21,000	0	0

(ii) Employees A, B, C, and D are highly compensated employees. Employees E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentage (ADP) for the highly compensated group is 7.25 percent. The ADP for the nonhighly compensated group is 4.72 percent. These percentages do not meet the requirements of section 401(k)(3)(A)(ii).

(iii) Employees A and C have each received a distribution of excess deferrals of $1,000. However, the ADR for employee A remains 4.0 percent and the actual deferral ratio for Employee C remains 10.0 percent. The ADP for the group of highly compensated employees remains 7.25 percent.

(iv) The ADP for the highly compensated group must be reduced to 6.72 percent. This is done by reducing the ADR of the highly compensated employees with the highest ADR (Employees C and D) to 8.94 percent. This makes Employee C's maximum elective contribution $6,258. This requires a distribution or recharacterization of $742. But since $1,000 has already been distributed as an excess deferral, no additional distribution or recharacterization is required or permitted. Employee D's elective contribution must be reduced by $689 ($6,500—.0894 ($65,000)) to $5,811 through distribution or recharacterization.

Example 2. A, B, and C are highly compensated employees of Employer R. Employer R maintains a cash or deferred arrangement. Employer R includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). For the plan year 1990, A, B, and C each earns compensation of $100,000 and contributes $7,000 to the plan during the period January through June. B retires in November of 1990 and makes a withdrawal of B's entire account balance of $200,000. In January of 1991, R computes the ADP test for its employees and learns that the highly compensated employees should have contributed only five percent of compensation. Since B made a contribution of $7,000 for 1990, B's contribution and compensation are used in determining the ADP despite the subsequent $200,000 withdrawal. A, B, and C must each receive a corrective distribution of $2,000 in order to meet the ADP test. Since B has already withdrawn B's total account balance under the plan, only A and C must receive a distribution of $2,000 each in order for the plan to meet the ADP test of section 401(k)(3)(A)(ii). Pursuant to the 1990 Form 1099–R Instructions, the plan must issue two Forms 1099–R to B, one reporting the portion of the distribution that was necessary to correct the excess contribution (including income), and one reporting the balance of the distribution. If B had withdrawn less than the total account balance, B would have to withdraw the lesser of $2,000 or the remaining account balance.

Example 3. Individual A has a child, B. Both participate in a cash or deferred arrangement maintained by Employer X. A is one of the 10 most highly compensated employees and B is a nonhighly compensated employee. Employer X includes elective contributions in compensation as permitted under

§ 1.414(s)–1(c)(4)(i). A has compensation of $100,000 and defers $7,000 under the cash or deferred arrangement; B has compensation of $40,000 and defers $4,000 under the arrangement. The actual deferral ratio of the family unit is 7.86 percent, calculated by aggregating the contributions and compensation of A and B ($7,000 + $4,000)/($100,000 + $40,000). For the plan, it is determined that under § 1.401(k)–1(f)(2), the actual deferral ratio of the aggregate family unit must be reduced to 7.20 percent. This reduction is applied in proportion to A's and B's contributions. The excess contributions are $920 ($11,000 total contributions minus $10,080 (7.20% x $140,000)). A's share of the excess contributions is $585.45 ($7,000/$11,000 x $920); B's share is $334.55 ($4,000/$11,000 x $920).

Example 4. (i) Employer T maintains a profit-sharing plan containing a cash or deferred arrangement for all employees. Six employees are covered by a collective bargaining agreement, the other seven employees are not. The employee data for 1994 is shown in the following table:

Employee	Collective bargaining unit status	Actual deferral ratio (ADR), (percent)
A	Member	8.0
B	Member	6.0
C	Nonmember	9.0
D	Nonmember	7.0
E–H	Members	4.5
I–M	Nonmembers	6.0

Employees A, B, C, and D are highly compensated.

(ii) For purposes of sections 410(b), 401(a)(4) and 401(k), the portion of T's plan covering collectively bargained unit members must be disaggregated from the portion covering other employees.

Employee	ADR (percent)
Collective Bargaining Unit Members:	
A	8.0
B	6.0
E–H	[1] 4.5
Other Employees:	
C	9.0
D	7.0
I–M	[1] 6.0

[1] Average.

(iii) The ADPs for the collectively bargained highly compensated group and nonhighly compensated group, respectively, are seven percent and 4.5 percent. The ADPs for the other highly compensated and nonhighly compensated employees, respectively, are eight percent and six percent.

(iv) The non-collectively bargained portion of the disaggregated plan satisfies the ADP test for the 1994 plan year, but the collectively bargained portion does not. Employer T is not required to make corrections to the collectively bargained portion of the cash or deferred arrangement, because a collectively bargained plan automatically satisfies the nondiscrimination requirements of 401(a)(4). However, unless Employer T corrects the ADP test failure in the collectively bargained portion of the plan, either by reducing A's ADR to seven percent or adding QNCs for the nonhighly compensated employees, all elective contributions made by collectively bargained employees for the year will be includible in income in 1994.

(g) *Definitions.* The following definitions apply for purposes of this section, unless the context clearly indicates otherwise:

(1) *Actual deferral percentage*—(i) *General rule.* The actual deferral percentage for a group of employees for a plan year is the average of the actual deferral ratios of employees in the group for that plan year. For plan years that begin after December 31, 1988, or such later date provided in paragraph (h) of this section, actual deferral ratios and the actual deferral percentage for a group are calculated to the nearest hundredth of a percentage point.

(ii) *Actual deferral ratio*—(A) *General rule.* An employee's actual deferral ratio for the plan year is the sum of the employee's elective contributions and amounts treated as elective contributions for the plan year, divided by the employee's compensation taken into account for the plan year. If an eligible employee makes no elective contributions, and no qualified matching contributions or qualified nonelective contributions are taken into account with respect to the employee, the actual deferral ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (g)(2) of this section for rules regarding the elective contributions, qualified nonelective contributions, and compensation taken into account in calculating this fraction.

(B) *Employee eligible under more than one arrangement—(1) Highly compensated employees.* For plan years beginning after December 31, 1984, the actual deferral ratio of a highly compensated employee who is eligible to participate in more than one cash or deferred arrangement of the same employer is generally calculated by treating all the cash or deferred arrangements in which the employee is eligible to participate as one arrangement. However, plans

that are not permitted to be aggregated under §1.410(b)–7(c), as modified in paragraph (g)(11) of this section, are not aggregated for this purpose. For example, if a highly compensated employee with compensation of $80,000 could make elective contributions under two separate cash or deferred arrangements, the actual deferral ratio for the employee under each arrangement would generally be calculated by dividing the total elective contributions by the employee under both arrangements by $80,000. If one of the cash or deferred arrangements were part of an ESOP, however, while the other was not, the actual deferral percentage of the employee under each arrangement would be calculated by dividing the employee's elective contributions under each arrangement by $80,000 because the ESOP portion is mandatorily disaggregated from the non-ESOP portion.

(*2*) *Nonhighly compensated employees.* For plan years beginning after December 31, 1984, and before January 1, 1987 (or such later date provided under paragraph (h) of this section), this paragraph (g)(1)(ii)(B) applies to all employees, and not only to highly compensated employees.

(*3*) *Treatment of plans with different plan years.* If the cash or deferred arrangements that are treated as a single arrangement under this paragraph (g)(1)(ii)(B) are parts of plans that have different plan years, the cash or deferred arrangements are treated as a single arrangement with respect to the plan years ending with or within the same calendar year.

(C) *Employees subject to family aggregation rules—(1) Aggregation of elective contributions and other amounts.* For plan years beginning after December 31, 1986, or any later date provided in paragraph (h) of this section, if a highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual deferral ratio for the family group (which is treated as one highly compensated employee) must be determined by combining the elective contributions, compensation, and amounts treated as elective contributions of all family members.

(*2*) *Effect on actual deferral percentage of nonhighly compensated employees.* The elective contributions, compensation, and amounts treated as elective contributions of all family members are disregarded for purposes of determining the actual deferral percentage for the group of nonhighly compensated employees.

(*3*) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation*—(i) *Years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, the term *compensation* means compensation as defined in section 414(s) and §1.414(s)–1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year for purposes of this section. An employer may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year for purposes of this section. See also section 401(a)(17) and §1.401(a)(17)–1(c)(1).

(ii) *Years beginning before January 1, 1987*—(A) *General rule.* An employee's compensation for a plan year beginning before January 1, 1987, or such later date provided under paragraph (h) of this section, is the amount taken into account under the plan (or plans) in calculating the elective contribution that may be made on behalf of the employee. In a plan that is top-heavy (as defined in section 416), compensation may not exceed $200,000. Compensation may not exclude amounts less than a stated amount, such as the integration level under the plan. Compensation

may include all compensation for the plan year, including compensation for the period when an employee was ineligible to make a cash or deferred election.

(B) *Nondiscrimination requirement*—(*1*) If the plan's definition of compensation has the effect of discriminating in favor of employees who are highly compensated, a nondiscriminatory definition shall be determined by the Commissioner.

(*2*) A plan's definition of compensation is treated as nondiscriminatory if the plan defines compensation for a plan year either as—

(*i*) an employee's total nondeferred compensation includible in gross income plus elective contributions under the plan and elective contributions under a plan described in section 125, and/or

(*ii*) an employee's W–2 or total nondeferred compensation includible in gross income.

(3) *Elective contributions.* The term ''elective contribution'' means employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under paragraph (a)(4) of this section). No amount that has become currently available to an employee or that is designated or treated, at the time of deferral or contribution, as an after-tax employee contribution may be treated as an elective contribution. See paragraphs (a)(2) and (a)(3) of this section. See also paragraph (a)(6)(iii) of this section for rules relating to the treatment as elective contributions of certain matching contributions made by partnerships.

(4) *Eligible employee*—(i) *General rule.* The term ''eligible employee'' means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts. An employee who is unable to make a cash or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make a cash or deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See paragraph (e)(5) of this section, however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in paragraphs (a)(3)(iv) and (a)(6)(ii)(C) of this section relating to the definition of a cash or deferred election. In no event is an election made after December 23, 1994 treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

(5) *Employee.* The term *employee* means an employee within the meaning of § 1.410(b)–9.

(6) *Employer*. The term *employer* means the employer within the meaning of § 1.410(b)–9.

(7) *Excess contributions and excess deferrals*—(i) *Excess contributions*. The term ''excess contribution'' means, with respect to a plan year, the excess of the elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions under paragraph (b)(2) of this section, on behalf of eligible highly compensated employees for the plan year over the maximum amount of the contributions permitted under paragraph (b)(2) of this section. The amount of excess contributions for each highly compensated employee is determined by using the method described in paragraph (f)(2) of this section.

(ii) *Excess deferrals*. The term ''excess deferrals'' means excess deferrals as defined in § 1.402(g)–1(e)(3).

(8) *Highly compensated employees*—(i) *Plan years beginning after December 31, 1986*. For plan years beginning after December 31, 1986, or such later date provided under paragraph (h) of this section, the term ''highly compensated employee'' has the meaning provided in section 414(q).

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1987*. For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided under paragraph (h) of this section, for purposes of the actual deferral percentage test, highly compensated employees are the one-third of all eligible employees (rounded to the nearest integer) who receive the most compensation. When one or more employees of a group would be highly compensated employees except that each member of the group receives the same amount of compensation, the employer must designate which employees of the group are highly compensated, so that one-third of all eligible employees are considered highly compensated.

(9) *Matching contributions*. The term ''matching contribution'' means matching contributions as defined in § 1.401(m)–1(f)(12).

(10) *Nonelective contributions*. The term ''nonelective contribution'' means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

(11) *Plan*—(i) *Application of section 410(b) rules*. The term *plan* means a plan within the meaning of § 1.410(b)–7 (a) and (b), after application of the mandatory disaggregation rules of § 1.410(b)–7(c) and the permissive aggregation rules of § 1.410(b)–7(d), with the modifications provided in paragraph (g)(11)(ii) of this section. Thus, for example, two plans (within the meaning of § 1.410(b)–7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of § 1.410(b)–7(d) are treated as a single plan for purposes of section 401(k). See also § 1.401(k)–1(b)(3)(ii).

(ii) *Modifications to section 410(b) rules*—(A) *In general*. For purposes of this paragraph (g)(11), § 1.410(b)–7 (c) and (d) are applied without regard to § 1.410(b)–7(c)(1), relating to section 401(k) and 401(m) plans.

(B) *Plans benefiting collective bargaining unit employees*. A plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in such a collective bargaining unit is treated as comprising separate plans. This paragraph (g)(11)(ii)(B) is generally applied separately with respect to each collective bargaining unit. At the option of the employer, however, two or more separate collective bargaining units can be treated as a single collective bargaining unit, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year. Thus, for example, if a plan benefits employees in three categories—employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in any collective bargaining unit—the plan can be treated as comprising three separate plans, each of which benefits only one category of employees. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated

as comprising only two separate plans, one benefiting all employees who are included in a collective bargaining unit and another benefiting all other employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and employees who are included in collective bargaining unit B, the plan can be treated as comprising two separate plans. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as a single plan. An employee is treated as included in a unit of employees covered by a collective bargaining agreement if and only if the employee is a collectively bargained employee within the meaning of §1.410(b)–6(d)(2).

(C) *Multiemployer plans.* Consistent with section 413(b), the portion of the plan that is maintained pursuant to a collective bargaining agreement (within the meaning of §1.413–1(a)(2)) is treated as a single plan maintained by a single employer that employs all the employees benefiting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The rules of paragraph (g)(11)(ii)(B) of this section (including the optional aggregation of collective bargaining units) apply to the resulting deemed single plan in the same manner as they would to a single employer plan, except that the plan administrator is substituted for the employer where appropriate and appropriate fiduciary obligations are taken into account. The noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the noncollective bargaining unit employees who benefit under the plan are employed by one or more employers.

(12) *Pre-ERISA money purchase pension plan*—(i) A pre-ERISA money purchase pension plan is a pension plan:

(A) That is a defined contribution plan (as defined in section 414(i));

(B) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement described in paragraph (a)(3)(i) of this section; and

(C) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(ii) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

(13) *Qualified matching contributions and qualified nonelective contributions*—(i) *Qualified matching contributions.* The term ''qualified matching contribution'' means matching contributions that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(ii) *Qualified nonelective contributions.* The term ''qualified nonelective contribution'' means employer contributions, other than elective contributions and matching contributions, that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(iii) *Additional requirements.* Except to the extent that paragraphs (c) and (d) of this section specifically provide otherwise, the matching contributions and the nonelective contributions must satisfy the requirements of paragraphs (c) and (d) of this section as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account as elective contributions under paragraph (b)(2) of this section. Thus, the matching and nonelective contributions must satisfy the vesting requirements of paragraph (c) of this section and be subject to the distribution requirements of paragraph (d) of this section when they are contributed to the plan. See §1.401(k)–1(f)(5)(iii) for rules regarding matching contributions not treated as forfeitable under section 411(a)(3)(G) because of excess deferrals or contributions.

(14) *Rural cooperative plan.* For purposes of this section, a rural cooperative plan is a plan described in section 401(k)(7).

(15) *Section 401(k) plan.* The term *section 401(k) plan* means a section 401(k) plan within the meaning of §1.410(b)–9.

(16) *Section 401(m) plan.* The term *section 401(m) plan* means a section 401(m) plan within the meaning of §1.401(b)–9.

(h) *Effective dates*—(1) *General rule*. Except as otherwise provided in this paragraph (h) or as specifically provided elsewhere in this section, this section applies to plan years beginning after December 31, 1979.

(2) *Collectively bargained plans*. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986:

(i) The provisions of this section first effective for plan years beginning after December 31, 1986, do not apply to years that begin before the earlier of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

(ii) The provisions of this section first effective for plan years beginning after December 31, 1988, do not apply to years beginning before the earlier of:

(A) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986); or

(B) January 1, 1991.

(3) *Transition rules*—(i) *Cash or deferred arrangements in existence on June 27, 1974*. See §1.402(a)–1(d)(3)(ii) for a transition rule applicable to cash or deferred arrangements in existence on June 27, 1974.

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1992*. For plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a cash or deferred arrangement was qualified during those years.

(iii) *Restructuring*—(A) *General rule*. In determining whether the requirements of section 401(k) are satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and other benefits, rights, and features provided to a group of employees under the plan. See §1.401(a)(4)–9(c). An employee may not be included in more than one component plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(k) are applied separately with respect to each component plan for the plan year. Thus, for example, the actual deferral ratio and the amount of excess contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(k). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans*—(*1*) *Minimum coverage requirement*. The group of eligible employees described in §1.401(k)–1(g)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(*2*) *Commonality requirement*. The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual deferral ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method, e.g., salaried or hourly, coverage under the same contribution formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under §1.410(b)–4(b). Employees whose only common attribute is the same or similar actual deferral ratios, or another attribute having substantially the same effect as the same or similar actual deferral ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

(4) *State and local government plans*—(i) *Plans adopted before May 6, 1986*. A

plan adopted by a state or local government prior to May 6, 1986, is subject to the transitional rules of paragraph (h)(4) (ii) or (iii) of this section.

(ii) *Plan years beginning before January 1, 1996.* (A) The plan does not fail to satisfy the requirements of section 401(a) merely because of the nonqualified cash or deferred arrangement.

(B) Employer contributions under the nonqualified cash or deferred arrangement are considered to satisfy the requirements of section 401(a)(4).

(C) Except as provided in paragraphs (a)(7) and (f) of this section, elective contributions under the arrangement are treated as employer contributions under the Internal Revenue Code of 1986, as if the arrangement were a qualified cash or deferred arrangement. See §1.401(k)–1(a)(4)(ii). See §1.402(a)–1(d) for rules governing when elective contributions under the arrangement are includible in an employee's gross income.

(iii) *Collectively bargained plans.* The transition rules in paragraph (h)(4)(ii) of this section apply to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers and adopted by a state or local government before May 6, 1986, effective on the date the provisions of section 401(k) and this section would be effective under paragraph (h)(2) of this section.

[T.D. 8357, 56 FR 40517, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63432, Dec. 4, 1991; T.D. 8357, 57 FR 10289, 10290, Mar. 25, 1992; 58 FR 14151, Mar. 16, 1993; T.D. 8581, 59 FR 66169, Dec. 23, 1994; T.D. 8581, 60 FR 12416, Mar. 7, 1995; T.D. 8581, 60 FR 15874, Mar. 28, 1995; T.D. 8581, 60 FR 25140, May 11, 1995]

§1.401(l)–0 Table of contents.

This section contains a listing of the headings of §§1.401(l)–1 through 1.401(l)–6.

§1.401(l)–1 Permitted disparity with respect to employer-provided contributions or benefits.

(a) Permitted disparity.
(1) In general.
(2) Overview.
(3) Exclusive rules.
(4) Exceptions.
(5) Additional rules.
(b) Relationship to other requirements.
(c) Definitions.
(1) Accumulation plan.
(2) Average annual compensation.
(3) Base benefit percentage.
(4) Base contribution percentage.
(5) Benefit formula.
(6) Benefit, right, or feature.
(7) Covered compensation.
(i) In general.
(ii) Special rules.
(A) Rounded table.
(B) Proposed regulation definition.
(iii) Period for using covered compensation amount.
(8) Defined benefit plan.
(9) Defined contribution plan.
(10) Disparity.
(11) Employee.
(12) Employer.
(13) Employer contributions.
(14) Excess benefit percentage.
(15) Excess contribution percentage.
(16) Excess plan.
(i) Defined benefit excess plan.
(ii) Defined contribution excess plan.
(17) Final average compensation.
(i) In general.
(ii) Limitations.
(iii) Determination of section 414(s) compensation.
(18) Gross benefit percentage.
(19) Highly compensated employee.
(20) Integration level.
(21) Nonexcludable employee.
(22) Nonhighly compensated employee.
(23) Offset level.
(24) Offset percentage.
(25) Offset plan.
(26) PIA.
(27) Plan.
(28) Plan year compensation.
(29) Qualified plan.
(30) Section 401(l) plan.
(31) Section 414(s) compensation.
(32) Social security retirement age.
(33) Straight life annuity.
(34) Taxable wage base.
(35) Year of service.

§1.401(l)–2 Permitted disparity for defined contribution plans.

(a) Requirements.
(1) In general.
(2) Excess plan requirement.
(3) Maximum disparity.
(4) Uniform disparity.
(5) Integration level.
(b) Maximum permitted disparity.
(1) In general.
(2) Maximum excess allowance.
(c) Uniform disparity.
(1) In general.
(2) Deemed uniformity.
(i) In general.
(ii) Overall permitted disparity.
(iii) Non-FICA employees.
(d) Integration level.
(1) In general.
(2) Taxable wage base.

(3) Single dollar amount.
(4) Intermediate amount.
(5) Prorated integration level for short plan year.
(e) Examples.

§ 1.401(l)–3 Permitted disparity for defined benefit plans.

(a) Requirements.
(1) In general.
(2) Excess or offset plan requirement.
(3) Maximum disparity.
(4) Uniform disparity.
(5) Integration or offset level.
(6) Benefits, rights, and features.
(b) Maximum permitted disparity.
(1) In general.
(2) Maximum excess allowance.
(3) Maximum offset allowance.
(4) Rules of application.
(i) Disparity provided for the plan year.
(ii) Reductions in disparity rate.
(iii) Normal and optional forms of benefit.
(A) In general.
(B) Level annuity forms.
(C) Other forms.
(D) Post-retirement cost-of-living adjustments.
(*1*) In general.
(*2*) Requirements.
(E) Section 417(e) exception.
(5) Examples.
(c) Uniform disparity.
(1) In general.
(2) Deemed uniformity.
(i) In general.
(ii) Use of fractional accrual and disparity for 35 years.
(iii) Use of fractional accrual and disparity for fewer than 35 years.
(iv) Different social security retirement ages.
(v) Reduction for integration level.
(vi) Overall permitted disparity.
(A) In general.
(B) Unit credit plans.
(C) Fractional accrual plans.
(vii) Non-FICA employees.
(viii) Average annual compensation adjustment for offset plan.
(ix) PIA offsets.
(3) Examples.
(d) Requirements for integration level or offset compensation.
(1) In general.
(2) Covered compensation.
(3) Uniform percentage of covered compensation.
(4) Single dollar amount.
(5) Intermediate amount.
(6) Intermediate amount safe harbor.
(7) Prorated integration level for short plan year.
(8) Demographic requirements.
(i) In general.
(ii) Attained age requirement.
(iii) Nondiscrimination requirement.
(A) Minimum percentage test.
(B) Ratio test.
(C) High dollar amount test.
(D) Individual disparity reductions.
(9) Reduction in the 0.75–percent factor if integration or offset level exceeds covered compensation.
(i) In general.
(ii) Uniform percentage of covered compensation.
(iii) Single dollar amount.
(A) Plan-wide reduction.
(B) Individual reductions.
(iv) Reductions.
(A) Table.
(B) Interpolation.
(10) Examples.
(e) Adjustments to the 0.75-percent factor for benefits commencing at ages other than social security retirement age.
(1) In general.
(2) Adjustments.
(i) Benefits commencing on or after age 55 and before social security retirement age.
(ii) Benefits commencing after social security retirement age and on or before age 70.
(iii) Benefits commencing before age 55.
(iv) Benefits commencing after age 70.
(3) Tables.
(4) Benefit commencement date.
(i) In general.
(ii) Qualified social security supplement.
(5) Examples.
(f) Benefits, rights, and features.
(1) Defined benefit excess plan.
(2) Offset plan.
(3) Examples.
(g) No reductions in 0.75-percent factor for ancillary benefits.
(h) Benefits attributable to employee contributions not taken into account.
(i) Multiple integration levels. [Reserved]
(j) Additional rules.

§ 1.401(l)–4 Special rules for railroad plans.

(a) In general.
(b) Defined contribution plans.
(1) In general.
(2) Single integration level method.
(i) In general.
(ii) Definitions.
(3) Two integration level method.
(i) In general.
(ii) Total disparity requirement.
(iii) Intermediate disparity requirement.
(iv) Definitions.
(c) Defined benefit excess plans.
(1) In general.
(2) Single integration level method.
(i) In general.
(ii) Definitions.
(3) Two integration level method.
(i) In general.
(ii) Employee with lower covered compensation.
(iii) Employee with lower railroad retirement covered compensation.

(iv) Definitions.
(d) Offset plans.
(1) In general.
(2) Maximum tier 2 and supplementary annuity offset allowance.
(e) Additional rules.
(1) Definitions.
(2) Adjustments to 0.75-percent factor.
(3) Adjustments to 0.56-percent factor.
(4) Overall permitted disparity.

§ 1.401(l)–5 Overall permitted disparity limits.

(a) Introduction.
(1) In general.
(2) Plan requirements.
(3) Plans taken into account.
(b) Annual overall permitted disparity limit.
(1) In general.
(2) Total annual disparity fraction.
(3) Annual defined contribution plan disparity fraction.
(4) Annual defined benefit excess plan disparity fraction.
(5) Annual offset plan disparity fraction.
(i) In general.
(ii) PIA offset plans.
(6) Annual imputed disparity fraction.
(7) Annual nondisparate fraction.
(8) Determination of fraction.
(i) General rule
(ii) Multiple formulas.
(iii) Offset arrangements.
(A) In general.
(B) Defined benefit plans.
(C) Defined contribution plans.
(iv) Applicable percentages.
(v) Fractional accrual plans.
(9) Examples.
(c) Cumulative permitted disparity limit.
(1) In general.
(i) Employees who benefit under defined benefit plans.
(ii) Employees who do not benefit under defined benefit plans.
(iii) Certain plan years disregarded.
(iv) Determination of type of plan.
(v) Applicable plan years.
(vi) Transition rule for defined contribution plans.
(2) Cumulative disparity fraction.
(3) Determination of total annual disparity fractions for prior years.
(4) Special rules for greater of formulas and offset arrangements.
(i) Greater of formulas.
(A) In general.
(B) Separate satisfaction by formulas.
(C) Single plan.
(ii) Offset arrangements.
(A) In general.
(B) Separate satisfaction by plans.
(C) No other plan.
(5) Examples.
(d) Additional rules.

§ 1.401(l)–6 Effective dates and transition rules.

(a) Statutory effective date.
(1) In general.
(2) Collectively bargained plans.
(b) Regulatory effective date.
(1) In general.
(2) Plans of tax-exempt organizations.
(3) Defined contribution plans.
(4) Defined benefit plans.
(c) Compliance during transition period.

[T.D. 8359, 56 FR 47617, Sept. 19, 1991; 57 FR 10818, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46830, Sept. 3, 1993]

§ 1.401(l)–1 Permitted disparity in employer-provided contributions or benefits.

(a) *Permitted disparity*—(1) *In general.* Section 401(a)(4) provides that a plan is a qualified plan only if the amount of contributions or benefits provided under the plan does not discriminate in favor of highly compensated employees. See § 1.401(a)(4)–1(b)(2). Section 401(a)(5)(C) provides that a plan does not discriminate in favor of highly compensated employees merely because of disparities in employer-provided contributions or benefits provided to, or on behalf of, employees under the plan that are permitted under section 401(l). Thus, if a plan satisfies section 401(l), permitted disparities in employer-provided contributions or benefits under a plan are disregarded, by reason of section 401(a)(5)(C), in determining whether the plan satisfies any of the safe harbors under §§ 1.401(a)(4)–2(b)(2) and 1.401(a)(4)–3(b). However, even if disparities in employer-provided contributions or benefits under a plan are permitted under section 401(l) and thus do not cause the plan to fail to satisfy § 1.401(a)(4)–1(b)(2), the plan may still fail to satisfy section 401(a)(4) for other reasons. Similarly, even if disparities in employer-provided contributions or benefits under a plan are not permitted under section 401(l) and thus may not be disregarded under section 401(a)(4) by reason of section 401(l), the plan may still be found to be nondiscriminatory under the tests of section 401(a)(4), including the rules for imputing permitted disparity under § 1.401(a)(4)–7.

(2) *Overview.* Rules relating to disparities in employer-provided contributions under a defined contribution plan

are provided in § 1.401(l)–2. For rules relating to disparities in employer-provided benefits under a defined benefit plan, see § 401(l)–3. For rules relating to the application of section 401(l) to a plan maintained by a railroad employer, see § 1.401(l)–4. For rules relating to the overall permitted disparity limits, see § 1.401(l)–5. For rules relating to the effective date of section 401(l), see § 1.401(l)–6.

(3) *Exclusive rules.* The rules provided in §§ 1.401(l)–1 through 1.401(l)–6 are the exclusive means for a plan to satisfy sections 401(l) and 401(a)(5)(C). Accordingly, a plan that provides disparities in employer-provided contributions or benefits that are not permitted under §§ 1.401(l)–1 through 1.401(l)–6 does not satisfy section 401(l) or 401(a)(5)(C).

(4) *Exceptions.* Sections 401(a)(5)(C) and 401(l) are not available in the following arrangements—

(i) A plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(ii) A plan, or the portion of a plan, that is an employee stock ownership plan described in section 4975(e)(7) (an ESOP) or a tax credit employee stock ownership plan described in section 409(a) (a TRASOP), except as provided in § 54.4975–11(a)(7)(ii) of this chapter, which contains a limited exception to this rule for certain ESOPs in existence on November 1, 1977.

(iii) With respect to elective contributions as defined in § 1.401(k)–1(g)(3) under a qualified cash or deferred arrangement as defined in § 1.401(k)–1(a)(4)(i) or with respect to employee or matching contributions defined in § 1.401(m)–1(f)(6) or (f)(12), respectively.

(iv) With respect to contributions to a simplified employee pension made under a salary reduction arrangement described in section 408(k)(6) (a SARSEP).

(5) *Additional rules.* The Commissioner may, in revenue rulings, notices, or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of section 401(l), including rules applying section 401(l) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not other years.

(b) *Relationship to other requirements.* Unless explicitly provided otherwise, section 401(l) does not provide an exception to any other requirement under section 401(a). Thus, for example, even if the plan complies with section 401(l), the plan may not provide a benefit lower than the minimum benefit required under section 416. Moreover, a plan may not adjust benefits in any manner that results in a decrease in any employee's accrued benefit in violation of section 411(d)(6) and section 411(b)(1)(G). However, a plan does not fail to satisfy section 401(l) merely because, in order to ensure compliance with section 411, an employee's accrued benefit under the plan is defined as the greater of the employee's previously accrued benefit and the benefit determined under a strict application of the plan's benefit formula and accrual method. See section 401(a)(15) for additional rules relating to circumstances under which plan benefits may not be decreased because of increases in social security benefits.

(c) *Definitions.* In applying §§ 1.401(l)–1 through 1.401(l)–6, the definitions in this paragraph (c) govern unless otherwise provided.

(1) *Accumulation plan. Accumulation plan* means an accumulation plan within the meaning of § 1.401(a)(4)–12.

(2) *Average annual compensation. Average annual compensation* means average annual compensation within the meaning of § 1.401(a)(4)–3(e)(2).

(3) *Base benefit percentage. Base benefit percentage* means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation at or below the integration level (expressed as a

percentage of such average annual compensation).

(4) *Base contribution percentage. Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(5) *Benefit formula. Benefit formula* means benefit formula within the meaning of § 1.401(a)(4)–12.

(6) *Benefit, right, or feature. Benefit, right, or feature* means a benefit, right, or feature within the meaning of § 1.401(a)(4)–12.

(7) *Covered compensation*—(i) *In general. Covered compensation* for an employee means the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee's covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year. An employee's covered compensation for a plan year beginning after the 35-year period applicable under this paragraph (c)(7)(i) is the employee's covered compensation for the plan year during which the 35-year period ends. An employee's covered compensation for a plan year beginning before the 35-year period applicable under this paragraph (c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

(ii) *Special rules*—(A) *Rounded table.* For purposes of determining the amount of an employee's covered compensation under paragraph (c)(7)(i) of this section, a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

(B) *Proposed regulation definition.* For plan years beginning before January 1, 1995, in lieu of the definition of covered compensation contained in paragraph (c)(7)(i) of this section, a plan may define covered compensation as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year preceding the calendar year in which the employee attains (or will attain) social security retirement age.

(iii) *Period for using covered compensation amount.* A plan must generally provide that an employee's covered compensation is automatically adjusted for each plan year. However, a plan may use an amount of covered compensation for employees equal to each employee's covered compensation (as defined in paragraph (c)(7)(i) or (c)(7)(ii) of this section) for a plan year earlier than the current plan year, provided the earlier plan year is the same for all employees and is not earlier than the later of—

(A) The plan year that begins 5 years before the current plan year, and

(B) The plan year beginning in 1989.

In the case of an accumulation plan, the benefit accrued for an employee in prior years is not affected by changes in the employee's covered compensation that occur in later years.

(8) *Defined benefit plan. Defined benefit plan* means a defined benefit plan within the meaning of § 1.410(b)–9.

(9) *Defined contribution plan. Defined contribution plan* means a defined contribution plan within the meaning of § 1.410(b)–9. In addition, for purposes of §§ 1.401(l)–1 through 1.401(l)–6, a defined contribution plan includes a simplified employee pension as defined in section 408(k) (SEP), other than a SEP (or portion or a SEP) that is a salary reduction arrangement described in section 408(k)(6) (SARSEP).

(10) *Disparity. Disparity* means—

(i) In the case of a defined contribution excess plan, the amount by which the excess contribution percentage exceeds the base contribution percentage,

(ii) In the case of a defined benefit excess plan, the amount by which the excess benefit percentage exceeds the base benefit percentage, and

(iii) In the case of an offset plan, the offset percentage.

(11) *Employee*. *Employee* means employee within the meaning of § 1.401(a)(4)–12.

(12) *Employer*. *Employer* means the employer within the meaning of § 1.410(b)–9.

(13) *Employer contributions*. *Employer contributions* means all amounts taken into account with respect to an employee under a plan under § 1.401(a)(4)–2(c)(2)(ii).

(14) *Excess benefit percentage*. *Excess benefit percentage* means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation above the integration level (expressed as a percentage of such average annual compensation).

(15) *Excess contribution percentage*. *Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation above the integration level (expressed as a percentage of such plan year compensation).

(16) *Excess plan*—(i) *Defined benefit excess plan*. *Defined benefit excess plan* means a defined benefit plan under which the rate at which employer-provided benefits are determined with respect to average annual compensation above the integration level under the plan (expressed as a percentage of such average annual compensation) is greater than the rate at which employer-provided benefits are determined with respect to average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(ii) *Defined contribution excess plan*. *Defined contribution excess plan* means a defined contribution plan under which the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation above the integration level (expressed as a percentage of such plan year compensation) is greater than the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(17) *Final average compensation*—(i) *In general*. *Final average compensation* for an employee means the average of the employee's annual section 414(s) compensation for the 3-consecutive-year period ending with or within the plan year or for the employee's period of employment if shorter. The year in which an employee terminates employment may be disregarded in determining final average compensation. The definition of final average compensation used in the plan must be applied consistently with respect to all employees. For example, if the plan provides that the year in which the employee terminates employment is disregarded in determining final average compensation, the year must be disregarded for all employees who terminate employment in that year. The plan may specify any 3-consecutive-year period ending in the plan year, provided the period is determined consistently for all employees. See § 1.401(a)(4)–11(d)(3)(iii) and § 1.414(s)–1(f) for rules permitting service and compensation with another employer to be taken into account for purposes of nondiscrimination testing, including satisfying section 401(l).

(ii) *Limitations*. In determining an employee's final average compensation under this paragraph (c)(17), annual section 414(s) compensation for any year in excess of the taxable wage base in effect at the beginning of that year must not be taken into account. A plan may provide that each employee's final average compensation for a plan year is limited to the employee's average annual compensation for the plan year.

(iii) *Determination of section 414(s) compensation*. A plan must use the same definition of section 414(s) compensation to determine final average compensation as the plan uses to determine average annual compensation (or plan year compensation in the case of an accumulation plan).

(18) *Gross benefit percentage*. *Gross benefit percentage* means the rate at which employer-provided benefits are determined under an offset plan (before application of the offset) with respect to

an employee's average annual compensation (expressed as a percentage of average annual compensation).

(19) *Highly compensated employee. Highly compensated employee* means HCE within the meaning of § 1.401(a)(4)–12.

(20) *Integration level. Integration level* means the dollar amount specified in an excess plan at or below which the rate of employer-provided contributions or benefits (expressed in each case as a percentage of an employee's plan year compensation or average annual compensation up to the specified dollar amount) under the plan is less than the rate of employer-provided contributions or benefits (expressed in each case as a percentage of the employee's plan year compensation or average annual compensation above the specified dollar amount) under the plan above such dollar amount.

(21) *Nonexcludable employee. Nonexcludable employee* means nonexcludable employee within the meaning of § 1.401(a)(4)–12.

(22) *Nonhighly compensated employee. Nonhighly compensated employee* means NHCE within the meaning of § 1.401(a)(4)–12.

(23) *Offset level. Offset level* means the dollar limit specified in the plan on the amount of each employee's final average compensation taken into account in determining the offset under an offset plan.

(24) *Offset percentage. Offset percentage* means the rate at which an employee's employer-provided benefit is reduced or offset under an offset plan (expressed as a percentage of the employee's final average compensation up to the offset level).

(25) *Offset plan. Offset plan* means a defined benefit plan that is not a defined benefit excess plan and that provides that each employee's employer-provided benefit is reduced or offset by a specified percentage of the employee's final average compensation up to the offset level under the plan.

(26) *PIA. PIA* or *primary insurance amount* means the old-age insurance benefit under section 202 of the Social Security Act (42 U.S.C. 402) payable to each employee at a single age that is not earlier than age 62 and not later than age 65. PIA must be determined under the Social Security Act as in effect at the time the employee's offset is determined. Thus, it is determined without assuming any future increases in compensation, any future increases in the taxable wage base, any changes in the formulas used under the Social Security Act to determine PIA (for example, changes in the breakpoints), or any future increases in the consumer price index. However, it may be assumed that the employee will continue to receive compensation at the same rate as that received at the time the offset is being determined, until reaching the single age described in the first sentence of this paragraph (c)(26). PIA must be determined in a consistent manner for all employees and in accordance with revenue rulings or other guidance provided by the Commissioner.

(27) *Plan. Plan* means a plan within the meaning of § 1.401(a)(4)–12 or a component plan treated as a plan under § 1.401(a)(4)–9(c).

(28) *Plan year compensation. Plan year compensation* means plan year compensation within the meaning of § 1.401(a)(4)–12.

(29) *Qualified plan. Qualified plan* means a qualified plan within the meaning of § 1.401(a)(4)–12.

(30) *Section 401(l) plan. Section 401(l) plan* means a section 401(l) plan within the meaning of § 1.401(a)(4)–12.

(31) *Section 414(s) compensation. Section 414(s) compensation* means section 414(s) compensation within the meaning of § 1.401(a)(4)–12.

(32) *Social security retirement age. Social security retirement age* for an employee means the social security retirement age of the employee as determined under section 415(b)(8).

(33) *Straight life annuity. Straight life annuity* means a straight life annuity within the meaning of § 1.401(a)(4)–12.

(34) *Taxable wage base. Taxable wage base* means the contribution and benefit base under section 230 of the Social Security Act (42 U.S.C. 430).

(35) *Year of service. Year of service* means a year of service as defined in the plan for purposes of the benefit formula and the accrual method under the plan, unless the context clearly indicates otherwise. See § 1.401(a)(4)–11(d)(3) for rules on years of service that may

be taken into account for purposes of nondiscrimination testing, including satisfying section 401(l).

[T.D. 8359, 56 FR 47618, Sept. 19, 1991; 57 FR 10818, 10951, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46831, Sept. 3, 1993]

§ 1.401(l)–2 Permitted disparity for defined contribution plans.

(a) *Requirements*—(1) *In general.* Disparity in the rates of employer contributions allocated to employees' accounts under a defined contribution plan is permitted under section 401(l) and this section for a plan year only if the plan satisfies paragraphs (a)(2) through (a)(5) of this section. A plan that otherwise satisfies this paragraph (a) will not be considered to fail section 401(l) merely because it contains one or more provisions described in § 1.401(a)(4)–2(b)(4). See § 1.401(a)(4)–8(b)(3)(i)(C) for special rules applicable to target benefit plans.

(2) *Excess plan requirement.* The plan must be a defined contribution excess plan.

(3) *Maximum disparity.* The disparity for all employees under the plan must not exceed the maximum permitted disparity prescribed in paragraph (b) of this section.

(4) *Uniform disparity.* The disparity for all employees under the plan must be uniform within the meaning of paragraph (c) of this section.

(5) *Integration level.* The integration level specified in the plan must satisfy paragraph (d) of this section.

(b) *Maximum permitted disparity*—(1) *In general.* The disparity provided for the plan year must not exceed the maximum excess allowance as defined in paragraph (b)(2) of this section. In addition, the plan must satisfy the overall permitted disparity limits of § 1.401(l)–5.

(2) *Maximum excess allowance.* The maximum excess allowance for a plan year is the lesser of—

(i) The base contribution percentage, or

(ii) The greater of—

(A) 5.7 percent, reduced as required under paragraph (d) of this section, or

(B) The percentage rate of tax under section 3111(a), in effect as of the beginning of the plan year, that is attributable to the old age insurance portion of the Old Age, Survivors and Disability Insurance provisions of the Social Security Act, reduced as required under paragraph (d) of this section. For a year in which the percentage rate of tax described in this paragraph (b)(2)(ii)(B) exceeds 5.7 percent, the Commissioner will publish the rate of such tax and a revised table under paragraph (d)(4) of this section.

(c) *Uniform disparity*—(1) *In general.* The disparity provided under a plan is uniform only if the plan uses the same base contribution percentage and the same excess contribution percentage for all employees in the plan.

(2) *Deemed uniformity*—(i) *In general.* The disparity under a plan does not fail to be uniform for purposes of this paragraph (c) merely because the plan contains one or more of the provisions described in paragraphs (c)(2) (ii) and (iii) of this section.

(ii) *Overall permitted disparity.* The plan provides that, in the case of each employee who has reached the cumulative permitted disparity limit applicable to the employee under § 1.401(l)–5(c), employer contributions are allocated to the account of the employee with respect to the employee's total plan year compensation at the excess contribution percentage.

(iii) *Non-FICA employees.* The plan provides that, in the case of each employee under the plan with respect to whom none of the taxes under section 3111(a), section 3221, or section 1401 is required to be paid, employer contributions are allocated to the account of the employee with respect to the employee's total plan year compensation at the excess contribution percentage.

(d) *Integration level*—(1) *In general.* The integration level under the plan must satisfy paragraph (d)(2), (d)(3), or (d)(4) of this section, as modified by paragraph (d)(5) of this section in the case of a short plan year. If a reduction applies to the disparity factor under this paragraph (d), the reduced factor is used for all purposes in determining whether the permitted disparity rules for defined contribution plans are satisfied.

(2) *Taxable wage base.* The requirement of this paragraph (d)(2) is satisfied only if the integration level under

the plan for each employee is the taxable wage base in effect as of the beginning of the plan year.

(3) *Single dollar amount.* The requirement of this paragraph (d)(3) is satisfied only if the integration level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that does not exceed the greater of $10,000 or 20 percent of the taxable wage base in effect as of the beginning of the plan year.

(4) *Intermediate amount.* The requirement of this paragraph (d)(4) is satisfied only if—

(i) The integration level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that is greater than the highest amount determined under paragraph (d)(3) of this section and less than the taxable wage base, and

(ii) The plan adjusts the factor determined under paragraph (b)(2)(ii) of this section in accordance with the table below.

TABLE

If the integration level		The 5.7 percent factor in the maximum excess allowance is reduced to—
Is more than	But not more than	
Greater of $10,000 or 20% of taxable wage base.	80% of taxable wage base.	4.3%
80% of taxable wage base.	Amount less than taxable wage base.	5.4%

(5) *Prorated integration level for short plan year.* If a plan uses paragraph (2) or (4) of the definition of plan year compensation under § 1.401(a)(4)–12 (i.e., section 414(s) compensation for the plan year or the period of plan participation) and has a plan year that comprises fewer than 12 months, the integration level under the plan for each employee must be an amount equal to the otherwise applicable integration level described in paragraph (d)(2), (d)(3), or (d)(4) of this section, multiplied by a fraction, the numerator of which is the number of months in the plan year, and the denominator of which is 12. No adjustment to the maximum excess allowance is required as a result of the application of this paragraph (d)(5), other than any adjustment already required under paragraph (d)(4) of this section.

(e) *Examples.* The following examples illustrate this section. In each example, 5.7 percent exceeds the percentage rate of tax described in paragraph (b)(2)(ii)(B) of this section.

Example 1. Employer X maintains a profit-sharing plan with the calendar year as its plan year. For the 1989 plan year, the plan provides that the account of each employee who has plan year compensation in excess of the taxable wage base in effect at the beginning of the plan year will receive an allocation for the plan year of 5.7 percent of plan year compensation in excess of the taxable wage base. The plan provides that no allocation will be made to the account of any employee for the plan year with respect to plan year compensation not in excess of the taxable wage base. The maximum excess allowance is exceeded for the 1989 plan year because the excess contribution percentage (5.7 percent) for the plan year exceeds the base contribution percentage (0 percent) for the plan year by more than the lesser of the base contribution percentage (0 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 2. Employer Y maintains a money purchase pension plan with the calendar year as its plan year. For the 1990 plan year, the plan provides that the account of each employee will receive an allocation of 5 percent of the employee's plan year compensation up to the taxable wage base in effect at the beginning of the plan year plus an allocation of 10 percent of the employee's plan year compensation in excess of the taxable wage base. The maximum excess allowance is not exceeded for the plan year because the excess contribution percentage (10 percent) for the plan year does not exceed the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 3. Assume the same facts as in *Example 2,* except that the plan provides that, with respect to plan year compensation in excess of the taxable wage base, the account of each employee will receive an allocation for the plan year of 12 percent of such compensation. The maximum excess allowance is exceeded for the plan year because the excess contribution percentage (12 percent) for the plan year exceeds the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 4. Employer Z maintains a money purchase pension plan with a plan year beginning July 1 and ending June 30. The taxable wage base for the 1990 calendar year is $51,300 and the taxable wage base for the 1991 calendar year is $53,400. For the plan year beginning July 1, 1990, and ending June 30, 1991, the plan provides that the account of each employee will receive an allocation of 4 percent of the employee's plan year compensation up to $53,400 plus an allocation of 6 percent of the employee's plan year compensation in excess of $53,400. Although the excess contribution percentage (6 percent) for the plan year does not exceed the base contribution percentage (4 percent) for the plan year by more than the lesser of the base contribution percentage (4 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent), the plan does not satisfy paragraph (a)(5) of this section because the integration level of $53,400 exceeds the maximum permitted integration level of $51,300 (the taxable wage base in effect as of the beginning of the plan year).

Example 5. Assume the same facts as in *Example 4*, except that for the plan year beginning July 1, 1990, and ending June 30, 1991, the plan provides that the account of each employee will receive an allocation of 5 percent of the employee's plan year compensation up to $30,000 plus an allocation of 9 percent of the employee's plan year compensation in excess of $30,000. The integration level of $30,000 is 58 percent of the taxable wage base of $51,300 for the 1990 calendar year. The maximum excess allowance is not exceeded for the plan year because the excess contribution percentage (9 percent) for the plan year does not exceed the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraphs (b)(2)(ii) and (d) of this section (4.3 percent) for the plan year.

[T.D. 8359, 56 FR 47621, Sept. 19, 1991; 57 FR 10818, 10951, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46832, Sept. 3, 1993]

§ 1.401(l)–3 Permitted disparity for defined benefit plans.

(a) *Requirements*—(1) *In general.* Disparity in the rates of employer-provided benefits under a defined benefit plan is permitted under section 401(l) and this section for a plan year only if the plan satisfies paragraphs (a)(2) through (a)(6) of this section. A plan that otherwise satisfies this paragraph (a) will not be considered to fail section 401(l) merely because it contains one or more provisions described in § 1.401(a)(4)–3(b)(6) (such as multiple formulas). Section 401(a)(5)(D) and § 1.401(a)(5)–1(d) provide other rules under which benefits provided under a defined benefit plan (including defined benefit excess and offset plans) may be limited. See § 1.401(a)(4)–3(b)(5)(viii) for special rules under which an insurance contract plan may satisfy § 1.401(a)(4)–1(b)(2) and section 401(l). See § 1.401(a)(4)–8(c)(3)(iii)(B) for special rules applicable to cash balance plans.

(2) *Excess or offset plan requirement.* The plan must be a defined benefit excess plan or an offset plan.

(3) *Maximum disparity.* The disparity for all employees under the plan must not exceed the maximum permitted disparity prescribed in paragraph (b) of this section.

(4) *Uniform disparity.* The disparity for all employees under the plan must be uniform within the meaning of paragraph (c) of this section.

(5) *Integration or offset level.* The integration or offset level specified in the plan must satisfy paragraph (d) of this section.

(6) *Benefits, rights, and features.* The benefits, rights, and features provided under the plan must satisfy paragraph (f)(1) of this section.

(b) *Maximum permitted disparity*—(1) *In general.* In the case of a defined benefit excess plan, the disparity provided for the plan year may not exceed the maximum excess allowance as defined in paragraph (b)(2) of this section. In the case of an offset plan, the disparity provided for the plan year may not exceed the maximum offset allowance as defined in paragraph (b)(3) of this section. In addition, either type of plan must satisfy the overall permitted disparity limits of § 1.401(l)–5.

(2) *Maximum excess allowance.* The maximum excess allowance for a plan year is the lesser of—

(i) 0.75 percent, reduced as required under paragraphs (d) and (e) of this section, or

(ii) The base benefit percentage for the plan year.

(3) *Maximum offset allowance.* The maximum offset allowance for a plan year is the lesser of—

(i) 0.75 percent, reduced as required under paragraphs (d) and (e) of this section, or

(ii) One-half of the gross benefit percentage, multiplied by a fraction (not to exceed one), the numerator of which is the employee's average annual compensation, and the denominator of which is the employee's final average compensation up to the offset level.

(4) *Rules of application*—(i) *Disparity provided for the plan year.* Disparity provided for the plan year generally means the disparity provided under the plan's benefit formula for the employee's year of service with respect to the plan year. However, if a plan determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), disparity provided under the plan also means the disparity in the benefit accrued for the employee for the plan year. Thus, a plan using the fractional accrual method must satisfy this paragraph (b) with respect to the plan's benefit formula and with respect to the benefits accrued for the plan year.

(ii) *Reduction in disparity rate.* Any reductions in the 0.75–percent factor required under paragraphs (d) and (e) of this section are cumulative.

(iii) *Normal and optional forms of benefit*—(A) *In general.* A plan satisfies the maximum permitted disparity requirement of this paragraph (b) only if the plan satisfies this paragraph (b) with respect to each optional form of benefit (including the normal form of benefit) provided under the plan.

(B) *Level annuity forms.* In the case of an optional form of benefit payable as a level annuity over a period of not less than the life of the employee, the optional form must satisfy the maximum permitted disparity requirement of this paragraph (b). Thus, for example, if the form of a defined benefit plan's normal retirement benefit is an annuity for life with a 10-year certain feature and the plan permits employees to elect an optional form of benefit in the form of a straight life annuity, the plan must satisfy the maximum disparity requirement of this paragraph (b) with respect to each of the optional forms of benefit. An annuity that decreases only after the death of the employee, or that decreases only after the death of either the employee or the joint annuitant, is considered a level annuity for purposes of this paragraph (b).

(C) *Other forms.* In the case of an optional form of benefit that is not described in paragraph (b)(4)(iii)(B) of this section, the optional form must satisfy the maximum permitted disparity requirement of this paragraph (b), when the respective portions of the optional form are normalized under the rules of § 1.401(a)(4)–12 to a straight life annuity commencing at the same time as the optional form of benefit, regardless of whether the straight life annuity form is actually provided under the plan. In the case of a defined benefit excess plan, the respective portions are the portion of the optional form attributable to average annual compensation up to the integration level (the ''base portion'') and the portion of the optional form attributable to average annual compensation in excess of the integration level (the ''excess portion''). In the case of an offset plan, the respective portions are the optional form determined without regard to the offset (the ''gross amount'') and the offset applied to the gross amount to determine the optional form (the ''offset amount'').

(D) *Post-retirement cost-of-living adjustments—(1) In general.* A benefit does not fail to be a level annuity described in paragraph (b)(4)(iii)(B) of this section merely because it provides an automatic post-retirement cost-of-living adjustment that satisfies paragraph (b)(4)(iii)(D)(*2*) of this section. Thus, increases in the employee's annuity pursuant to such a cost-of-living adjustment do not cause the disparity provided under the optional form of benefit to exceed the maximum disparity permitted under this paragraph (b). For rules on ad hoc post-retirement cost-of-living adjustments, see § 1.401(a)(4)–10(b).

(*2*) *Requirements.* A cost-of-living adjustment satisfies this paragaph (b)(4)(iii)(D)(*2*) if—

(*i*) It is included in the accrued benefit of all employees, and.

(*ii*) It increases, on a uniform and consistent basis, the benefits of all former employees who are no younger than age 62, at a rate no greater than adjustments to social security benefits under section 215(i)(2)(A) of the Social Security Act that have occurred since

the later of the employee's attainment of age 62 or commencement of benefits.

(E) *Section 417(e) exception*. A plan will not fail to satisfy this paragraph (b) merely because the disparity in a benefit that is subject to the interest rate restrictions of sections 401(a)(11) and 417(e) exceeds the maximum disparity that would otherwise be allowed under this paragraph (b) if the increase in disparity is required to satisfy § 1.417(e)–1(d). In applying the exception in this paragraph (b)(4)(iii)(E), for purposes of determining what is required under § 1.417(e)–1(d), a plan may use the rate described in § 1.417(e)–1(d)(2)(i) for all employees, without regard to whether the present value of an employee's vested benefit exceeds $25,000.

(5) *Examples*. The following examples illustrate this paragraph (b). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan N is a defined benefit excess plan that provides a normal retirement benefit of 0.5 percent of average annual compensation in excess of the integration level, for each year of service. The plan provides no benefits with respect to average annual compensation up to the integration level. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage (0.5 percent) exceeds the base benefit percentage (0 percent) by more than the base benefit percentage (0 percent).

Example 2. Plan O is an offset plan that provides a normal retirement benefit equal to 2 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. The disparity provided under the plan satisfies this paragraph (b) because the offset percentage (0.75 percent) does not exceed the maximum offset allowance equal to the lesser of 0.75 percent or one-half of the gross benefit percentage (1 percent).

Example 3. Plan P is a defined benefit excess plan that provides a normal retirement benefit of 0.5 percent of average annual compensation up to the integration level, plus 1.25 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage (1.25 percent) exceeds the base benefit percentage (0.5 percent) by more than the base benefit percentage (0.5 percent).

Example 4. Plan Q is an offset plan that provides a normal retirement benefit of 1 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. The disparity under the plan exceeds the maximum offset allowance because the offset percentage exceeds one-half of the gross benefit percentage (0.5 percent).

Example 5. (a) Plan R is an offset plan that provides a normal retirement benefit of 1 percent of average annual compensation, minus 0.5 percent of final average compensation up to the offset level, for each year of service up to 35. The plan determines an employee's average annual compensation using an averaging period comprising five consecutive 12-month periods and taking into account the employee's compensation for the ten consecutive 12-month periods ending with the plan year. The plan does not provide that an employee's final average compensation is limited to the employee's average annual compensation.

(b) Employee A has average annual compensation of $20,000, final average compensation of $25,000, and covered compensation of $32,000. The maximum offset allowance applicable to Employee A for the plan year under paragraph (b)(3) of this section is one-half of the gross benefit percentage multiplied by the ratio, not to exceed one, of Employee A's average annual compensation to Employee A's final average compensation up to the offset level. Thus, the maximum offset allowance is 0.4 percent (½ × 1 percent×$20,000/$25,000). With respect to Employee A, the benefit formula provides an offset that exceeds the maximum offset allowance. The plan must therefore reduce Employee A's offset percentage to 0.4 percent. (Under paragraph (c)(2)(viii) of this section, Employee A's adjusted disparity rate is deemed uniform.)

(c) Alternatively, under § 1.401(l)–1(c)(17)(ii) (the definition of final average compensation), the plan could specify that an employee's final average compensation is limited to

the amount of the employee's average annual compensation. Thus, the ratio of average annual compensation to final average compensation would always be equal to at least one, and the maximum offset allowance under the plan would be one-half of the gross benefit percentage.

Example 6. Plan S is a defined benefit excess plan that provides a base benefit percentage of 1 percent of average annual compensation up to the integration level for each year of service. The plan also provides, for each of the first 10 years of service, an excess benefit percentage of 1.85 percent of average annual compensation in excess of the integration level. For each year of service after 10, the plan provides an excess benefit percentage of 1.65 percent of the employee's average annual compensation in excess of the integration level. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage for each of the first ten years of service (1.85 percent) exceeds the base benefit percentage (1 percent) by more than 0.75 percent.

Example 7. The facts are the same as in *Example 6*, except that the plan provides an excess benefit percentage of 1.65 percent of average annual compensation in excess of the integration level for each of the first 10 years of service and an excess benefit percentage of 1.85 percent of average annual compensation in excess of the integration level for each year of service after 10. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage for each year of service after 10 (1.85 percent) exceeds the base benefit percentage (1 percent) by more than 0.75 percent.

Example 8. Plan T is a defined benefit excess plan that provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.7 percent of average annual compensation in excess of the integration level, for each year of service up to 35, payable in the form of a joint and survivor annuity. The plan also allows an employee to receive the retirement benefit in the form of an actuarially equivalent straight life annuity. The actuarially equivalent straight life annuity equals 1.09 percent of average annual compensation up to the integration level, plus 1.85 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The disparity provided under the plan with respect to the straight life annuity form of benefit (0.76 percent) exceeds the maximum excess allowance because the excess benefit percentage (1.85 percent) exceeds the base benefit percentage (1.09 percent) by more than 0.75 percent.

Example 9. Plan U is a defined benefit excess plan that provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.7 percent of average annual compensation in excess of the integration level, for each year of service up to 35, payable in the form of a straight life annuity. Plan U provides a single sum optional form of benefit at normal retirement age equal to 100 times the monthly annuity payable at that age. Thus, if an employee elects the single sum optional form of benefit, the base portion of the single sum benefit is 8.33 percent (100 times 1.0 percent/12) of average annual compensation up to the integration level per year of service, and the excess portion of the single sum benefit is 14.17 percent (100 times 1.7 percent/12) of average annual compensation in excess of the integration level per year of service. Each respective portion of the single sum option is normalized to a straight life annuity commencing at normal retirement age, using 8-percent interest and the UP–84 mortality table. After normalization, the base portion of the benefit is 1.02 percent of average annual compensation up to the integration level, and the excess portion of the benefit is 1.73 percent of average annual compensation in excess of the integration level. The single sum optional form of benefit satisfies this paragraph (b) because the disparity provided in the optional form of benefit does not exceed the maximum excess allowance.

(c) *Uniform disparity*—(1) *In general*. The disparity provided under a defined benefit excess plan is uniform only if the plan uses the same base benefit percentage and the same excess benefit percentage for all employees with the same number of years of service. The disparity provided under an offset plan is uniform only if the plan uses the same gross benefit percentage and the same offset percentage for all employees with the same number of years of service. The disparity provided under a plan that determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C) is uniform only if the plan satisfies one of the deemed uniformity rules of paragraph (c)(2) (ii) or (iii) of this section.

(2) *Deemed uniformity*—(i) *In general*. The disparity provided under a plan does not fail to be uniform for purposes of this paragraph (c) merely because the plan contains one or more of the provisions described in paragraphs (c)(2) (ii) through (ix) of this section.

(ii) *Use of fractional accrual and disparity for 35 years*. The plan contains a

benefit formula as described in paragraphs (c)(2)(ii) (A) and (B) of this section, and the plan determines each employee's accrued benefit under the method described in §1.401(a)(4)–3(b)(4)(i)(B), i.e., by multiplying the employee's fractional rule benefit (within the meaning of §1.411(b)–1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age.

(A) For each year of service at least up to 35, the benefit plan formula provides the same base benefit percentage and the same excess benefit percentage for all employees in the case of a defined benefit excess plan or the same gross benefit percentage and the same offset percentage for all employees in the case of an offset plan.

(B) For each additional year of service, the benefit formula provides a uniform percentage of all average annual compensation that is no greater than the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(ii)(A) of this section, whichever is applicable.

(iii) *Use of fractional accrual and disparity for fewer than 35 years.* The plan contains a benefit formula as described in paragraphs (c)(2)(iii) (A) through (C) of this section, and the plan determines each employee's accrued benefit under the method described in §1.401(a)(4)–3(b)(4)(i)(B).

(A) For each year in the employee's initial period of service comprising fewer than 35 years, the benefit formula provides the same base benefit percentage and the same excess benefit percentage for all employees in the case of a defined benefit excess plan or the same gross benefit percentage and the same offset percentage for all employees in the case of an offset plan.

(B) For each year of service after the initial period and at least up to 35, the benefit formula provides a uniform percentage of all average annual compensation, that is equal to the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(iii)(A) of this section.

(C) For each year of service after the period described in paragraph (c)(2)(iii)(B) of this section, the benefit formula provides a uniform percentage of all average annual compensation that is no greater than the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(iii)(A) of this section.

(iv) *Different social security retirement ages.* The benefit formula uses the same excess benefit percentage or the same gross benefit percentage for all employees with the same number of years of service and, for employees with social security retirement ages later than age 65, adjusts the 0.75-percent factor in the maximum excess or offset allowance as required under paragraph (e)(1) of this section, by increasing the base benefit percentage in the case of a defined benefit excess plan, or reducing the offset percentage in the case of an offset plan.

(v) *Reduction for integration level.* The plan uses an integration level or offset level greater than each employee's covered compensation and makes individual reductions in the 0.75-percent factor, as permitted under paragraph (d)(9)(iii)(B) of this section, by increasing the base benefit percentage in the case of a defined benefit excess plan or reducing the offset percentage in the case of an offset plan.

(vi) *Overall permitted disparity*—(A) *In general.* The benefit formula provides that, with respect to each employee's years of service after reaching the cumulative permitted disparity limit applicable to the employee under §1.401(l)–5(c), employer-provided benefits are determined with respect to the employee's total average annual compensation at a rate equal to the nondisparate percentage. For purposes of this paragraph (c)(2)(vi), the nondisparate percentage is generally the excess benefit percentage or gross benefit percentage otherwise applicable under the benefit formula to an employee with the same number of years of service.

(B) *Unit credit plans.* In the case of a unit credit plan described in §1.401(a)(4)–3(b)(3), if the 411(b)(1)(B) limit percentage is less than the nondisparate percentage, the 411(b)(1)(B) limit percentage must be substituted for the nondisparate percentage. For this purpose, the 411(b)(1)(B) limit percentage is 133⅓ percent of the smallest

base benefit percentage, or 133⅓ percent of the smallest difference between the gross benefit percentage and the offset percentage, whichever is applicable, where the smallest base benefit percentage or difference is determined by reference to the benefit formula as applied to employees with no more years of service than the employee.

(C) *Fractional accrual plans.* In the case of a fractional accrual plan described in §1.401(a)(4)–3(b)(4), the benefit formula must provide for the nondisparate percentage with respect to years of service after the employee would reach the cumulative permitted disparity limit applicable to the employee under §1.401(l)–5(c) as modified by this paragraph (c)(2)(vi)(C). Solely for purposes of this paragraph (c)(2)(vi)(C), the employee's annual disparity fractions (and thus the year in which the employee would reach the cumulative permitted disparity limit) are determined using the disparity provided under the benefit formula (rather than the special rule for fractional accrual plans in §1.401(l)–5(b)(8)(v)).

(vii) *Non-FICA employees.* The plan provides that, in the case of each employee under the plan with respect to whom none of the taxes under section 3111(a), section 3221, or section 1401 is required to be paid, employer-provided benefits are determined with respect to the employee's total average annual compensation at the excess benefit percentage or gross benefit percentage applicable to an employee with the same number of years of service.

(viii) *Average annual compensation adjustment for offset plan.* In the case of each employee whose final average compensation exceeds the employee's average annual compensation, the plan adjusts the offset percentage as required under paragraph (b)(3)(ii) of this section in order to satisfy the maximum offset allowance.

(ix) *PIA offsets.* In the case of an offset plan, the plan provides that the offset applied to each employee's benefit is the lesser of a specified percentage of the employee's PIA and an offset that otherwise satisfies the requirements of this section (the ''section 401(l) overlay''). The specified percentage of PIA must be the same for all employees with the same number of years of service. In the case of a plan that determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), the specified percentage of PIA is deemed to be the same for all employees with the same number of years of service if the plan satisfies either of the deemed uniformity rules in paragraph (c)(2)(ii) or (iii) of this section, substituting ''offset, expressed as a percentage of PIA, per year of service'' for the term ''offset percentage'' (in addition to satisfying either of those rules with respect to the section 401(l) overlay).

(3) *Examples.* The following examples illustrate this paragraph (c). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that satisfies the 133⅓ percent accrual rule of section 411(b)(1)(B). The plan provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation in excess of the integration level, for each year of service up to 25. The plan also provides a benefit of 1.0 percent of all average annual compensation for each year of service in excess of 25. The disparity provided under the plan is uniform because the plan uses the same base and excess benefit percentages for all employees with the same number of years of service. If the plan formula were the same except that it used a different excess benefit percentage for some of the years of service between one and 25, the disparity under the plan would continue to be uniform.

Example 2. Plan O is a defined benefit excess plan that provides a normal retirement

benefit of 50 percent of average annual compensation up to the integration level and 68.75 percent of average annual compensation in excess of the integration level, multiplied by a fraction, the numerator of which is the employee's service, up to 25 years, and the denominator of which is 25. The plan determines an employee's accrued benefit as described in §1.401(a)(4)–3(b)(4)(i)(B). The benefit formula thus provides a base benefit percentage of 2 percent (50 percent×1/25) and an excess benefit percentage of 2.75 percent (68.75 percent×1/25) for each of an employee's first 25 years of service and no benefit for years of service after 25. The disparity provided under the plan is not uniform within the meaning of this paragraph (c) because the benefit formula does not satisfy either of the uniform disparity rules for fractional accrual plans under paragraphs (c)(2) (ii) and (iii) of this section.

Example 3. Plan P is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation for each year of service up to 35, minus 0.75 percent of the final average compensation up to the offset level for each year of service up to 25. The plan determines an employee's accrued benefit under the method described in §1.401(a)(4)–3(b)(4)(i)(B). Because the formula under the plan provides the same gross benefit percentage and offset percentage for 25 years of service (fewer than 35) and, for years of service after 25 and up to 35, provides a benefit at a uniform rate (equal to the gross benefit percentage) of all average annual compensation, and the plan accrues the benefit ratably, the disparity under the plan is deemed to be uniform under paragraph (c)(2)(iii) of this section.

Example 4. Plan Q is an offset plan that benefits employees with social security retirement ages of 65, 66, and 67. For each year of service up to 35, the plan provides a normal retirement benefit equal to 2 percent of average annual compensation, minus an offset based on the employee's final average compensation up to the offset level. For employees with a social security retirement age of 65, the offset percentage is 0.75 percent; for employees with a social security retirement age of 66, the offset percentage is 0.70 percent; and for employees with a social security retirement age of 67, the offset percentage is 0.65 percent. The disparity under the plan is deemed to be uniform under paragraph (c)(2)(iv) of this section because the plan uses the same gross benefit percentage for all employees and reduces the offset percentage for employees with social security retirement ages of 66 and 67 to comply with the adjustments in the 0.75-percent factor in the maximum excess or offset allowance required under paragraph (e)(1) of this section. (Because Plan Q effectively provides unreduced benefits prior to the social security retirement age for employees with social security retirement ages of 66 and 67, the 0.75-percent factor in the maximum offset allowance must be reduced to 0.70 percent and 0.65 percent, respectively.) Alternatively, Plan Q could satisfy this paragraph (c) if it provided a uniform offset percentage of 0.65 percent for all employees because 0.65 percent is the maximum offset allowance under the plan for an employee with a social security retirement age of 67.

Example 5. Plan R is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus an offset determined as a percentage of total final average compensation, for each year of service up to 35. For an employee whose final average compensation does not exceed the employee's covered compensation, the offset percentage is 0.75 percent. For an employee whose final average compensation exceeds the employee's covered compensation, the plan reduces the offset percentage, as required by paragraph (d) of this section. The reduced offset percentage is determined by comparing the employee's final average compensation to the employee's covered compensation as permitted under paragraph (d)(9)(iii)(B) of this section. The disparity provided under the plan is deemed uniform under paragraph (c)(2)(v) of this section because the plan uses the same gross benefit percentage for all employees and makes individual reductions in the 0.75-percent factor, as permitted under paragraph (d)(9)(iii)(B) of this section, by reducing the offset percentage in the case of an employee whose final average compensation exceeds covered compensation.

(d) *Requirements for integration or offset level*—(1) *In general.* The integration level under a defined benefit excess plan or the offset level under an offset plan must satisfy paragraphs (d)(2), (d)(3), (d)(4), (d)(5) or (d)(6) of this section, as modified by paragraph (d)(7) of this section in the case of a short plan year. Paragraph (d)(8) of this section contains demographic tests that apply to certain defined benefit plans. Paragraph (d)(9) of this section explains certain reductions required in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. Paragraph (d)(10) of this section contains examples. If a reduction applies to the 0.75-percent factor under this paragraph (d), the reduced factor is used for all purposes in determining whether the permitted disparity rules for defined benefit plans are satisfied.

(2) *Covered compensation.* The requirement of this paragraph (d)(2) is satisfied only if the integration or offset

level under the plan for each employee is the employee's covered compensation.

(3) *Uniform percentage of covered compensation.* The requirement of this paragraph (d)(3) is satisfied only if—

(i) The integration or offset level under the plan for each employee is a uniform percentage (greater than 100 percent) of each employee's covered compensation,

(ii) In the case of a defined benefit excess plan, the integration level does not exceed the taxable wage base in effect for the plan year, and, in the case of an offset plan, the offset level does not exceed the employee's final average compensation, and

(iii) The plan adjusts the 0.75-percent factor in the maximum excess or offset allowance in accordance with paragraph (d)(9) of this section.

(4) *Single dollar amount.* The requirement of this paragraph (d)(4) is satisfied only if the integration or offset level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that does not exceed the greater of $10,000 or one-half of the covered compensation of an individual who attains social security retirement age in the calendar year in which the plan year begins. In the case of a calendar year in which no individual could attain social security retirement age, for example, the year 2003, this rule is applied using covered compensation of an individual attaining social security retirement age in the preceding calendar year.

(5) *Intermediate amount.* The requirement of this paragraph (d)(5) is satisfied only if—

(i) The integration or offset level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that is greater than the highest amount determined under paragraph (d)(4) of this section,

(ii) In the case of a defined benefit excess plan, the single dollar amount does not exceed the taxable wage base in effect for the plan year, and, in the case of an offset plan, the single dollar amount does not exceed the employee's final average compensation,

(iii) The plan satisfies the demographic requirements of paragraph (d)(8) of this section, and

(iv) The plan adjusts the 0.75-percent factor in the maximum excess or offset allowance in accordance with paragraph (d)(9) of this section.

For purposes of this paragraph (d)(5), an offset level of each employee's final average compensation is considered a single dollar amount determined under a formula specified in the plan.

(6) *Intermediate amount safe harbor.* The requirement of this paragraph (d)(6) is satisfied only if—

(i) The integration or offset level under the plan for all employees is a single dollar amount described in paragraph (d)(5) of this section, and

(ii) The 0.75-percent factor in the maximum excess or offset allowance under paragraph (b)(2) or (b)(3) of this section is reduced to the lesser of the adjusted factor determined under paragraph (d)(9) of this section or 80 percent of the otherwise applicable factor under paragraph (b)(2) or (b)(3) of this section, determined without regard to paragraph (d)(9) of this section.

(7) *Prorated integration level for short plan year.* If an accumulation plan uses paragraph (2) or (4) of the definition of plan year compensation under §1.401(a)(4)–12 (i.e., section 414(s) compensation for the plan year or the period of plan participation) and has a plan year that comprises fewer than 12 months, the integration or offset level under the plan for each employee must be an amount equal to the otherwise applicable integration or offset level described in paragraph (d)(2), (d)(3), (d)(4), (d)(5), or (d)(6) of this section, multiplied by a fraction, the numerator of which is the number of months in the plan year and the denominator of which is 12. No adjustment to the maximum excess or offset allowance is required as a result of the application of this paragraph (d)(7), other than any adjustment already required under paragraph (d)(6) or (d)(9) of this section.

(8) *Demographic requirements*—(i) *In general.* A plan that satisfies the demographic requirements of paragraphs (d)(8)(ii) and (iii) of this section may use an integration level described in paragraph (d)(5) of this section.

(ii) *Attained age requirement.* The requirement of this paragraph (d)(8)(ii) is satisfied only if the average attained age of the nonhighly compensated employees in the plan is not greater than the greater of—

(A) Age 50, or

(B) 5 plus the average attained age of the highly compensated employees in the plan. For purposes of this paragraph (d)(8)(ii), attained ages are determined as of the beginning of the plan year.

(iii) *Nondiscrimination requirement.* The requirement of this paragraph (d)(8)(iii) is satisfied only if at least one of the following tests in paragraphs (d)(8)(iii) (A) through (D) of this section is satisfied.

(A) *Minimum percentage test.* This test is satisfied only if more than 50 percent of the nonhighly compensated employees in the plan have average annual compensation at least equal to 120 percent of the integration or offset level.

(B) *Ratio test.* This test is satisfied only if the percentage of nonhighly compensated nonexcludable employees, who are in the plan and who have average annual compensation at least equal to 120 percent of the integration or offset level, is at least 70 percent of the percentage of highly compensated nonexcludable employees who are employees in the plan.

(C) *High dollar amount test.* This test is satisfied only if the integration or offset level exceeds 150 percent of the covered compensation of an individual who attains social security retirement age in the calendar year in which the plan year begins. In the case of a calendar year in which no individual could attain social security retirement age, for example, the year 2003, this rule is applied using covered compensation of an individual attaining social security retirement age in the preceding calendar year.

(D) *Individual disparity reductions.* This test is satisfied only if the plan is an offset plan that uses an offset level of each employee's final average compensation and makes individual disparity reductions as permitted under paragraph (d)(9)(iii)(B) of this section.

(9) *Reduction in the 0.75-percent factor if integration or offset level exceeds covered compensation*—(i) *In general.* If the integration or offset level specified under the plan is each employee's covered compensation as of the plan year, no reduction in the 0.75-percent factor in the maximum excess or offset allowance is required for the plan year under this paragraph (d)(9). If a plan specifies an integration or offset level that exceeds an employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced as required in paragraph (d)(9)(ii) or (iii) of this section. Paragraph (d)(9)(iv) of this section contains a table of the applicable reductions.

(ii) *Uniform percentage of covered compensation.* If a plan specifies an integration or offset level that is a uniform percentage (in excess of 100 percent) of each employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced in accordance with the table in paragraph (d)(9)(iv) of this section. Thus, for example, if a plan specifies an integration or offset level of 120 percent of each employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.69 percent in accordance with the table because the specified integration or offset level is more than covered compensation but not more than 125 percent of covered compensation.

(iii) *Single dollar amount.* If a plan specifies an integration or offset level of a single dollar amount as permitted under paragraph (d)(5) of this section (for example, $30,000), the applicable reduction in the maximum excess or offset allowance must be determined under paragraph (d)(9)(iii) (A) or (B) of this section, as specified under the plan.

(A) *Plan-wide reduction.* The applicable reduction in the maximum excess or offset allowance under the table in paragraph (d)(9)(iv) of this section may be determined by comparing the single dollar amount specified in the plan to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins. Thus, for example, if a plan specifies a single integration or offset level of $30,000 that is uniformly applicable to all employees

for a plan year and the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins is $20,000, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.60 percent for all employees in accordance with the table in paragraph (d)(9)(iv) of this section because the specified integration or offset level of $30,000 is more than 125 percent of $20,000 but not more than 150 percent of $20,000. In the case of a calendar year in which no individual could attain social security retirement age (for example, 2003), the comparison is made with covered compensation of an individual who attained social security retirement age in the preceding calendar year. If an offset plan uses an offset level of each employee's final average compensation, the reduction under this paragraph (d)(9)(iii)(A) is determined by comparing the highest possible amount of final average compensation to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins.

(B) *Individual reductions*. The applicable reduction in the maximum excess or offset allowance under the table in paragraph (d)(9)(iv) of this section may be determined by comparing the single dollar amount specified in the plan to the covered compensation of each employee under the plan. Thus, for example, if a plan specifies a single integration or offset level of $30,000 that is uniformly applicable to all employees for a plan year, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.60 percent for an employee with covered compensation of $20,000, but need not be reduced for an employee whose covered compensation is $30,000 or greater.

(iv) *Reductions*—(A) *Table*.

TABLE

If the integration or offset level is	The permitted disparity factor is
100 percent of covered compensation	0.75 percent
125 percent of covered compensation	0.69 percent
150 percent of covered compensation	0.60 percent
175 percent of covered compensation	0.53 percent
200 percent of covered compensation	0.47 percent
The taxable wage base or final average compensation.	0.42 percent

(B) *Interpolation*. If the integration or offset level used under a plan is between the percentages of covered compensation in the table, the permitted disparity factor applicable to the plan can be determined either by straight-line interpolation between the permitted disparity factors in the table or by rounding the integration or offset level up to the next highest percentage of covered compensation in the table.

(10) *Examples*. The following examples illustrate this paragraph (d). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of an offset plan, the plan provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. (a) Plan M is a defined benefit excess plan that uses the calendar year as its plan year. For the 1989 plan year, the plan uses an integration level of $20,000, which is 118 percent of the 1989 covered compensation of $16,968 for an individual reaching social security retirement age in 1989. The plan may use that integration level without satisfying paragraph (d)(8) of this section, provided the adjustment to the 0.75-percent factor required under paragraph (d)(6) of this section is made. That adjustment is the lesser of the factor determined under paragraph (d)(9) of this section or 80 percent of the factor otherwise applicable under paragraph (b)(2) or (b)(3) of this section.

(b) The plan determines the factor under paragraph (d)(9) of this section by comparing the integration level to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins and by rounding the integration level up to 125 percent of that covered compensation amount. The 0.75-percent factor is therefore replaced by 0.69 percent pursuant to the table in paragraph (d)(9) of this section. The 0.69–percent factor is 92 percent of the 0.75-percent factor. Because the lesser of 80 percent and 92 percent is 80 percent, the 0.75-percent factor is reduced to 0.6 percent (80 percent of 0.75 percent) under paragraph (d)(6) of this section. The 0.6–percent factor applies to benefits

commencing at age 65 for an employee with a social security retirement age of 65. In determining normal retirement benefits for employees with social security retirement ages of 66 or 67, the applicable factors for benefits commencing at age 65 are, respectively, 0.56 percent (80 percent of 0.7 percent) and 0.52 percent (80 percent of 0.65 percent).

(c) The plan could also determine the factor under paragraph (d)(9) of this section by comparing the integration level to the covered compensation of each employee under the plan, or by straight line interpolation between the disparity factors contained in the table in paragraph (d)(9) of this section, or both. (Of course, if the plan satisfied paragraph (d)(8) of this section, the plan could use the factor determined under paragraph (d)(9) of this section.)

Example 2. (a) Plan N, an accumulation plan, is a defined benefit excess plan that, for each year of service up to 35, accrues a normal retirement benefit of 1 percent of plan year compensation up to the taxable wage base, plus 1.75 percent of plan year compensation above the taxable wage base, for each year of service up to 35. An employee's total retirement benefit is the sum of the accruals for all years. The plan satisfies paragraph (d)(8) of this section.

(b) Because the plan uses the taxable wage base (an amount above covered compensation) as the integration level, it must reduce the 0.75-percent factor in the maximum excess allowance as required under paragraphs (d)(5) and (d)(9) of this section. The reduced factor, if determined on a plan-wide basis under paragraph (d)(9)(iii)(A) of this section, is 0.42 percent. The plan must therefore reduce the disparity in the plan so that it does not exceed 0.42 percent.

Example 3. (a) For the 1990 plan year, Plan O provides a normal retirement benefit of 2 percent of average annual compensation, minus a percentage of final average compensation up to $48,000, for each year of service up to 35. The plan satisfies paragraph (d)(8) of this section. As permitted under paragraph (d)(9) of this section, the plan provides that each employee's offset percentage is determined by comparing $48,000 to the employee's covered compensation and by rounding the result up to the next highest percentage of covered compensation.

(b) Employee A has a social security retirement age of 66 and covered compensation of $40,000. Because the plan provides for commencement of Employee A's benefit at age 65, the 0.75-percent factor in the maximum offset allowance is reduced to 0.7 percent under paragraph (e)(1) of this section (the ''paragraph (e) factor''). In addition, because $48,000 is rounded up to 125 percent of Employee A's covered compensation, the 0.75-percent factor in the maximum offset allowance is reduced to 0.69 percent under paragraph (d)(9) of this section (the ''paragraph (d) factor''). The reductions are cumulative under paragraph (b)(3)(ii) of this section.

(c) The cumulative reductions can be made by multiplying the paragraph (e) facdtor by the ratio of the paragraph (d) factor to 0.75 percent or by multiplying the paragraph (d) factor by the ratio of the paragraph (e) factor to 0.75 percent. The disparity factor for Employee A is therefore 0.64 percent ((0.7 percent × 0.69 percent/0.75 percent) or (0.69 percent x 0.7 percent/0.75 percent)).

Example 4. Plan P is an offset plan that uses the calendar year as the plan year and uses an offset level of each employee's final average compensation. Assume that the taxable wage bases for 1990–1992 are the following:

1990—$51,300
1991—$53.400
1992—$58,000

Employee B's final average compensation, determined as of the close of the 1992 plan year, is the average of Employee B's annual compensation for the period 1990–1992. Employee B's annual compensation for each year is the following:

1990—$47,000
1991—$59,000
1992—$65,000

For purposes of determining the offset applied to Employee B's employer-provided benefit under the plan. Employee's B's final average compensation as of the close of the 1992 plan year is $52,800 ($47,000 + $53,400 + $58,000/3). This is because annual compensation in excess of the taxable wage base in effect at the beginning of the year may not be taken into account in determining an employee's final average compensation or in determining the employee's offset. If the plan determines the offset applied to Employee B's benefit by reference to compensation in excess of $52,800, the plan fails to satisfy this paragraph (d).

(e) *Adjustments to the 0.75-percent factor for benefits commencing at ages other than social security retirement age*—(1) *In general.* The 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance applies to a benefit commencing at an employee's social security retirement age. Except as provided in paragraph (g) of this section, if a benefit payable to an employee under a defined benefit excess plan or a defined benefit offset plan commences at an age before the employee's social security retirement age (including a benefit payable at the normal retirement age under the plan), the 0.75-percent factor in the maximum excess allowance or in the maximum

offset allowance, respectively, is reduced in accordance with paragraph (e)(2)(i) of this section. If a benefit payable to an employee under a defined benefit excess plan or a defined offset plan commences at an age after the employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance, respectively, may be increased in accordance with paragraph (e)(2)(ii) of this section. Paragraph (e)(4) of this section provides rules on the age at which a benefit commences. See paragraph (f) of this section for the requirements applicable to optional forms of benefit.

(2) *Adjustments*—(i) *Benefits commencing on or after age 55 and before social security retirement age.* If benefits commence before an employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance must be reduced for such early commencement of benefits in accordance with the tables set forth in paragraph (e)(3) of this section.

(ii) *Benefits commencing after social security retirement age and on or before age 70.* If benefits commence after an employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance may be increased for such delayed commencement of benefits in accordance with the tables set forth in paragraph (e)(3) of this section.

(iii) *Benefits commencing before age 55.* If benefits commence before the employee attains age 55, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance is further reduced (on a monthly basis to reflect the month in which benefits commence) to a factor that is the actuarial equivalent of the 0.75-percent factor, as adjusted under the tables in paragraph (e)(3) of this section, applicable to a benefit commencing in the month in which the employee attains age 55. In determining actuarial equivalence for this purpose, a reasonable interest rate must be used. In addition, a reasonable mortality table must be used to determine the actuarial present value, as defined in §1.401(a)(4)–12, of the benefits commencing at age 55 and at the earlier commencement age, and a reasonable mortality table may be used to determine the actuarial present value at the earlier commencement age of the benefits commencing at age 55. A standard interest rate and a standard mortality table, as defined in §1.401(a)(4)–12, are considered reasonable.

(iv) *Benefits commencing after age 70.* If benefits commence after the employee attains age 70, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance may be further increased (on a monthly basis to reflect the month in which benefits commence) to a factor that is the actuarial equivalent of the 0.75-percent factor (as adjusted in accordance with this paragraph (e)) applicable to a benefit commencing in the month in which the employee attains age 70. In determining actuarial equivalence for this purpose, a reasonable interest rate must be used. In addition, a reasonable mortality table must be used to determine the actuarial present value, as defined in §1.401(a)(4)–12, of the benefits commencing at age 70 and at the later commencement age, and a reasonable mortality table may be used to determine the value at the later commencement age of the benefits commencing at age 70. A standard interest rate and a standard mortality table, as defined in §1.401(a)(4)–12, are considered reasonable.

(3) *Tables.* Tables I, II, and III provide the adjustments in the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance applicable to benefits commencing on or after age 55 and on or before age 70 to an employee who has a social security retirement age of 65, 66 or 67. Table IV is a simplified table for a plan that uses a single disparity factor of 0.65 percent for all employees at age 65. The factors in the following tables are applicable to benefits that commence in the month the employee attains the specified age. Accordingly, if benefits commence in a month other than the month in which the employee attains the specified age, appropriate adjustments in the 0.75-percent factor in the maximum excess allowance and the maximum offset allowance must be made. For this purpose, adjustments

may be based on straight-line interpolation from the factors in the tables or in accordance with the methods of adjustment specified in paragraphs (e)(2)(iii) and (iv) of this section.

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.002
69	0.908
68	0.825
67	0.750
66	0.700
65	0.650
64	0.600
63	0.550
62	0.500
61	0.475
60	0.450
59	0.425
58	0.400
57	0.375
56	0.344
55	0.316

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.101
69	0.998
68	0.907
67	0.824
66	0.750
65	0.700
64	0.650
63	0.600
62	0.550
61	0.500
60	0.475
59	0.450
58	0.425
57	0.400
56	0.375
55	0.344

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.209
69	1.096
68	0.996
67	0.905
66	0.824
65	0.750
64	0.700
63	0.650
62	0.600

TABLE III—Continued

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
61	0.550
60	0.500
59	0.475
58	0.450
57	0.425
56	0.400
55	0.375

TABLE IV

[Simplified table]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.048
69	0.950
68	0.863
67	0.784
66	0.714
65	0.650
64	0.607
63	0.563
62	0.520
61	0.477
60	0.433
59	0.412
58	0.390
57	0.368
56	0.347
55	0.325

(4) *Benefit commencement date*—(i) *In general*. Except as provided in paragraph (e)(4)(ii) of this section, a benefit commences for purposes of this paragraph (e) on the first day of the period for which the benefit is paid under the plan.

(ii) *Qualified social security supplement*. If a plan uses a qualified social security supplement, as defined in §1.401(a)(4)–12, to provide an aggregate benefit at retirement before social security retirement age that is a uniform percentage of average annual compensation, benefits will be considered to commence on the first day of the period for which the qualified social security supplement is no longer payable. In order for this paragraph (e)(4)(ii) to apply, the uniform percentage must be equal to the excess benefit percentage in the case of an excess plan or the gross benefit percentage in the case of an offset plan.

(5) *Examples*. The following examples illustrate this paragraph (e). Unless otherwise provided, the following facts

apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.25 percent of average annual compensation up to the integration level, plus 2.0 percent of average annual compensation in excess of the integration level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is 0.75 percent (2 percent–1.25 percent). Because this disparity exceeds the 0.375 percent factor provided in the table for a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan fails to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit.

Example 2. Assume the same facts as in *Example 1,* except that the base benefit percentage under the plan is 1.75 percent. Thus, the disparity provided under the plan at age 55 is 0.25 percent (2 percent–1.75 percent). Because the disparity does not exceed the 0.375 percent factor provided in the table for a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan does not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit.

Example 3. Plan N is an offset plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.75 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is 0.75 percent. Because this disparity exceeds the 0.375–percent factor provided in the table for an offset applied to a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan fails to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit. The plan would not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit if the applicable factor for determining the offset applied to the benefit were reduced to 0.375 percent.

Example 4. Plan O is a defined benefit excess plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.25 percent of average annual compensation up to the integration level, plus 2.0 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan provides benefits commencing before normal retirement age with the following reductions:

Age	Percentage of normal retirement benefit (%)
64	90
63	85
62	80

Under the plan, a benefit payable at age 64 is equal to 90 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.8 percent, the base benefit percentage under the plan is 1.125 percent, and the disparity provided under the plan at age 64 is 0.675 percent. Similarly, a benefit payable at age 63 is equal to 85 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.7 percent, the base benefit percentage under the plan is 1.0625 percent, and the disparity provided under the plan at age 63 is 0.6375 percent. Finally, a benefit payable at age 62 is equal to 80 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.6 percent, the base benefit percentage under the plan is 1.0 percent, and the disparity provided under the plan at age 62 is 0.6 percent. Because the disparities provided under the plan at each early commencement age do not exceed the factors provided in the applicable table in paragraph (e)(3) of this section, the plan does not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefits.

Example 5. Plan P is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to the integration level, plus 1.5 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan does not provide any benefits, other than normal

retirement benefits, commencing before an employee's social security retirement age. Employee A, born in 1947, has a social security retirement age of 66. Because the plan provides for the distribution of normal retirement benefits before Employee A's social security retirement age, the 0.75-percent factor in the maximum excess allowance applicable to Employee A must be reduced to 0.70 percent in accordance with this paragraph (e). Accordingly, the disparity provided to A under the plan exceeds the maximum excess allowance because the excess benefit percentage (1.5 percent) exceeds the base benefit percentage (0.75 percent) by more than the maximum excess allowance of 0.70 percent, as reduced in accordance with this paragraph (e).

Example 6. Assume the same facts as in *Example 5*, except that the plan also provides an early retirement benefit, commencing at age 62, to an employee who satisfies the conditions for early retirement specified in the plan. The early retirement benefit is based upon the employee's accrued benefit at early retirement age and equals the amount that would have been paid commencing at the employee's normal retirement age based upon the employee's average annual compensation, covered compensation and years of service at the date of the employee's early retirement. Employee B, who has a social security retirement age of 65, meets the conditions for early retirement under the plan and retires at age 62 with 30 years of service. At the time of early retirement, Employee B has average annual compensation of $20,000 and covered compensation of $16,000. Under the plan's benefit formula, Employee B has accrued a normal retirement benefit, commencing at age 65, of $5,400 ((22.5 percent × $16,000) + (45 percent × $4,000)) based on Employee B's average annual compensation, covered compensation and years of service at early retirement. Accordingly, under the plan's early retirement provisions, Employee B is entitled to receive, commencing at early retirement, a benefit of $5,400. Because the early retirement benefit is a benefit commencing at age 62 (before Employee B's social security retirement age), the 0.75-percent factor in the maximum excess allowance must be reduced to 0.60 percent in accordance with this paragraph (e). Accordingly, the disparity provided to Employee B under the plan at early retirement exceeds the maximum excess allowance.

Example 7. (a) Plan Q is a defined benefit excess plan that provides a normal retirement benefit of 1.35 percent of average annual compensation up to the integration level, plus 2 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan provides that an employee with 10 years of service at age 55 may receive an unreduced retirement benefit. The plan also provides that employee with a supplemental benefit of 0.65 percent of average annual compensation up to the integration level for each year of service up to 35, payable from early retirement until age 65. The supplemental benefit is a qualified social security supplement under §1.401(a)(4)–12. The effect of the supplement is to provide an employee with a uniform benefit of 2 percent of average annual compensation from early retirement until age 65, when the supplement is no longer payable. Therefore, for purposes of this paragraph (e), the employee's benefit will be considered to commence at age 65.

(b) Assume that Plan Q is instead an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. The plan provides the same early retirement benefit on the same conditions, except that the supplement is 0.65 percent of an employee's final average compensation up to the offset level. An employee at age 55 thus receives a uniform benefit of 2 percent of average annual compensation until age 65, when the supplement is no longer payable. Therefore, for purposes of this paragraph (e), the employee's benefit will be considered to commence at age 65.

(f) *Benefits, rights, and features*—(1) *Defined benefit excess plan*. In the case of a defined benefit excess plan, each benefit, right, or feature provided under the plan with respect to employer-provided benefits attributable to average annual compensation above the integration level (an ''excess benefit, right, or feature'') must also be provided on the same terms with respect to employer-provided benefits attributable to average annual compensation up to the integration level (a ''base benefit, right, or feature''). Alternatively, an excess benefit, right, or feature may be provided on different terms than the base benefit, right, or feature, if the terms used to determine the base benefit, right, or feature produce a benefit, right, or feature of inherently equal or greater value than the benefit, right, or feature that would be produced under the terms used to determine the excess benefit, right, or feature.

(2) *Offset plan*. In the case of an offset plan, each benefit, right, or feature provided under the plan with respect to employer-provided benefits before application of the offset (a ''gross benefit, right, or feature'') must be provided on

the same terms as those used to determine the offset applied to the gross benefit, right, or feature. Alternatively, a gross benefit, right, or feature may be provided on different terms from those used to determine the offset applied to the gross benefit, right, or feature, if the terms used to determine the gross benefit, right, or feature produce a benefit, right, or feature of inherently equal or greater value than the benefit, right, or feature that would be produced under the terms used to determine the offset applied to the gross benefit, right, or feature. In addition, if benefits commence before an employee's normal retirement age, the gross benefit percentage under the plan must be reduced by a number of percentage points that is not less than the number of percentage points by which the offset percentage must be reduced, from normal retirement age to the age at which benefits commence, under the rules of paragraph (e) of this section.

(3) *Examples*. The following examples illustrate this paragraph (f). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65. All optional forms of benefit under each plan are provided on the same terms.

Example 1. Plan M is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. The plan provides an early retirement benefit for any employee who terminates employment at or after age 55 with 10 or more years of service. In determining an employee's early retirement, the 1.65 percent excess benefit percentage is reduced in accordance with the table in paragraph (e)(3) of this section for a plan that uses a single disparity factor of 0.65 percent for all employees at age 65. However, a larger reduction factor is applied to determine the base benefit percentage at early retirement. The plan violates this paragraph (f) because the excess early retirement benefit is not provided on the same terms as the base early retirement benefit, nor do the terms used to determine the base early retirement benefit produce an early retirement benefit of inherently equal or greater value than the early retirement benefit that would be produced under the terms used to determine the excess benefit, right, or feature.

Example 2. The facts are the same as in *Example 1* except that the plan determines the early retirement benefit by applying the same reduction factors under paragraph (e)(3) of this section to the base and excess benefit percentages. Furthermore, if an employee terminates employment at or after age 55 with 30 or more years of service, the plan provides that the base benefit percentage of 1 percent is not reduced. Although the excess early retirement benefit is provided on different terms than the base early retirement benefit, the plan satisfies this paragraph (f) because the terms used to determine the base early retirement benefit produce an early retirement of inherently equal or greater value than the early retirement benefit that would be produced under the terms used to determine the excess benefit, right, or feature.

Example 3. Plan N is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. In determining the qualified joint and survivor (''QJSA'') form of the normal retirement benefit, the plan applies a factor of 80 percent to the gross benefit percentage and a factor of 100 percent to the offset percentage. Thus, the QJSA form is 1.6 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. The plan violates this paragraph (f) because the gross QJSA form is not provided on the same terms as the terms used to determine the offset applied to the QJSA, nor does it produce a QJSA benefit that is of inherently equal or greater value than the QJSA benefit that would be produced under the terms used to determine the offset under the plan.

Example 4. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation

above the integration level, for each year of service up to 35. The plan also provides a single sum optional form of benefit determined by applying a single interest rate and mortality assumption to the entire normal retirement benefit. The plan satisfies this paragraph (f) because the excess optional form is provided on the same terms as the base optional form. The plan would also satisfy this paragraph (f) if it used a lower interest rate to determine the base optional form than used to determine the excess optional form because the lower interest rate would produce an optional form of inherently equal or greater value than the optional form produced by using the same interest rate.

Example 5. Plan R is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. If an employee continues to work after normal retirement age, the plan provides that the employee receives credit for additional years of service up to the service limit of 35. The plan also provides that the disparity provided under the plan will increase as permitted under paragraph (e) of this section for benefits commencing after social security retirement age. However, the plan does not provide an increase in the base benefit percentage to reflect the fact that the employee has delayed commencement of benefits past normal retirement age. Thus, for example, for an employee at age 68, the plan provides a benefit of 1 percent of average annual compensation up to the integration level, plus 1.86 percent of average annual compensation above the integration level, for each year of service up to 35. The plan violates this paragraph (f) because the excess benefit provided for an employee after normal retirement age is not provided on the same terms as the base benefit, nor do the terms used to determine the base benefit produce a benefit of inherently equal or greater value than the benefit that would be produced under the terms used to determine the excess benefit.

Example 6. Plan Q is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. In accordance with paragraph (e) of this section, the plan reduces the offset percentage under the plan for early retirement and provides a benefit at age 55 of 2 percent of average annual compensation, minus 0.325 percent of final average compensation up to the offset level, for each year of service up to 35. However, the early retirement benefit does not meet this paragraph (f) because an employee's gross benefit percentage is not reduced for early retirement.

Example 7. The facts are the same as in *Example 6* except that the plan reduces the gross benefit percentage for early retirement at age 55 to 1.675 percent. Because the gross benefit percentage is reduced by 0.325 percent (from 2.0 percent to 1.675 percent), the same percentage point reduction made in the offset percentage (from 0.65 percent to 0.325 percent), the early retirement benefit meets this paragraph (f).

(g) *No reductions in 0.75-percent factor for ancillary benefits*. For purposes of applying the maximum excess allowance or the maximum offset allowance under paragraph (b)(2) or (3) of this section, no reduction is made to the 0.75-percent factor merely because the plan provides disparity in qualified disability benefits (within the meaning of section 411(a)(9)) or preretirement death benefits and the relevant benefits are payable before an employee's social security retirement age.

(h) *Benefits attributable to employee contributions not taken into account*. Benefits attributable to employee contributions to a defined benefit plan are not taken into account in determining whether the disparity provided under a defined benefit excess plan or an offset plan exceeds the maximum permitted disparity described in paragraph (b) of this section. See §1.401(a)(4)–6(b) for methods of determining the employer-provided benefit under a plan that includes employee contributions not allocated to separate accounts (i.e., a contributory DB plan), including §1.401(a)(4)–6(b)(2)(iii)(B) for adjustments to the base and excess benefit percentages or the gross benefit percentage under a section 401(l) plan. If, after adjustment, the employee's base benefit percentage or gross benefit percentage (whichever is applicable) is less than zero, such percentage is deemed to be zero for purposes of the maximum excess allowance or maximum offset allowance under paragraph (b)(2) or (3) of this section.

(i) *Multiple integration levels* [Reserved]

(j) *Additional rules*. The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe additional rules as may be necessary or appropriate to carry out the purposes of this section,

including updated tables under paragraphs (d) and (e) of this section providing for reductions in the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance and rules in paragraph (h) of this section for determining the portion of an employee's benefit attributable to employee contributions.

[T.D. 8359, 56 FR 47622, Sept. 19, 1991; 57 FR 10818, 10819, 10951, 10952, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46832, Sept. 3, 1993]

§ 1.401(l)–4 Special rules for railroad plans.

(a) *In general*. Section 401(l)(6) provides that, in the case of a plan maintained by a railroad employer that covers employees who are entitled to benefits under the Railroad Retirement Act of 1974, in determining whether such a plan satisfies section 401(l), rules similar to the rules under section 401(l) apply and such rules take into account the employer-derived portion of tier 2 and supplemental annuity benefits provided under the railroad retirement system. In general, for purposes of determining whether a defined contribution plan or a defined benefit plan maintained by a railroad employer and covering employees described in te preceding sentence, satisfies section 401(l), the employer-derived portion of an employee's tier 2 benefits and supplementary annuity benefits under the Railroad Retirement Act of 1974 are treated as though such benefits were provided by the railroad employer under a qualified plan. Paragraph (b) of this section contains rules for defined contribution plans. Paragraph (c) of this section contains rules for defined benefit excess plans. Paragraph (d) of this section contains rules for offset plans. Paragraph (e) of this section contains definitions and additional rules of application.

(b) *Defined contribution plans*—(1) *In general*. A defined contribution plan maintained by a railroad employer satisfies section 401(l) and § 1.401(l)–2 for a plan year only if the plan satisfies paragraph (b)(2) or (b)(3) of this section for the plan year.

(2) *Single integration level method*—(i) *In general*. A plan satisfies this paragraph (b)(2) if—

(A) The plan specifies a single integration level for all employees that does not exceed the railroad retirement taxable wage base in effect as of the beginning of the plan year,

(B) The plan uses the same base contribution percentage and the same excess contribution percentage for all employees, and

(C) The excess contribution percentage does not exceed the sum of 11.4 percentage points and the base contribution percentage.

(ii) *Definitions*. The following definitions govern for purposes of this paragraph (b)(2).

(A) *Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation at or below the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(B) *Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation above the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(3) *Two integration level method*—(i) *In general*. A plan satisfies this paragraph (b)(3) if—

(A) The plan specifies two integration levels for all employees, equal to the railroad retirement taxable wage base in effect as of the beginning of the plan year and the taxable wage base in effect as of the beginning of the plan year, and

(B) The plan satisfies paragraphs (b)(3) (ii) and (iii) of this section.

(ii) *Total disparity requirement*. A plan satisfies this paragraph (b)(3)(ii) if—

(A) The plan uses the same base contribution percentage and the same excess contribution percentage for all employees, and

(B) The excess contribution percentage does not exceed the sum of 11.4 percentage points and the base contribution percentage.

(iii) *Intermediate disparity requirement*. A plan satisfies this paragraph (b)(3)(iii) if—

(A) The plan uses the same base contribution percentage and the same intermediate contribution percentage for all employees, and

(B) The intermediate contribution percentage does not exceed the sum of 5.7 percentage points and the base contribution percentage.

(iv) *Definitions.* The following definitions govern for purposes of this paragraph (b)(3).

(A) *Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation at or below the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(B) *Intermediate contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation between the railroad retirement taxable wage base and the taxable wage base (expressed as a percentage of such plan year compensation).

(C) *Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation above the taxable wage base (expressed as a percentage of such plan year compensation).

(c) *Defined benefit excess plans*—(1) *In general.* A defined benefit excess plan maintained by a railroad employer satisfies section 401(l) and § 1.401(l)–3 for a plan year only if the plan satisfies paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) *Single integration level method*—(i) *In general.* A plan satisfies this paragraph (c)(2) if—

(A) The plan specifies a single integration level for all employees that does not exceed railroad retirement covered compensation,

(B) The plan uses the same base benefit percentage and the same excess benefit percentage for all employees, and

(C) The excess benefit percentage does not exceed the lesser of—

(*1*) Two times the sum of 0.56 percent and the base benefit percentage, or

(*2*) 0.56 percent plus the base benefit percentage plus 0.75 percent.

(ii) *Definitions.* The following definitions govern for purposes of this paragraph (c)(2).

(A) *Base benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation at or below the employee's railroad retirement covered compensation (expressed as a percentage of such average annual compensation).

(B) *Excess benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation above the employee's railroad retirement covered compensation (expressed as a percentage of such average annual compensation).

(3) *Two integration level method*—(i) *In general.* A plan satisfies this paragraph (c)(3) for a plan year if—

(A) The plan specifies two integration levels for all employees, equal to each employee's railroad retirement covered compensation and each employee's covered compensation, and

(B) The plan satisfies paragraph (c)(3)(ii) and (iii) of this section.

(ii) *Employee with lower covered compensation.* A plan satisfies this paragraph (c)(3)(ii) if, with respect to each employee whose lower integration level is the employee's covered compensation—

(A) The plan uses the same base benefit percentage and the same intermediate benefit percentage for all employees,

(B) The intermediate benefit percentage does not exceed the base benefit percentage by more than the lesser of 0.75 percent or the base benefit percentage,

(C) The plan uses the same intermediate benefit percentage and the same excess benefit percentage for all employees, and

(D) The excess benefit percentage does not exceed the intermediate benefit percentage by more than 0.56 percent.

(iii) *Employee with lower railroad retirement covered compensation.* A plan satisfies this paragraph (c)(3)(iii) if, with respect to each employee whose lower integration level is the employee's railroad retirement covered compensation—

(A) The plan uses the same base benefit percentage and the same excess benefit percentage for all employees,

(B) The excess benefit percentage does not exceed the lesser of—

(*1*) Two times the sum of 0.56 percent and the base benefit percentage, or

(*2*) The sum of 0.56 percent plus the base benefit percentage plus 0.75 percent,

(C) The plan uses the same the base benefit percentage and the same intermediate benefit percentage for all employees, and

(D) The intermediate benefit percentage does not exceed the sum of 0.56 percent plus the base benefit percentage.

(iv) *Definitions.* The following definitions govern for purposes of this paragraph (c)(3).

(A) *Base benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation at or below the lower integration level specified in the plan (expressed as a percentage of such average annual compensation).

(B) *Intermediate benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation between the lower and higher integration levels specified in the plan (expressed as a percentage of such average annual compensation).

(C) *Excess benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation above the higher integration level specified in the plan (expressed as a percentage of such average annual compensation).

(d) *Offset plans*—(1) *In general.* An offset plan maintained by a railroad employer satisfies section 401(l) and §1.401(l)–3 for a plan year only if—

(i) The plan satisfies §1.401(l)–3 for the plan year without regard to the offset for the employer-derived portion of tier 2 and supplementary annuity benefits provided under the railroad retirement system, and

(ii) The offset for the employer-derived portion of tier 2 and supplementary annuity benefits provided under the railroad retirement system does not exceed the maximum tier 2 and supplementary annuity offset allowance.

(2) *Maximum tier 2 and supplementary annuity offset allowance.* For purposes of paragraph (d)(1) of this section, the maximum tier 2 and supplementary annuity offset allowance for a plan year is equal to 0.56 percent of the employee's railroad retirement covered compensation for the plan year.

(e) *Additional rules*—(1) *Definitions.* The following definitions govern for purposes of this section.

(i) *Railroad retirement taxable wage base* means the applicable base, as determined under section 3231(e)(2)B)(ii), for purposes of the tax under section 3221(b) (the tier 2 tax).

(ii) *Railroad retirement covered compensation* for an employee means 12 multiplied by the average of the 60 highest monthly railroad retirement taxable wage bases in effect for the employee's period of employment. The monthly railroad retirement taxable wage base is determined by dividing the railroad retirement taxable wage base for the calendar year in which the month occurs by 12. An employee's railroad retirement covered compensation for the plan year is determined as of the beginning of the plan year. A plan must provide that an employee's railroad retirement covered compensation is automatically adjusted for each plan year. See §1.401(l)–1(b) for rules relating to prohibited decreases in an employee's accrued benefit within the meaning of section 411(d)(6) or section 411(b)(1)(G).

(2) *Adjustments to 0.75-percent factor.* The 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance is subject to the reductions prescribed in §1.401(l)–3 (d) and (e), except that in the case of an employee with at least 30 years of service with a railroad employer, the following tables are substituted for Tables I through III contained in §1.401(l)–3(e)(3).

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.750
65	0.750
64	0.750
63	0.750
62	0.750
61	0.525
60	0.525
59	0.508
58	0.490
57	0.472
56	0.433
55	0.398

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.750
64	0.750
63	0.750
62	0.750
61	0.563
60	0.563
59	0.544
58	0.525
57	0.506
56	0.488
55	0.447

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.750
63	0.750
62	0.750
61	0.600
60	0.600
59	0.580
58	0.560
57	0.540
56	0.520
55	0.500

(3) *Adjustments to 0.56-percent factor.* The 0.56-percent factor for defined benefit excess plans and offset plans under paragraphs (c) and (d) of this section respectively is subject to the reductions prescribed in §1.401(l)–3 (d) and (e), except that, for purposes of applying this paragraph (e)(3)—

(i) ''Railroad retirement covered compensation'' is substituted for ''covered compensation'' in §1.401(l)–3(d),

(ii) The reductions under §1.401(l)–3(d) are made by multiplying the 0.56-percent factor by the ratio of the applicable factor from the table in §1.401(l)–(3)(d)(9)(iv)(A) to 0.75, and

(iii) The following tables are substituted for Tables I through III set forth in §1.401(l)–3(e)(3).

(A) Tables applicable to 0.56% factor for employees covered by tier 2 of railroad retirement with 30 or more years of railroad service.

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.560
65	0.560
64	0.560
63	0.560
62	0.560
61	0.560
60	0.560
59	0.541
58	0.523
57	0.504
56	0.462
55	0.425

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.560
64	0.560
63	0.560
62	0.560
61	0.560
60	0.560
59	0.541
58	0.523
57	0.504
56	0.485
55	0.445

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.560
63	0.560
62	0.560
61	0.560
60	0.560
59	0.541
58	0.523
57	0.504
56	0.485

TABLE III—Continued

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
55	0.467

(B) Tables applicable to 0.56% factor for employees covered by tier 2 of railroad retirement with less than 30 years of railroad service.

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.523
65	0.485
64	0.448
63	0.420
62	0.392
61	0.379
60	0.366
59	0.353
58	0.340
57	0.327
56	0.300
55	0.275

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.523
64	0.485
63	0.448
62	0.420
61	0.392
60	0.378
59	0.364
58	0.350
57	0.336
56	0.322
55	0.295

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.523
63	0.485
62	0.448
61	0.418
60	0.388
59	0.373
58	0.358
57	0.343
56	0.329

TABLE III—Continued

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
55	0.314

(4) *Overall permitted disparity*. The overall permitted disparity rules of § 1.401(l)–5 apply to employees who benefit under a plan maintained by a railroad employer.

[T.D. 8359, 56 FR 47632, Sept. 19, 1991; 57 FR 10819, 10952, Mar. 31, 1992]

§ 1.401(l)–5 Overall permitted disparity limits.

(a) *Introduction*—(1) *In general*. The maximum excess allowance and maximum offset allowance limit the disparity that can be provided under a plan for a plan year. The overall permitted disparity rules apply to limit the disparity provided for a plan year if an employee benefits under more than one plan maintained by the employer (the ''annual overall permitted disparity limit'') and to limit the disparity provided for an employee's total years of service, either in a single plan or in more than one plan of the employer (the ''cumulative overall permitted disparity limit''). The overall permitted disparity rules take into account the disparity provided under a section 401(l) plan and the permitted disparity imputed under a plan that satisfies section 401(a)(4) by relying on § 1.401(a)(4)–7. A plan that is not a section 401(l) plan is generally deemed to impute permitted disparity under § 1.401(a)(4)–7 unless established otherwise. Paragraph (b) of this section provides rules on the annual overall permitted disparity limit. Paragraph (c) of this section provides rules on the cumulative overall permitted disparity limit.

(2) *Plan requirements*. In order to satisfy section 401(l), a plan must provide that the overall permitted disparity limits may not be exceeded and must specify how employer-provided contributions or benefits under the plan are adjusted, if necessary, to satisfy the overall permitted disparity limits. Any adjustments made to satisfy the overall permitted disparity limits must

be made in a uniform manner for all employees.

(3) *Plans taken into account.* For purposes of this section, all plans of the employer are taken into account. In addition, all plans of any other employer are taken into account for all periods of service with the other employer for which the employee receives credit for purposes of benefit accrual under any plan of the current employer.

(b) *Annual overall permitted disparity limit*—(1) *In general.* If, in the plan year, an employee benefits under more than one plan, the annual overall permitted disparity limit is satisfied only if the employee's total annual disparity fraction, as defined in paragraph (b)(2) of this section, does not exceed one. Paragraphs (b)(3) through (b)(8) of this section explain the determination of an employee's annual disparity fractions. Paragraph (b)(9) of this section provides examples.

(2) *Total annual disparity fraction.* An employee's total annual disparity fraction is the sum of the employee's annual disparity fractions, as defined in paragraphs (b)(3) through (b)(7) of this section. An employee's total annual disparity fraction is determined as of the end of the current plan year, based on the employee's annual disparity fractions under all plans with plan years ending in the current plan year.

(3) *Annual defined contribution plan disparity fraction.* For a plan year, the annual defined contribution plan disparity fraction for an employee benefiting under a defined contribution plan that is a section 401(l) plan is a fraction—

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum excess allowance under §1.401(l)–2(b)(2) for the plan year.

(4) *Annual defined benefit excess plan disparity fraction.* For a plan year, the annual defined benefit excess plan disparity fraction for an employee benefiting under a defined benefit excess plan that is a section 401(l) plan is a fraction—

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum excess allowance under §1.401(l)–3(b)(2) for the plan year.

(5) *Annual offset plan disparity fraction*—(i) *In general.* For a plan year, the annual offset plan disparity fraction for an employee benefiting under an offset plan that is a section 401(l) plan is a fraction—

(A) The numerator of which is the disparity provided under the plan for the plan year; and

(B) The denominator of which is the maximum offset allowance under §1.401(l)–3(b)(3) for the plan year.

(ii) *PIA offset plans.* In the case of an offset plan that applies an offset of a specified percentage of the employee's PIA, as permitted under §1.401(l)–3(c)(2)(ix), the numerator of the annual offset plan disparity fraction is the offset percentage used in the section 401(l) overlay under the plan.

(6) *Annual imputed disparity fraction.* For a plan year, the annual imputed disparity fraction for an employee benefiting under a plan that imputes permitted disparity with respect to the employee under §1.401(a)(4)–7 is one.

(7) *Annual nondisparate fraction.* For a plan year, the annual nondisparate fraction for an employee benefiting under a plan that neither is a section 401(l) plan nor imputes permitted disparity under §1.401(a)(4)–7 is zero.

(8) *Determination of fraction*—(i) *General rule.* A separate annual disparity fraction is generally determined for each plan under which the employee benefits. Thus, for example, if two plans are aggregated and treated as a single plan for purposes of section 401(a)(4), a single annual disparity fraction applies to the aggregated plan.

(ii) *Multiple formulas.* If a plan provides an allocation or benefit equal to the sum of two or more formulas, each formula is considered a separate plan for purposes of this section. If a plan provides an allocation or benefit equal to the greater of two or more formulas, an annual disparity fraction is calculated for the employee under each formula and the largest of the fractions is the employee's annual disparity fraction under the plan.

(iii) *Offset arrangements*—(A) *In general.* If an employee benefits under two

plans taken into account under paragraph (a)(3) of this section as described in paragraph (b)(8)(iii)(B) or (C) of this section, the employee's annual disparity fraction under both plans is the larger of the annual disparity fractions calculated separately under each plan.

(B) *Defined benefit plans.* The employee's employer-provided accrued benefit under a defined benefit plan is offset by the employee's total employer-provided accrued benefit under another defined benefit plan or by the actuarial equivalent (as defined in §1.401(a)(4)–12) of the employee's total account balance under a defined contribution plan that is attributable to employer contributions.

(C) *Defined contribution plans.* The amount allocated to the employee's account under a defined contribution plan is offset by the total amount allocated to the employee's account under another defined contribution plan.

(iv) *Applicable percentages.* The disparity provided under a plan is determined on the base and excess percentages under an excess plan and the offset percentage under an offset plan, regardless of whether the employee's plan year or average annual compensation exceeds the integration or offset level under the plan.

(v) *Fractional accrual plans.* If a section 401(l) plan determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), the numerator of an employee's annual disparity fraction is based on the disparity provided in the benefit accrued for the employee for the plan year.

(9) *Examples.* The following examples illustrate this paragraph (b). Except as otherwise provided, each plan is a section 401(l) plan.

Example 1. (a) Employee A benefits for the plan year under a defined contribution excess plan, Plan X, and a defined benefit excess plan, Plan Y, of the employer. Plans X and Y have the same plan year. Employee A benefits under no other plan of the employer for the plan year of any other plan ending in the plan year of Plans X and Y. Plan X provides a base contribution percentage of 5 percent and an excess contribution percentage of 7 percent, thus providing Employee A with disparity of 2 percent for the plan year. The maximum excess allowance for the plan year under Plan X is 5 percent. Plan Y provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.35 percent, thus providing Employee A with disparity of 0.35 percent for the plan year. The maximum excess allowance for the plan year under Plan Y is 0.75 percent.

(b) Employee A's annual defined contribution plan disparity fraction under Plan X for the plan year is 0.4 (2 percent divided by 5 percent). Employee A's annual defined benefit excess plan disparity fraction under Plan Y for the plan year is 0.47 (0.35 percent divided by 0.75 percent). Employee A's total annual disparity fraction is the sum of 0.4 and 0.47 or 0.87. Because Employee A's total annual disparity fraction does not exceed one, the plans satisfy the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 2. (a) The facts are the same as in *Example 1,* except that Plan Y is a defined contribution plan, rather than a defined benefit plan. Plan X and Plan Y cover the same employees and are identical in their terms except for the base and excess contribution percentages provided under the plans. Plan Y provides a base contribution percentage of 3 percent and an excess contribution percentage of 6 percent, thus providing Employee A with disparity of 3 percent for the plan year. The maximum excess allowance for the plan year under Plan Y is 3 percent.

(b) Employee A's annual defined contribution plan disparity fraction under Plan X for the plan year is 0.4 (2 percent divided by 5 percent). Employee A's annual defined contribution plan disparity fraction under Plan Y for the plan year is 1 (3 percent divided by 3 percent). Because Employee A's total annual disparity fraction (the sum of 0.4 and 1 or 1.4) exceeds one, the plans do not satisfy the annual overall permitted disparity requirements with respect to Employee A for the plan year.

(c) Plan X and Plan Y are aggregated for purposes of section 401(a)(4) and form a single section 401(l) plan. Under the plan, the base contribution percentage is 8 percent (5 percent plus 3 percent), and the excess contribution percentage is 13 percent (7 percent plus 6 percent). A single annual defined contribution plan disparity fraction is determined for Employee A for the plan year, the numerator of which is the disparity of 5 percent provided under the plan (13 percent minus 8 percent), and the denominator of which is 5.7 percent, the maximum excess allowance that applies to the plan. Because Employee A's only annual disparity fraction of 0.88 (5 percent divided by 5.7 percent) does not exceed one, Employee A's total annual disparity fraction also does not exceed one. The plan thus satisfies the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 3. Assume the same facts as in *Example 2,* except that Plan X and Plan Y use

different integration levels. Therefore, when Plan X and Plan Y are aggregated to form a single plan for purposes of section 401(a)(4), the single plan does not satisfy section 401(l). In applying the general test of §1.401(a)(4)–2(c), the plan imputes disparity under §1.401(a)(4)–7. Employee A's only annual disparity fraction is the annual imputed disparity fraction of one. Employee A's total annual disparity fraction is also one, and the plan satisfies the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 4. (a) Employee B participates in two plans: Plan M, which is a section 401(l) plan, and Plan N, which is subject to the general test under §1.401(a)(4)–3(c). Plan M provides that the disparity provided an employee for the plan year will be reduced to the extent necessary to satisfy the annual overall permitted disparity limits. The employer wishes to impute permitted disparity under §1.401(a)(4)–7 in order for Plan N to satisfy section 401(a)(4). Employee B's imputed disparity fraction under Plan N is therefore one, and Plan M provides no disparity for Employee B for the plan year. As a result, Plan M provides disparity that is neither uniform nor deemed uniform under §1.401(l)–3(c); Plan M therefore does not satisfy section 401(l).

(b) Assume instead that Plan M provides that the annual overall permitted disparity limits must be satisfied without reducing the disparity provided for an employee under Plan M, thus requiring a reduction in the employee's annual disparity fraction under another plan. In that case, the disparity provided under Plan M would be uniform for the plan year and Plan M would continue to satisfy section 401(l). However, imputation of permitted disparity with respect to Employee B would not be allowed under Plan N.

(c) *Cumulative permitted disparity limit*—(1) *In general*—(i) *Employees who benefit under defined benefit plans.* In the case of an employee who has benefited under one or more defined benefit plans for a plan year described in paragraph (c)(1)(v) of this section, the cumulative permitted disparity limit is satisfied if the employee's cumulative disparity fraction, as defined in paragraph (c)(2) of this section, does not exceed 35.

(ii) *Employees who do not benefit under defined benefit plans.* In the case of an employee who has not benefited under a defined benefit plan for any plan year described in paragraph (c)(1)(v) of this section, the cumulative permitted disparity limit is satisfied.

(iii) *Certain plan years disregarded.* For purposes of this paragraph (c), an employee is not treated as benefiting under a defined benefit plan for a plan year described in paragraph (c)(1)(v) of this section if the employer can establish that for that plan year the defined benefit plan was not a section 401(l) plan and did not impute permitted disparity under §1.401(a)(4)–7.

(iv) *Determination of type of plan.* For purposes of this paragraph (c), a target benefit plan that relies on the special rule of §1.401(a)(4)–8(b)(3) to satisfy section 401(a)(4) and a DB/DC plan within the meaning of §1.401(a)(4)–9(a) are treated as defined benefit plans. Similarly, a cash balance plan that relies on the special rule of §1.401(a)(4)–8(c)(3) to satisfy section 401(a)(4) is treated as a defined contribution plan.

(v) *Applicable plan years.* In applying paragraphs (c)(1) (i), (ii), and (iii) of this section, for purposes of determining whether an employee benefits under a defined benefit plan, the applicable plan years are all plan years that begin on or after the regulatory effective date, as set forth in §1.401(l)–6(b), or, in the case of governmental plans, as set forth in §1.401(a)(4)–13(b).

(vi) *Transition rule for defined contribution plans.* A defined contribution plan is deemed to satisfy the cumulative permitted disparity limit for the first plan year to which these regulations apply, as set forth in §1.401(l)–6(b), or, in the case of governmental plans, as set forth in §1.401(a)(4)–13(b).

(2) *Cumulative disparity fraction.* An employee's cumulative disparity fraction is the sum of the employee's total annual disparity fractions, as defined in paragraph (b)(2) of this section, attributable to the employee's total years of service under all plans.

(3) *Determination of total annual disparity fractions for prior years.* For each of the employee's years of service credited as of the end of the last plan year beginning before January 1, 1989, not to exceed 35, under all plans as of that time that are taken into account under paragraph (a)(3) of this section (whether or not terminated), the employee's total annual disparity fraction is one. Therefore, if, before the first plan year beginning on or after January 1, 1989, an employee never participated in or benefited under any plan taken into account under paragraph (a)(3) of this

section, the employee's total annual disparity fractions are determined without regard to this paragraph (c)(3). An employer may apply the rule in this paragraph (c)(3) with respect to all employees, using a year (including the current year) that is chosen by the employer and is later than 1989. Thus, for example, in lieu of calculating annual disparity fractions for all plan years, the employer may assume that the full disparity limit has been used in each prior plan year for which an employee has been credited with a year of service.

(4) *Special rules for greater of formulas and offset arrangements*—(i) *Greater of formulas*—(A) *In general.* A defined benefit plan that is a section 401(l) plan and that provides a benefit equal to the greater of the benefits determined under two or more formulas is deemed to satisfy the cumulative permitted disparity limit with respect to an employee if each of the requirements in paragraphs (c)(4)(i) (B) and (C) of this section is satisfied. For this purpose, a plan that uses a fresh-start formula that determines the accrued benefit as the greater of two amounts under §1.401(a)(4)–13(c)(4) (ii) or (iii) provides a benefit equal to the greater of the benefits determined under two or more formulas.

(B) *Separate satisfaction by formulas.* Each formula under the plan would satisfy the cumulative permitted disparity limit if it were the only formula under the plan. In the case of a current formula that applies to the employee's total years of service (as, for example, under §1.401(a)(4)–13(c)(4) (ii)(B) or (iii)(B)), for purposes of determining whether that formula would satisfy the cumulative permitted disparity limit if it were the only formula under the plan, the special rule for prior years under paragraph (c)(3) of this section may be disregarded.

(C) *Single plan.* The employee has never benefited under another plan taken into account under paragraph (a)(3) of this section that is a section 401(l) plan or that satisfies section 401(a)(4) by relying on §1.401(a)(4)–7. For this purpose, if the benefit under the plan is offset in an offset arrangement described in paragraph (b)(8)(iii)(B) of this section, the other plan is disregarded. In addition, a plan does not fail the requirements of this paragraph (c)(4)(i)(C) merely because the employee benefits under another defined benefit plan, provided that—

(*1*) With respect to each benefit formula under the plan, no years of service taken into account under that benefit formula are taken into account under a benefit formula of the other plan; and

(*2*) Paragraph (c)(4)(i)(B) of this section would be satisfied if the plans were treated as a single plan that provided a benefit equal to the greater of the benefits provided under two or more formulas. For this purpose, a formula consists of the sum of a formula for the years of service taken into account under one plan and a formula for the years of service taken into account under the other plan. Thus, each possible combination of the formulas under the plans must satisfy paragraph (c)(4)(i)(B) of this section.

(ii) *Offset arrangements*—(A) *In general.* If a defined benefit plan is a section 401(l) plan and the benefit under the plan (the gross benefit plan) is offset by the benefit under another plan (the offsetting plan) in an offset arrangement described in paragraph (b)(8)(iii)(B) of this section, the gross benefit plan is deemed to satisfy the cumulative permitted disparity limit with respect to an employee if each of the requirements in paragraphs (c)(4)(ii) (B) and (C) of this section is satisfied.

(B) *Separate satisfaction by plans.* This requirement is satisfied if the gross benefit plan would satisfy the cumulative disparity limit if no offset applied, and the offsetting plan satisfies the cumulative permitted disparity limit, not taking into account the gross benefit plan.

(C) *No other plan.* Except for the plans in the offset arrangement, the employee has never benefited under another plan taken into account under paragraph (a)(3) of this section that is a section 401(l) plan or that satisfies section 401(a)(4) by relying on §1.401(a)(4)–7. An offset arrangement does not fail the requirements of this paragraph (c)(4)(ii)(C) merely because the employee benefits under another defined benefit plan, provided no years

of service taken into account under a benefit formula of any plan in the offset arrangement are also taken into account under a benefit formula of the other plan.

(5) *Examples*. The following examples illustrate this paragraph (c). In each example the plan is noncontributory and, unless provided otherwise, is the only plan ever maintained by the employer. Each plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under § 1.401(l)–3(b)(2) or (3). Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to covered compensation, plus 1.75 percent of average annual compensation above covered compensation, for each year of service without limit. The disparity provided under the plan for the plan year is 0.75 percent, the excess benefit percentage of 1.75 percent minus the base benefit percentage of 1 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is one. Because the plan contains no limit on the years of service taken into account under the plan, the sum of the total annual disparity fractions for a potential employee with more than 35 years of service will exceed 35. In addition, the plan does not provide that the overall permitted disparity limits may not be exceeded as required by paragraph (a)(2) of this section. The plan therefore does not satisfy the cumulative permitted disparity limit of this paragraph (c).

Example 2. Plan N is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.75 percent of final average compensation up to the lesser of covered compensation and average annual compensation, for each year of service up to 35. The disparity provided under the plan for the plan year is 0.75 percent, the offset percentage. The maximum offset allowance for the plan year is 0.75 percent. Thus, each employee's annual offset plan disparity fraction under the plan for each plan year is one. Because the plan limits the years of service taken into account under the plan to 35, the sum of the total annual disparity fractions for an employee cannot exceed 35. The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 3. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation, plus 1.25 percent of average annual compensation above covered compensation, for each year of service up to 45. The disparity provided under the plan for the plan year is 0.5 percent, the excess benefit percentage of 1.25 percent minus the base benefit percentage of 0.75 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is 0.67 (0.5 percent divided by 0.75 percent). Because the plan limits the years of service taken into account under the plan to 45, the sum of the total annual disparity fractions for an employee cannot exceed 30 (0.67 x 45). The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 4. (a) Plan P is a defined contribution excess plan. Plan P provides a base contribution percentage of 6 percent and an excess contribution percentage of 11.7 percent, thus providing disparity of 5.7 percent for the plan year. Because the maximum excess allowance for each plan year under Plan P is 5.7 percent, each employee's annual defined contribution plan disparity fraction under Plan P for each plan year is one. Plan Q is a defined benefit excess plan maintained by the same employer. Plan Q provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.75 percent for each year of service up to 35, thus providing disparity of 0.75 percent for the plan year. Because the maximum excess allowance for each plan year under Plan Q is 0.75 percent, each employee's annual defined benefit excess plan disparity fraction under Plan Q for each plan year is one.

(b) Employee A benefits under Plan P for the 1980 through the 1994 plan years. The sum of Employee A's total annual disparity fractions under Plan P is 15. (Under paragraph (c)(3)(i) of this section, Employee A's annual disparity fraction for each year of service as of the end of the 1988 plan year is one.) As of the 1995 plan year, Employee A no longer benefits under Plan P and begins to benefit under Plan Q for the first time. In order to satisfy the cumulative permitted disparity limit of this paragraph (c), Plan Q must provide that no disparity will be provided if the sum of an employee's total annual disparity fractions reaches 35, taking into account the employee's annual defined contribution plan disparity fractions under Plan P as well as the employee's annual defined benefit excess plan disparity fractions under Plan Q. Thus, after Employee A has benefited under Plan Q for 20 years, Plan Q may not provide any disparity in additional benefits accrued for Employee A.

Example 5. (a) Plan O is a noncontributory defined benefit excess plan. Plan O provides an employee whose social security retirement age is 65 with the greater of the benefits determined under two formulas. The first formula provides a benefit of 1 percent of average annual compensation up to covered compensation, plus 1.75 percent of average annual compensation above covered compensation, for each year of service up to 35. The second formula provides a benefit of 1 percent of average annual compensation up to covered compensation, plus 1.6 percent of average annual compensation above covered compensation, for each year of service up to 40.

(b) Under paragraph (b)(4) of this section, an employee's annual defined benefit excess plan fraction for each of the 35 years under the first formula is 0.75/0.75 or one, and an employee's annual defined benefit excess plan fraction for each of the 40 years under the second formula is 0.6/0.75 or 0.8. Under paragraph (b)(8)(ii) of this section, an employee's annual defined benefit excess plan fraction (and total annual disparity fraction because the employee benefits only under Plan O) for the plan year is the larger fraction under the two formulas or one. Therefore, after 35 years, the employee has a cumulative disparity fraction of 35. The disparity provided under the second formula for years of service after 35 thus exceeds the cumulative permitted disparity limit unless the plan qualifies for the special rule in paragraph (c)(4)(i) of this section.

(c) Assume the condition in paragraph (c)(4)(i)(C) of this section is satisfied because no employee has benefited under another plan taken into account under paragraph (a)(3) of this section. In addition, the largest cumulative disparity fraction possible under the first formula is 35 times one or 35, and the largest cumulative disparity fraction possible under the second formula is 40 times 0.8 or 32. Thus, the requirement of paragraph (c)(4)(i)(B) of this section is also satisfied because each formula would satisfy the cumulative permitted disparity limit if it were the only formula under the plan. Under paragraph (c)(4)(i) of this section, the plan is deemed to satisfy the cumulative permitted disparity limit with respect to an employee whose social security retirement age is 65.

(d) *Additional rules.* The Commissioner may prescribe additional rules under this section as the Commissioner considers appropriate. Additional rules may include (without being limited to) rules for computing the fractions described in this section with respect to terminated plans, rules for applying the overall permitted disparity limits to employees who benefit under plans maintained by railroad employers, and rules for determining which plans do not satisfy section 401(l) if the overall permitted disparity limits are exceeded.

[T.D. 8359, 56 FR 47634, Sept. 19, 1991; 57 FR 10819, 10952, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46833, Sept. 3, 1993]

§ 1.401(l)–6 Effective dates and transition rules.

(a) *Statutory effective date*—(1) *In general.* Except as otherwise provided in paragraph (a)(2) of this section, section 401(a)(5)(C) is effective for plan years beginning on or after January 1, 1989, and section 401(l) is effective with respect to plan years, and benefits attributable to plan years, beginning on or after January 1, 1989. The preceding sentence is applicable to a plan without regard to whether the plan was in existence as of a particular date.

(2) *Collectively bargained plans.* (i) In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, sections 401(a)(5) and 401(l) are applicable for plan years beginning on or after the later of—

(A) January 1, 1989; or

(B) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986). However, notwithstanding the preceding sentence, sections 401(a)(5) and 401(l) apply to plans described in this paragraph (a)(2) no later than the first plan year beginning after January 1, 1991.

(ii) For purposes of paragraph (a)(2)(i)(B) of this section, a change made after October 22, 1986, in the terms or conditions of a collectively bargained plan, pursuant to a collective bargaining agreement ratified before March 1, 1986, is not treated as a change in the terms and conditions of the plan.

(iii) In the case of a collectively bargained plan described in paragraph (a)(2)(i) of this section, if the date in paragraph (a)(2)(i)(B) of this section precedes November 15, 1988, then the date in this paragraph (a)(2) is replaced with the date on which the last of any

collective bargaining agreements in effect on November 15, 1988, terminates, provided that the plan complies during this period with a reasonable good faith interpretation of section 401(l).

(iv) Whether a plan is maintained pursuant to a collective bargaining agreement is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan is not treated as maintained under a collective bargaining agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See § 301.7701–17T of this chapter for other requirements for a plan to be considered to be collectively bargained.

(b) *Regulatory effective date*—(1) *In general*. Except as otherwise provided in paragraph (b)(2) of this section, §§ 1.401(l)–1 through 1.401(l)–6 apply to plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations*. In the case of plans maintained by an organization exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§ 1.401(l)–1 through 1.401(l)–6 apply to plan years beginning on or after January 1, 1996.

(3) *Defined contribution plans*. A defined contribution plan satisfies section 401(l) with respect to a plan year beginning on or after the effective date of these regulations, as set forth in paragraphs (b)(1) and (b)(2) of this section, if it satisfies the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 for the plan year.

(4) *Defined benefit plans*. A defined benefit excess plan or offset plan satisfies section 401(l) with respect to all plan years, and benefits attributable to all plan years, beginning on or after the effective date of these regulations, as set forth in paragraphs (b)(1) and (b)(2) of this section, by satisfying the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 and the requirements of § 1.401(a)(4)–13(c) (and § 1.401(a)(4)–13(d), if applicable), using a fresh-start date that is on or after December 31, 1988, and before the effective date of these regulations. A defined benefit excess plan or offset plan that does not satisfy section 401(l) with respect to all plan years beginning on or after the effective date of these regulations may, under the rules of § 1.401(a)(4)–13(c) (and § 1.401(a)(4)–13(d), if applicable), satisfy section 401(l) for plan years beginning after a fresh-start date by satisfying the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 after the fresh-start date.

(c) *Compliance during transition period*. For plan years beginning on or after January 1, 1989, and before the effective date of these regulations, as set forth in paragraph (b) of this section, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(l). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(l) will generally be determined based on all of the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(*l*) if it is operated in accordance with the terms of §§ 1.401(*l*)–1 through 1.401(*l*)–5.

[T.D. 8486, 58 FR 46835, Sept. 3, 1993]

§ 1.401(m)–0 Employee and matching contributions, table of contents.

This section contains the captions that appear in §§ 1.401(m)–1 and 1.401(m)–2.

§ 1.401(m)–1 Employee and matching contributions.

(a) General rules.
(1) Nondiscriminatory amount of contributions.
(2) Other nondiscrimination rules.
(3) Rules applicable to collectively bargained plans.
(b) Actual contribution percentage test.
(1) General rule.
(2) Plan provision requirement.
(3) Aggregation of plans.
(i) General rule.
(ii) Restructuring and Permissive Disaggregation.
(4) Employee and matching contributions taken into account under the actual contribution percentage test.
(i) Employee contributions.
(A) General rule.
(B) Recharacterized elective contributions.
(ii) Matching contributions.

(A) General rule.
(B) Matching contributions and qualified nonelective contributions used to satisfy actual deferral percentage test.
(C) Treatment of forfeited matching contributions.
(5) Qualified nonelective contributions and elective contributions that may be taken into account under the actual contribution percentage test.
(c) Additional requirements.
(1) Coordination with other plans.
(2) Recordkeeping requirement.
(3) Consistent application of separate line of business rules.
(d) Examples.
(e) Correction of excess aggregate contributions.
(1) General rule.
(i) Permissible correction methods.
(ii) Combination of correction methods.
(iii) Impermissible correction methods.
(iv) Partial correction.
(2) Amount of excess aggregate contributions.
(i) General rule.
(ii) Coordination with correction of excess contributions.
(iii) Correction of family members.
(3) Corrective distribution of excess aggregate contributions (and income).
(i) General rule.
(ii) Income allocable to excess aggregate contributions.
(A) General rule.
(B) Method of allocating income.
(C) Alternative method of allocating income.
(D) Safe harbor method of allocating gap period income.
(E) Allocable income for recharacterized elective contributions.
(iii) No employee or spousal consent required.
(iv) Treatment of corrective distributions and forfeited contributions as employer contributions.
(v) Tax treatment of corrective distributions.
(A) General rule.
(B) Rule for de minimis distributions.
(C) Rule for certain 1987 and 1988 excess aggregate contributions.
(vi) No reduction of required minimum distribution.
(vii) No corrective distribution of matching contributions other than excess aggregate contributions.
(4) Coordination with section 401(a)(4).
(5) Failure to correct.
(i) Failure to correct within 2½ months after end of plan year.
(ii) Failure to correct within 12 months after end of plan year.
(6) Examples.
(f) Definitions.
(1) Actual contribution percentage.
(i) General rule.
(ii) Actual contribution ratio.
(A) General rule.
(B) Highly compensated employee eligible under more than one plan.
(C) Employees subject to family aggregation rules.
(*1*) Aggregation of employee contributions and other amounts.
(*2*) Effect on actual contribution percentage of nonhighly compensated employees.
(*3*) Multiple family groups.
(2) Compensation.
(3) Elective contributions.
(4) Eligible employee.
(i) General.
(ii) Certain one-time elections.
(5) Employee.
(6) Employee contributions.
(7) Employer.
(8) Excess aggregate contributions.
(9) Excess contributions.
(10) Excess deferrals.
(11) Highly compensated employee.
(12) Matching contributions.
(i) In general.
(ii) Employer contributions made on account of employee or elective contributions.
(iii) Contributions used to meet the requirements of section 416.
(13) Nonelective contributions.
(14) Plan.
(15) Qualified nonelective contributions.
(16) Section 401(k) plan.
(17) Section 401(m) plan.
(g) Effective dates.
(1) General rule.
(2) Collectively bargained plans.
(3) Certain annuity contracts.
(4) State and local government plans.
(5) Transition rule for plan years beginning before 1992.
(i) General rule.
(ii) Restructuring.
(A) General rule.
(B) Identification of component plans.
(*1*) Minimum coverage requirement.
(*2*) Commonality requirement.

§ 1.401(m)–2 Multiple Use of alternative limitation.

(a) In general.
(b) General rule for determination of multiple use.
(1) In general.
(2) Alternative limitation.
(3) Aggregate limit.
(i) In general.
(ii) Relevant actual deferral percentage and relevant actual contribution percentage defined.
(iii) Examples.
(c) Correction of multiple use.
(1) In general.
(2) Treatment of required reduction.

(3) Required reduction.
(4) Examples.
(d) Effective date.
(1) General rule.
(2) Transition rule.

[T.D. 8357, 56 FR 40534, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63432, Dec. 4, 1991; T.D. 8581, 59 FR 66175, Dec. 23, 1994]

§ 1.401(m)–1 Employee and matching contributions.

(a) General Rules—(1) *Nondiscriminatory amount of contributions.* A defined contribution plan does not satisfy section 401(a)(4) for a plan year unless the amount of employee and matching contributions to the plan for the plan year satisfies section 401(a)(4). See § 1.401(a)(4)–1(b)(2)(ii). Except as specifically provided otherwise, for plan years beginning after December 31, 1986 (or such later date provided in paragraph (g) of this section) the amount of employee and matching contributions under a plan satisfies the requirements of section 401(a)(4) only if the employee and matching contributions under the plan satisfy the actual contribution percentage test of section 401(m)(2) and paragraph (b) of this section. See § 1.401(a)(4)–1(b)(2)(ii)(B). Also, except as specifically provided otherwise, for plan years beginning after December 31, 1988 (or such later date provided in § 1.401(m)–2(d)), the amount of employee and matching contributions under a plan satisfies the requirements of sections 401(m) and 401(a)(4) only if any multiple use of the alternative methods of compliance with sections 401 (k) and (m) (contained in sections 401(k)(3)(A)(ii)(II) and 401(m)(2)(A)(ii), respectively) is corrected under § 1.401(m)– 2(c). See section 401(m)(9) and § 1.401(m)–2. For these purposes, the employee and matching contributions are combined with the elective and qualified nonelective contributions, if any, that are treated as matching contributions, and the recharacterized elective contributions, if any, that are treated as employee contributions for purposes of section 401(m).

(2) *Other nondiscrimination rules.* Nondiscrimination requirements in addition to those described in paragraph (a)(1) of this section apply to employee and matching contributions under sections 401(a)(4) and 410(b). For example, under section 401(a)(4) a plan may not discriminate with respect to the availability of benefits, rights, and features under the plan. See § 1.401(a)(4)–1(b)(3). The right to make each level of employee contributions, and the right to each level of matching contributions, are benefits, rights, or features subject to this requirement, and each level must therefore generally be available to a group of employees that satisfies section 410(b). See § 1.401(a)(4)–4(e)(3) (i) and (iii) (F) through (G). Thus, for example, a plan does not satisfy section 401(a)(4) if it provides a higher rate of matching contributions for highly compensated employees than for nonhighly compensated employees. See paragraph (e)(4) of this section for rules relating to the application of section 401(a)(4) to the correction of excess aggregate contributions. See § 1.401(a)(4)–11(g)(3)(vii) for special rules relating to correction of violations of the minimum coverage requirements or discriminatory rates of match in a section 401(m) plan. For special rules governing the application of section 410(b) to employee and matching contributions, see §§ 1.410(b)–7(c)(1) and 1.410(b)–8(a)(1).

(3) *Rules applicable to collectively bargained plans.* The requirements of this section are treated as satisfied by employee and matching contributions under a collectively bargained plan (or the portion of a plan) that automatically satisfies section 410(b). See §§ 1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7). There are no excess aggregate contributions under a plan (or a portion of a plan) that is treated under this paragraph (a)(3) as satisfying the requirements of this section. Thus, the provisions of section 4979 and § 54.4979–1 of this chapter do not apply to contributions described in the first sentence of this paragraph (a)(3).

(b) *Actual contribution percentage test*—(1) *General rule.* (i) For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, the actual contribution percentage test is satisfied if—

(A) The actual contribution percentage for the group of eligible highly compensated employees is not more than the actual contribution percentage for the group of all other eligible employees multiplied by 1.25; or

(B) The excess of the actual contribution percentage for the group of eligible highly compensated employees over the actual contribution percentage for the group of all other eligible employees is not more than two percentage points, and the actual contribution percentage for the group of eligible highly compensated employees is not more than the actual contribution percentage for the group of all other eligible employees multiplied by two.

(ii) A plan does not fail to satisfy the requirements of this paragraph (b)(1) merely because all of the eligible employees under the plan for a year are highly compensated employees.

(2) *Plan provision requirement.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, a plan that permits employee or matching contributions does not satisfy the requirements of section 401(a) unless it provides that the actual contribution percentage test of section 401(m)(2) will be met. For purposes of this paragraph (b)(2), the plan may incorporate the provisions of section 401(m)(2), this paragraph (b), and, if applicable, section 401(m)(9) and §1.401(m)–2.

(3) *Aggregation of plans*—(i) *General rule.* See §1.401(m)–1(f)(14) for the definition of a plan used for purposes of this section and §1.401(m)–2. That definition contains the exclusive rules for aggregation and disaggregation of plans for purposes of this section and §1.401(m)–2.

(ii) *Restructuring and Permissive Disaggregation.* Effective for plan years beginning after December 31, 1991, restructuring under §1.401(a)(4)–9(c) may not be used to demonstrate compliance with the requirements of section 401(m). See §1.401(a)(4)– 9(c)(3)(ii). For plan years beginning before January 1, 1992, see §1.401(m)–1(g)(5)(ii). An employer may, however, treat a plan benefiting otherwise excludable employees as two separate plans for purposes of sections 401(m) and 410(b) in accordance with §§1.410(b)–6(b)(3) and 1.410(b)–7(c)(3).

(4) *Employee and matching contributions taken into account under the actual contribution percentage test*—(i) *Employee contributions*—(A) *General rule.* An employee contribution is taken into account under paragraph (b)(1) of this section for the plan year in which the contribution is made to the trust. For this purpose, a payment by the employee to an agent of the plan is treated as a contribution to the trust at the time of payment to the agent if the funds paid are transmitted to the trust within a reasonable period after the payment to the agent.

(B) *Recharacterized elective contributions.* An excess contribution that is recharacterized under §1.401(k)–1(f)(3) is taken into account as an employee contribution for the plan year that includes the time at which the excess contribution is includible in the gross income of the employee under §1.401(k)–1(f)(3)(ii).

(ii) *Matching contributions*—(A) *General rule.* A matching contribution is taken into account under paragraph (b)(1) of this section for a plan year only if the contribution is allocated to the employee's account under the terms of the plan as of any date within the plan year, is actually paid to the trust no later than 12 months after the close of the plan year, and is made on behalf of an employee on account of the employee's elective contributions or employee contributions for the plan year. Matching contributions that do not satisfy these requirements are not taken into account under paragraph (b)(1) of this section for any plan year. Instead, the amount of these matching contributions must satisfy the requirements of section 401(a)(4) (without regard to the special nondiscrimination rule in paragraph (b)(1) of this section) for the plan year for which they are allocated under the plan, as if they were nonelective contributions and were the only nonelective employer contributions for that year. See §§1.401(a)(4)–1(b)(2)(ii)(B); 1.410(b)–7(c)(1).

(B) *Matching contributions and qualified nonelective contributions used to satisfy actual deferral percentage test.* A matching contribution that is treated as an elective contribution is subject to the actual deferral percentage test of section 401(k)(3) and is not taken into account under paragraph (b)(1) of this section. See §1.401(k)–1(b)(5)(iii) for the rule relating to years before January 1, 1987. A qualified nonelective

contribution that is treated as an elective contribution is subject to the actual deferral percentage test of section 401(k)(3) and is not taken into account as a matching contribution under paragraph (b)(1) or (5) of this section.

(C) *Treatment of forfeited matching contributions.* A matching contribution that is forfeited to correct excess aggregate contributions, or because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution, is not taken into account under paragraph (b)(1) of this section.

(5) *Qualified nonelective contributions and elective contributions that may be taken into account under the actual contribution percentage test.* Except as specifically provided otherwise, for purposes of paragraph (b)(1) of this section, all or part of the qualified nonelective contributions and elective contributions made with respect to any or all employees who are eligible employees under the plan of the employer being tested may be treated as matching contributions provided that each of the following requirements (to the extent applicable) is satisfied:

(i) The amount of nonelective contributions, including those qualified nonelective contributions treated as matching contributions for purposes of the actual contribution percentage test, satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2).

(ii) The amount of nonelective contributions, excluding those qualified nonelective contributions treated as matching contributions for purposes of the actual contribution percentage test and those qualified nonelective contributions treated as elective contributions under §1.401(k)–1(b)(5) for purposes of the actual deferral percentage test, satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2).

(iii) The elective contributions, including those treated as matching contributions for purposes of the actual contribution percentage test, satisfy the requirements of section 401(k)(3).

(iv) The qualified nonelective contributions are allocated to the employee under the plan as of a date within the plan year (within the meaning of §1.401(k)–1(b)(4)(i)(A)), and the elective contributions satisfy §1.401(k)–1(b)(4)(i) for the plan year.

(v) For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, the plan that takes qualified nonelective contributions and elective contributions into account in determining whether employee and matching contributions satisfy the requirements of section 401(m)(2)(A), and the plans to which the qualified nonelective contributions and elective contributions are made, could be aggregated under §1.410(b)–7(d) after application of the mandatory disaggregation rules of §1.410(b)–7(c), as modified in §1.401(k)–1(g)(11). If the plan year of the section 401(m) plan is changed to satisfy the requirement under §1.410(b)–7(d)(5) that the aggregated plans have the same plan year, the elective contributions may be taken into account in the resulting short plan year only if these contributions satisfy the requirements of §1.401(k)–1(b)(4) with respect to the short year, and the qualified nonelective contributions may be taken into account in the resulting short plan year only if these contributions satisfy the requirements of §1.401(k)–1(b)(4)(i)(A) with respect to the short year as if they were elective contributions.

(c) *Additional requirements*—(1) *Coordination with other plans.* Except as expressly permitted under section 401(k) or 401(m), for plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, employee or matching contributions (or elective contributions treated as matching contributions under paragraph (b)(5) of this section) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee or matching contributions are made) satisfy the requirements of section 401(a). Indeed, the portion of a plan that consists of employee and matching contributions is treated as a separate plan for purposes of sections 401(a)(4) and 410(b). See §1.410(b)–7(c)(1). Similarly, although matching contributions and qualified nonelective contributions may be used to enable a

plan to satisfy the minimum contribution or benefit requirements under section 416, matching contributions that are used in this way are not treated as matching contributions, and must therefore satisfy the nondiscrimination requirements of section 401(a)(4) without regard to section 401(k) or 401(m). See §1.416–1, M–18 & M–19 and paragraph (f)(12)(iii) of this section. See also §1.401(k)–1(b)(5) for circumstances under which matching contributions may be used to determine whether a plan satisfies the requirements of section 401(k). This paragraph does not apply for purposes of determining whether a plan satisfies the average benefit percentage test of section 410(b)(2)(A)(ii).

(2) *Recordkeeping requirement.* A plan satisfies this section only if the employer maintains the records necessary to demonstrate compliance with the applicable nondiscrimination requirements of paragraph (b) of this section, including records showing the extent to which qualified nonelective contributions and elective contributions are taken into account.

(3) *Consistent application of separate line of business rules.* If an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b), and applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of the plan that consists of matching contributions or to the portion of the plan that consists of employee contributions (the ''matching and employee contribution portions''), then the requirements of this section, section 401(m), and §1.401(m)–2 must be applied on an employer-wide rather than a qualified-separate-line-of-business basis to all of the plans or portions of plans taken into account in determining whether those requirements are satisfied by the matching and employee contribution portions of the plan (regardless of whether the other plans or portions of plans also satisfy the requirements necessary to apply the special rule in §1.414(r)–1(c)(2)(ii)). Conversely, if an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b), and does not apply the special rule for employer-wide plans in §1.414(r)1–(c)(2)(ii) to either the matching or employee contribution portions of the plan, then the requirements of this section, section 401(m) and §1.401(m)–2 must be applied on a qualified-separate-line-of-business rather than an employer-wide basis to all of the plans or portions of plans taken into account in determining whether those requirements are satisfied by the matching and employee contribution portions of the plan (regardless of whether one or more of the other plans or portions of plans is tested under the special rule §1.414(r)–1(c)(2)(ii)). This requirement applies solely for purposes of determining whether the requirements of this section, section 401(m), and §1.401(m)–2 are satisfied by the matching and employee contribution portions of the plan. The rules of this paragraph are illustrated by the following example.

Example. (i) Employer A maintains a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. Under the profit-sharing plan, each $1.00 of elective contributions under the cash or deferred arrangement is matched by $0.50 of employer contributions. Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b). However, Employer A applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of its profitsharing plan that consists of matching contributions. Employer A makes qualified nonelective contributions to the profit-sharing plan for the 1995 plan year.

(ii) Under these facts, the requirements of sections 401(a)(4) and 410(b) must be applied on an employer-wide rather than a qualified-separate-line-of-business basis in determining whether these qualified nonelective contributions (and any elective contributions under the cash or deferred arrangement) satisfy the requirements of §1.401(m)–1(b)(5), and thus whether they may be taken into account under the actual contribution percentage test. Thus, in order for the nonelective contributions to be used to satisfy the actual contribution percentage test, both (1) the total amount of nonelective contributions under the profit-sharing plan, including the qualified nonelective contributions to be used to satisfy the actual contribution percentage test, and (2) the total amount of nonelective contributions under the profit-

sharing plan, excluding the qualified nonelective contributions to be used to satisfy the actual contribution percentage test, must satisfy the requirements of section 401(a)(4) on an employer-wide basis. Further, in order for any elective contributions under the cash or deferred arrangement to be used to satisfy the actual contribution percentage test, the total amount of elective contributions, including any treated as matching contributions under the actual contribution percentage test, must satisfy the requirements of section 401(k)(3) on an employer-wide basis. Of course, in order for the profit-sharing plan to satisfy section 401(a), it must still satisfy sections 410(b) and 401(a)(4) on a qualified-separate-line-of-business basis.

(d) *Examples*. The provisions of paragraphs (a) through (c) of this section are illustrated by the following examples. Assume in each case that the employer is a corporation, and that the employer's taxable year and plan year are the calendar year. Also assume that the employee contributions, elective contributions, matching contributions and qualified nonelective contributions meet the applicable requirements of sections 401(a)(4) and 410. For methods to be used to correct excess aggregate contributions, see paragraph (e) of this section.

Example 1. (i) Employer L maintains a profit-sharing plan providing for voluntary employee contributions. L does not maintain a plan that includes a cash or deferred arrangement. For the 1988 plan year, the actual contribution percentages (ACPs) for the highly compensated employees and nonhighly compensated employees are shown in the following chart:

	Actual contribution percentage
Highly compensated	10
Nonhighly compensated	5

(ii) This plan fails to qualify under either of the tests of section 401(m)(2)(A) because the ACP for highly compensated employees is more than 125 percent of the ACP for nonhighly compensated employees, and exceeds the ACP for the nonhighly compensated employees by more than two percentage points. L must either reduce the ACP for the highly compensated employees to seven percent (to satisfy the 200 percent/two percentage point test) or increase the ACP of the nonhighly compensated employees to eight percent (to satisfy the 125 percent test).

Example 2. (i) Employer M maintains a plan under which each dollar of employee contributions is matched with $.50 of employer contributions. M maintains no other plan. For the 1988 plan year, the average percentage of compensation contributed to the plan for the employees is shown in the following chart:

	Employee contributions (percent)	Matching contributions (percent)	Actual contribution percentage
Highly compensated	10	5	15
Nonhighly compensated	5	2.5	7.5

(ii) This plan fails to satisfy either of the tests of section 401(m)(2)(A). Employer M must either reduce the actual contribution percentage of the highly compensated employees to 9.5 percent (to satisfy the 200 percent/two percentage point test) or increase the actual contribution percentage of the nonhighly compensated employees to 12 percent (to satisfy the 125 percent test).

Example 3. (i) Employer N maintains a plan that contains a cash or deferred arrangement and permits employee contributions. Employer N includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). For the 1988 plan year, the average percentages of compensation contributed to the plan by the highly compensated and nonhighly compensated employees as elective contributions and employee contributions are shown in the chart below. Elective contributions meet the requirements of paragraph (b)(5) of this section.

	Elective Contributions (percent)	Employee Contributions (percent)
Highly compensated	10	10
Nonhighly compensated	10	6

(ii) The plan fails to meet the requirements of section 401(m) because the actual contribution percentage (ACP) of highly compensated employees is more than 125 percent of the ACP of the other employees, and exceeds the ACP of the other employees by more than two percentage points.

(iii) The plan provides that elective contributions made by nonhighly compensated employees may be used to meet the requirements of section 401(m) to the extent needed under that section. Under this provision, the plan uses elective contributions equal to two percent of the compensation of the nonhighly compensated employees in the ACP test. After this adjustment, the actual deferral percentages (ADPs) and ACPs are as follows:

	ADP (percent)	ACP (percent)
Highly compensated	10	10
Nonhighly compensated	8	8

(iv) The ACP of the highly compensated employees meets the requirements of section

401(m)(2)(A)(i) because it is 125 percent of that for nonhighly compensated employees. The ADP of the highly compensated employees similarly satisfies the 125 percent test. The plan would also meet the requirements of section 401(m) if all elective contributions were used in the ACP test. This is because the ACP for the highly compensated employees (20 percent) would be 125 percent of the ACP for the nonhighly compensated employees (16 percent).

Example 4. (i) Employer P maintains a plan that includes a cash or deferred arrangement. Elective contributions, qualified nonelective contributions (QNCs), employee contributions, and matching contributions are made to the plan. Employer P includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). The elective contributions and QNCs meet the requirements of paragraph (b)(5) of this section. For the 1989 plan year, the QNCs, elective contributions, and employee and matching contributions, expressed as a percentage of compensation, are shown in the following table:

	QNCs (percent)	Elective Contributions (percent)	Employee/ Matching Contributions (percent)
Highly compensated	3	5	6
Nonhighly compensated	3	4	2

(ii) The elective contributions meet the test of section 401(k)(3)(A)(ii). The employee and matching contributions, however, do not meet the actual contribution percentage (ACP) test. P may not use any QNCs of the nonhighly compensated employees to meet the ACP test because the remaining QNCs would discriminate in favor of the highly compensated employees. However, P could make additional QNCs or matching contributions of two percent of compensation on behalf of the nonhighly compensated employees. Alternatively, P could treat all QNCs for all employees and elective contributions equal to one percent of compensation for nonhighly compensated employees as matching contributions and make additional QNCs of 1.2 percent of compensation on behalf of nonhighly compensated employees. The ACPs for highly and nonhighly compensated employees would then be nine percent and 7.2 percent, respectively, thus satisfying the 125 percent test. The actual deferral percentages would be five and three percent, respectively, which would satisfy the 200 percent/two percentage point test.

Example 5. (i) Employer P maintains a cash or deferred arrangement. Elective contributions, qualified nonelective contributions (QNCs), employee contributions, and matching contributions are made to the plan. The elective contributions and the QNCs meet the requirements of paragraph (b)(5) of this section. For the 1989 plan year, the contributions are shown in the following table:

	QNCs (percent)	Elective contributions (percent)	Employee/ matching contributions (percent)
Highly compensated	0	6	6
Nonhighly compensated	3	3	3

(ii) The QNCs may be used in the actual deferral percentage (ADP) test, the actual contribution percentage (ACP) test, or a combination of the two. If P treats one-third of the QNCs as elective contributions and two-thirds as matching contributions, the ADPs for the highly compensated and nonhighly compensated employees are six and four percent, respectively, and satisfy the 200 percent/two percentage point test. Similarly, the ACPs for the two groups are six and five percent, respectively, and satisfy the 125 percent test.

(e) *Correction of excess aggregate contributions*—(1) *General rule*—(i) *Permissible correction methods.* A plan satisfies the requirements of section 401(m)(2) and paragraph (b)(1) of this section with respect to the amount of employee and matching contributions under the plan if the employer, in accordance with the terms of the plan and paragraph (b)(5) of this section, makes qualified nonelective contributions or elective contributions that, in combination with employee and matching contributions, satisfy the actual contribution percentage test. In addition, a plan subject to the requirements of section 401(m) satisfies section 401(m)(2) and paragraph (b)(1) of this section if, in accordance with the terms of the plan, excess aggregate contributions on behalf of highly compensated employees (and the income allocable to these contributions) are distributed in accordance with paragraph (e)(3) of this section. Matching contributions (and the income allocable to matching contributions) that are not vested (determined without regard to any increase in vesting that may occur after the date of the forfeiture) may also be forfeited to correct excess aggregate contributions. Finally, a plan may limit employee or matching contributions in a manner that prevents excess aggregate contributions from being made.

(ii) *Combination of correction methods.* The plan may permit a combination of the methods listed in paragraph (e)(1)(i) of this section to avoid or correct excess aggregate contributions.

(iii) *Impermissible correction methods.* Excess aggregate contributions may not be corrected by forfeiting vested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess aggregate contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5). See paragraph (e)(5) of this section for the effects of a failure to correct excess aggregate contributions. See §1.411(a)–4(b)(7) regarding permissible forfeitures of matching contributions.

(iv) *Partial correction.* Any distribution of less than the entire amount of excess aggregate contributions (and income) is treated as a pro rata distribution of excess aggregate contributions and income.

(2) *Amount of excess aggregate contributions*—(i) *General rule.* The amount of excess aggregate contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's employee and matching contributions must be reduced for the employee's actual contribution ratio to equal the highest permitted actual contribution ratio under the plan. To calculate the highest permitted actual contribution ratio under a plan, the actual contribution ratio of the highly compensated employee with the highest actual contribution ratio is reduced by the amount required to cause the employee's actual contribution ratio to equal the ratio of the highly compensated employee with the next highest actual contribution ratio. If a lesser reduction would enable the arrangement to satisfy the actual contribution percentage test, only this lesser reduction may be made. This process must be repeated until the plan satisfies the actual contribution percentage test. The highest actual contribution ratio remaining under the plan after leveling is the highest permitted actual contribution ratio. For each highly compensated employee, the amount of excess aggregate contributions for a plan year is equal to the total employee and matching contributions, plus qualified nonelective contributions and elective contributions taken into account in determining the employee's actual contribution ratio under paragraph (f)(1) of this section, minus the amount determined by multiplying the employee's actual contribution ratio (determined after application of this paragraph (e)(2)) by the compensation used in determining the ratio. In no case may the amount of excess aggregate contributions with respect to any highly compensated employee exceed the amount of employee and matching contributions made on behalf of the highly compensated employee for the plan year.

(ii) *Coordination with correction of excess contributions.* The amount of excess aggregate contributions with respect to an employee for a plan year is calculated after determining the excess contributions to be recharacterized as employee contributions for the plan year.

(iii) *Correction of family members.* The determination and correction of excess aggregate contributions of a highly compensated employee whose actual contribution ratio is determined under the family aggregation rules of paragraph (f)(1)(ii)(C) of this section, is accomplished by reducing the actual contribution ratio as required under this paragraph (e)(2) and allocating the excess aggregate contributions for the family group among the family members in proportion to the employee and matching contributions of each family member that are combined to determine the actual contribution ratio.

(3) *Corrective distribution of excess aggregate contributions (and income)*—(i) *General rule.* Excess aggregate contributions (and income allocable thereto) are distributed in accordance with this paragraph (e)(3) only if the excess aggregate contributions and allocable income are designated by the employer as a distribution of excess aggregate contributions (and income), and are distributed to the appropriate highly

compensated employees after the close of the plan year in which the excess aggregate contributions arose and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess aggregate contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which the excess aggregate contribution arose, the distribution is deemed to have been a corrective distribution of excess aggregate contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess aggregate contributions*—(A) *General rule.* The income allocable to excess aggregate contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the ''gap period'').

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess aggregate contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating income.* A plan may allocate income to excess aggregate contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to employee contributions, matching contributions, and amounts treated as matching contributions by a fraction. The numerator of the fraction is the excess aggregate contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(*1*) The total account balance of the employee attributable to employee and matching contributions, and amounts treated as matching contributions as of the beginning of the plan year; plus

(*2*) The employee and matching contributions, and amounts treated as matching contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess aggregate contributions for the gap period is equal to 10 percent of the income allocable to excess aggregate contributions for the plan year (calculated under the method described in paragraph (e)(3)(ii)(C) of this section), multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(E) *Allocable income for recharacterized elective contributions.* If recharacterized elective contributions are distributed as excess aggregate contributions, the income allocable to the excess aggregate contributions is determined as if recharacterized elective contributions had been distributed as excess contributions. Thus, income must be allocated to the recharacterized amounts distributed using the methods in §1.401(k)–1(f)(4)(ii).

(iii) *No employee or spousal consent required.* A distribution of excess aggregate contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions and forfeited contributions as employer contributions.* Excess aggregate contributions, including forfeited matching contributions, are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan. Forfeited matching contributions that are reallocated to the accounts of other participants for the plan year in which the forfeiture occurs are treated under section 415 as

annual additions for the participants to whose accounts they are reallocated and for the participants from whose accounts they are forfeited.

(v) *Tax treatment of corrective distributions*—(A) *General rule*. Except as otherwise provided in this paragraph (e)(3)(v), a corrective distribution of excess aggregate contributions (and income) that is made within 2½ months after the end of the plan year for which the excess aggregate contributions were made is includible in the employee's gross income for the taxable year of the employee ending with or within the plan year for which the excess aggregate contributions were made. A corrective distribution of excess aggregate contributions (and income) that is made more than 2½ months after the plan year for which the excess aggregate contributions were made is includible in the employee's gross income in the taxable year of the employee in which distributed. The portion of the distribution that is treated as an investment in the contract under section 72 is determined without regard to any plan contributions other than those distributed as excess aggregate contributions. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (e)(5) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions*. If the total excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year are less than $100 (excluding income), a corrective distribution of excess aggregate contributions (and income) is includible in gross income in the recipient's taxable year in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess aggregate contributions*. Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this paragraph (e)(3)(v) of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (e)(3)(v)(A) of this section, or in the year described in paragraph (e)(3)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but not later than April 17, 1989.

(vi) *No reduction of required minimum distribution*. A distribution of excess aggregate contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(vii) *No corrective distribution of matching contributions other than excess aggregate contributions*. A matching contribution that is an excess aggregate contribution may be distributed as provided in section 401(m)(6) and §1.401(m)–1(e)(3). A matching contribution may not be distributed merely because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution. See §§1.401(k)–1(f)(5)(iii) and 1.411(a)–4(b)(7) regarding permissible forfeitures of matching contributions that relate to excess contributions, excess deferrals, or excess aggregate contributions.

(4) *Coordination with section 401(a)(4)*. A matching contribution is taken into account under section 401(a)(4) even if it is distributed, unless the distributed contribution is an excess aggregate contribution. However, the method of distributing excess aggregate contributions provided in the plan must satisfy the requirements of section 401(a)(4). This requires that after correction each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)–4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if employee contributions are distributed under this paragraph (e) to highly compensated employees to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the highly compensated employees' accounts. See §1.411(a)–4(b)(7) for a rule that allows forfeiture of

these matching contributions to avoid a violation of section 401(a)(4). See also § 1.401(a)(4)–11(g)(3)(vii)(B) regarding the use of additional allocations to the accounts of nonhighly compensated employees for the purpose of correcting a discriminatory rate of matching contributions. A method of distributing excess aggregate contributions will not be considered discriminatory solely because, in accordance with the terms of the plan, unmatched employee contributions that exceed the highest rate at which employee contributions are matched are distributed before matched employee contributions, or matching contributions are distributed (or forfeited) prior to employee contributions. See *Example 6* in paragraph (e)(6) of this section.

(5) *Failure to correct*—(i) *Failure to correct within 2½ months after end of plan year*. If a plan does not correct excess aggregate contributions within 2½ months after the close of the plan year for which the excess aggregate contributions are made, the employer will be liable for a 10 percent excise tax on the amount of the excess aggregate contributions. See section 4979 and § 54.4979–1. Qualified nonelective contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess aggregate contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year*. If excess aggregate contributions are not corrected within 12 months after the close of the plan year for which they were made, the plan will fail to meet the requirements of section 401(a)(4) for the plan year for which the excess aggregate contributions were made and all subsequent plan years in which the excess aggregate contributions remain in the plan.

(6) *Examples*. The principles of this paragraph (e) are illustrated by the following examples. Assume in each example that no income or loss is allocable to elective, employee, or matching contributions.

Example 1. (i) Employer A maintains a thrift plan that does not include a cash or deferred arrangement. In 1990, the actual contribution percentage (ACP) for nonhighly compensated employees is four percent. Thus, the ACP for the group of highly compensated employees may not exceed six percent. The three highly compensated employees who participate have the following compensation, contributions, and actual contribution ratios (ACRs):

Employee	Compensation	Employee and matching contributions	Actual contribution ratio (percent)
A	100,000	10,000	10
B	90,000	6,300	7
C	75,000	3,750	5
Average			7.33

(ii) The maximum amount of employee and matching contributions permitted on behalf of A, B, and C is determined by reducing contributions in order of their ACRs, beginning with the highest ACR. Thus, A's contribution is first reduced to $7,000 or 7.0 percent. Since the resulting ACP of 6.33 percent still exceeds the permitted highly compensated ACP of six percent, the contributions allocated to A and B must be further reduced to 6.5 percent. This results in an ACP of six percent, which meets the 200 percent/two percentage point test. The excess aggregate contributions for A and B are $3,500 and $450, respectively.

Example 2. (i) Employee A is the sole highly compensated participant in a cash or deferred arrangement maintained by Employer X. The plan that includes the arrangement, Plan X, provides a fully vested matching contribution equal to 50 percent of elective contributions. Plan X is a calendar year plan. Employer X includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). Plan X corrects excess contributions by recharacterization. For the 1988 plan year, A's compensation is $58,333, and A's elective contributions are $7,000. The actual deferral percentages and actual contribution percentages of A and other employees under Plan X are shown below:

	Actual deferral percentage	Actual contribution percentage
Employee A	12	6
Nonhighly compensated	8	4

(ii) In February 1989, Employer X determines that A's actual deferral ratio must be reduced to 10 percent, or $5,833, which requires a recharacterization of $1,167 as an employee contribution. This increases A's actual contribution ratio to eight percent ($3,500 in matching contributions plus $1,167 recharacterized as employee contributions, divided by $58,333 in compensation). Since A's actual contribution ratio must be limited to six percent for Plan X to satisfy the actual contribution percentage test, Plan X must distribute $1,167 of A's employee and matching contributions. If $1,167 in matching contributions is distributed, this will correct the excess aggregate contributions and will not result in a discriminatory rate of matching contributions. See *Example 8*.

Example 3. Same as *Example 2*, except that in 1988 A also had elective contributions of $1,313 under Plan Y, maintained by an employer unrelated to X. In January 1989, A requests and receives a distribution of $1,000 in excess deferrals from Plan X. Pursuant to the terms of Plan X, A forfeits the $500 match on the excess deferrals to correct a discriminatory rate of match (see *Example 8*). The $1,167 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by the $1,000 already distributed as an excess deferral, leaving $167 to be recharacterized. See §1.401(k)–1(f)(5)(i). Pursuant to the terms of Plan X, A forfeits the $83.50 match on the recharacterized $167 to correct a discriminatory rate of match. A's actual contribution ratio is now 5.29 percent ($2,916.50 ($3,500–$500–$83.50)) in matching contributions plus $167 in employee contributions, divided by $58,333 in compensation. Since Plan X satisfies the actual contribution percentage test, no further distribution is required or permitted.

Example 4. Same as *Example 3*, except that A does not request a distribution of excess deferrals until March 1989. Employer X has already recharacterized $1,167 as employee contributions. Under §1.402(g)–1(e)(6), the amount of excess deferrals is reduced by the amount of excess contributions that are recharacterized. Because the amount recharacterized is greater than the excess deferrals, Plan X is neither required nor permitted to make a distribution of excess deferrals, and the recharacterization has corrected the excess deferrals.

Example 5. For the 1987 plan year, Employee B defers $7,000 under Plan C and $1,000 under plan D. Plans C and D are maintained by unrelated Employers C and D; both Plans C and D have calendar plan years. Plan C provides a fully vested, 100 percent matching contribution and does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k). Employer C determines that B has excess contributions of $600 and excess aggregate contributions of $1,600. B timely requests and receives a distribution of the $1,000 excess deferral from Plan C, and pursuant to the terms of Plan C, forfeits the corresponding $1,000 matching contribution to correct a discriminatory rate of match (see *Example 8*). Plan C provides that excess contributions and excess aggregate contributions are corrected by distribution. No distribution is required or permitted to correct the excess contributions because $1,000 has been distributed from this plan as excess deferrals. The distribution required to correct the excess aggregate contributions (after forfeiting the matching contribution) is $600 ($1,600 in excess aggregate contributions minus $1,000 in forfeited matching contributions). If B had corrected the excess deferrals of $1,000 by withdrawing $1,000 from Plan D, Plan C would have had to correct the $600 excess contributions in Plan C by distributing $600. Since B then would have forfeited $600 (instead of $1,000) in matching contributions, B would have had $1,000 ($1,600 in excess aggregate contributions minus $600 in forfeited matching contributions) remaining of excess aggregate contributions in Plan C. These would have been corrected by distributing an additional $1,000 from Plan C.

Example 6. Employee B is the sole highly compensated employee in a thrift plan under which the employer matches 100 percent of employee contributions up to two percent of compensation, and 50 percent of employee contributions up to the next four percent of compensation. For the 1988 plan year, B has compensation of $100,000. B makes an employee contribution of $7,000, or seven percent, and receives a four percent matching contribution of $4,000. Thus, B's actual contribution ratio (ACR) is 11 percent. The actual contribution percentage for the nonhighly compensated employees is five percent, and the employer determines that B's ACR must be reduced to seven percent to comply with the rules of section 401(m). In this case, the plan satisfies the requirements of this paragraph if it distributes the unmatched employee contributions of $1,000, and $2,000 of matched employee contributions with their related matches of $1,000. This would leave B with four percent employee contributions, and three percent matching contributions, for an ACR of seven percent. The plan could instead distribute all matching contributions. The plan would fail to meet the requirements of this paragraph if it distributed $4,000 (four percent) of B's employee contributions and none of B's matching contributions because this would

result in a discriminatory rate of matching contributions. See §1.401(m)–1(e)(2) and (4). See also *Example 8*.

Example 7. (i) Employee C is a highly compensated employee in Employer X's thrift plan, which matches 100 percent of employee contributions up to five percent of compensation. The matching contribution is vested at the rate of 20 percent per year. In 1991, C makes $5,000 in employee contributions and receives $5,000 of matching contributions. C is 60 percent vested in the matching contributions at the end of the 1991 plan year.

(ii) In February 1992, X determines that C has excess aggregate contributions of $1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(iii) X has two options available in distributing C's excess contributions. The first option is to distribute $600 of vested matching contributions and forfeit $400 of nonvested matching contributions. These amounts are in proportion to C's vested and nonvested interests in all matching contributions. The second option is to distribute $1,000 of vested matching contributions, leaving the nonvested matching contributions in the plan.

(iv) If the second option is chosen, the plan must also provide a separate vesting schedule for vesting these nonvested matching contributions. This is necessary because the nonvested matching contributions must vest as rapidly as they would have had no distribution been made. Thus, 50 percent must vest in each of the next two years.

(v) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are distributed because the effect is that matching contributions for highly compensated employees vest more rapidly than those for nonhighly compensated employees. See §1.401(m)–1(e)(4).

Example 8. (i) Employer B maintains a calendar year profit sharing plan that includes a cash or deferred arrangement. Elective contributions are matched at the rate of 100 percent. After-tax employee contributions are permitted under the plan only for nonhighly compensated employees and are matched at the same rate. No employees make excess deferrals. Employee A, a highly compensated employee, makes an $8,000 elective contribution and receives an $8,000 matching contribution.

(ii) Employer B performs the actual deferral percentage (ADP), the actual contribution percentage (ACP), and the multiple use tests. To correct failures of the ADP and ACP tests, the plan distributes to A $1,000 of excess contributions and $500 of excess aggregate contributions. After the distributions, A's contributions for the year are $7,000 of elective contributions and $7,500 of matching contributions. As a result, A has received a higher effective rate of matching contributions than nonhighly compensated employees ($7,000 of elective contributions matched by $7,500 is an effective matching rate of 107 percent). If this amount remains in A's account without correction, it will cause the plan to fail to satisfy section 401(a)(4), because only a highly compensated employee receives the higher matching contribution rate. The remaining $500 matching contribution may be forfeited (but not distributed) under section 411(a)(3)(G), if the plan so provides. The plan could instead correct the discriminatory rate of matching contributions by making additional allocations to the accounts of nonhighly compensated employees. See §1.401(a)(4)–11(g)(3)(vii)(B) and (6), *Example 7*.

(f) *Definitions*. The following definitions apply for purposes of this section and §1.401(m)–2 except as otherwise specifically provided:

(1) *Actual contribution percentage*—(i) *General rule*. The actual contribution percentage for a group of employees for a plan year is the average of the actual contribution ratios of the employees in the group. For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, actual contribution ratios and the actual contribution percentage for a group are calculated to the nearest one-hundredth of a percentage point.

(ii) *Actual contribution ratio*—(A) *General rule*. An employee's actual contribution ratio is the sum of the employee and matching contributions allocated to the employee's account for the plan year, and the qualified nonelective and elective contributions treated as matching contributions for the plan year, divided by the employee's compensation for the plan year. If an eligible employee makes no employee contributions and no matching, qualified nonelective contributions, or elective contributions are taken into account with respect to the employee, the actual contribution ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (f)(2) of this section for rules regarding the employee and matching contributions, qualified nonelective and elective contributions, and compensation that are taken into account in calculating this fraction.

(B) *Highly compensated employee eligible under more than one plan*. The actual contribution ratio of a highly compensated employee who is eligible to

participate in more than one plan of an employer to which employee or matching contributions are made is calculated by treating all the plans in which the employee is eligible to participate as one plan. However, plans that are not permitted to be aggregated under §1.410(b)–7(c), as modified in §1.401(k)–1(g)(11), are not aggregated for this purpose. For example, if a highly compensated employee with compensation of $80,000 may receive matching contributions under two plans of an employer, the employee's actual contribution ratio under each plan is calculated by dividing the employee's total matching contributions under both plans by $80,000, unless the plans are required to be disaggregated. In that case, the actual contribution ratio of the employee under each plan is to be calculated by dividing the employee's matching contributions under that plan by $80,000. See paragraph (b)(3) of this section for the treatment of certain multiple plans. For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, if a highly compensated employee participates in two or more plans that have different plan years, this paragraph (f)(1)(ii) is applied by treating all plans whose plan years end with or within the same calendar year as a single plan.

(C) *Employees subject to family aggregation rules—(1)* Aggregation of employee contributions and other amounts. For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, if a highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual contribution ratio for the family group (treated as one highly compensated employee) must be determined by combining the employee contributions, matching contributions, amounts treated as matching contributions, and compensation of all family members.

(*2*) *Effect on actual contribution percentage of nonhighly compensated employees.* The employee and matching contributions, amounts treated as matching contributions, and compensation of all family members are disregarded for purposes of determining the actual contribution percentage for the group of highly compensated employees, and the group of nonhighly compensated employees.

(*3*) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation.* The term *compensation* means compensation as defined in §1.401(k)–1(g)(2)(i).

(3) *Elective contributions.* The term ''elective contribution'' means elective contribution as defined in §1.401(k)–1(g)(3).

(4) *Eligible employee*—(i) *General rule.* The term ''eligible employee'' means an employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures) under the plan for a plan year. For example, if an employee must perform ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make an employee contribution for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs these acts. An employee who is unable to make an employee contribution or to receive an allocation of matching contributions because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make an employee contribution or to receive an allocation of matching contributions for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. An employee who would be eligible to make employee contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is an eligible employee for purposes of section

401(m) for a plan year even though the employee may not make an employee contribution or receive an allocation of matching contributions by reason of the suspension. Finally, an employee does not fail to be an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible under any plan of the employer providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. In no event is an election made after December 23, 1994 treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

(5) *Employee.* The term ''employee'' means an employee as defined in §1.401(k)–1(g)(5).

(6) *Employee contributions.* The term ''employee contribution'' means any mandatory or voluntary contribution to the plan that is treated at the time of contribution as an after-tax employee contribution (e.g., by reporting the contribution as taxable income subject to applicable withholding requirements) and is allocated to a separate account to which the attributable earnings and losses are allocated. See §1.401(k)–1(a)(2)(ii). The term includes:

(i) Employee contributions to the defined contribution portion of a plan described in section 414(k);

(ii) Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B);

(iii) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(iv) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions; and

(v) Employee contributions to an annuity contract described in section 403(b).

The term does not include repayment of loans, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to a plan from another plan. For purposes of this paragraph (f)(6), employee contributions described in paragraph (f)(6)(ii) of this section are deemed contributed to a defined contribution plan.

(7) *Employer.* The term ''employer'' means the employer as defined in §1.401(k)–1(g)(6).

(8) *Excess aggregate contributions.* The term ''excess aggregate contribution'' means, with respect to any plan year, the excess of the aggregate amount of the employee and matching contributions (and any qualified nonelective contribution or elective deferral taken into account in computing the contribution percentage) actually made on behalf of highly compensated employees for the plan year, over the maximum amount of contributions permitted under the limitations of section 401(m)(2)(A). The amount of excess aggregate contributions for each highly compensated employee is determined by using the method described in paragraph (e)(2) of this section. For purposes of this paragraph, qualified matching contributions treated as elective contributions in accordance with §1.401(k)–1(b)(5) are disregarded.

(9) *Excess contributions.* The term ''excess contribution'' means an excess contribution as defined in §1.401(k)–1(g)(7)(i).

(10) *Excess deferrals.* The term ''excess deferrals'' means excess deferral as defined in §1.402(g)–1(e)(1)(iii).

(11) *Highly compensated employee.* The term ''highly compensated employee'' means a highly compensated employee as defined in section 414(q).

(12) *Matching contributions*—(i) *In general.* The term ''matching contribution'' means:

(A) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an employee contribution to a plan maintained by the employer;

(B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral (as defined in §1.402(g)–1(b)); and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective contributions.

(ii) *Employer contributions made on account of employee or elective contributions.* For purposes of paragraph (f)(12)(i) of this section, whether an employer contribution is made on account of an employee contribution or an elective contribution is determined on the basis of all relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. Thus, for example, an employer contribution made to a defined contribution plan on account of contributions made by an employee under an employer-sponsored savings arrangement that are not held in a plan that is intended to be a qualified plan or a plan described in §1.402(g)–1(b) is not a matching contribution. Notwithstanding the foregoing, for plan years beginning before January 1, 1992, an employer may elect to take into account as matching contributions, contributions made to a plan pursuant to an arrangement under which the employer makes contributions to the plan on account of either employee contributions to the plan or contributions made by an employee to an employer-sponsored savings arrangement that are not held in the plan, provided that the arrangement was in effect prior to August 8, 1988.

(iii) *Contributions used to meet the requirements of section 416.* For plan years beginning after December 31, 1988, a contribution or allocation that is used to meet the minimum contribution or benefit requirement of section 416 is not treated as made on account of an employee or elective contribution and therefore is not a matching contribution.

(13) *Nonelective contributions.* The term ''nonelective contribution'' means nonelective contributions as defined in §1.401(k)–1(g)(10).

(14) *Plan.* The term ''plan'' means a plan as defined in §1.401(k)–1(g)(11).

(15) *Qualified nonelective contributions.* The term ''qualified nonelective contribution'' means qualified nonelective contributions as defined in §1.401(k)–1(g)(13)(ii).

(16) *Section 401(k) plan.* The term *section 401(k) plan* means a section 401(k) plan within the meaning of §1.410(b)–9.

(17) *Section 401(m) plan.* The term *section 401(m) plan* means a section 401(m) plan within the meaning of §1.410(b)–9.

(g) *Effective dates*—(1) *General rule.* Except as provided in paragraphs (g)(2), (g)(3), (g)(4), and (g)(5) of this section, or as specifically provided otherwise in this section, this section is effective for plan years beginning after December 31, 1986.

(2) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, this section does not apply to years beginning before the earlier of—

(i) January 1, 1989, or

(ii) The date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986).

(3) *Certain annuity contracts*—(i) In the case of an annuity contract under section 403(b), not maintained pursuant to a collective bargaining agreement, except as otherwise provided in paragraph (g)(5) of this section, this section applies to plan years beginning after December 31, 1988.

(ii) In the case of an annuity contract described in section 403(b) maintained pursuant to a collective bargaining agreement described in paragraph (g)(2)(i) of this section, this section does not apply to years beginning before the earlier of

(A) The later of—

(*1*) January 1, 1989, or

(*2*) The date determined under paragraph (g)(2)(ii) of this section; or

(B) January 1, 1991.

(4) *State and local government plans.* A governmental plan described in section 414(d), including a plan subject to section 403(b)(12)(A)(i) (nonelective plan) is treated as satisfying section 401(m) for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. For purposes of this paragraph (g)(4), the term *governing body with authority to amend the plan* means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(5) *Transition rule for plan years beginning before 1992*—(i) *General rule.* For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a plan was qualified during those years.

(ii) *Restructuring*—(A) *General rule.* In determining whether the requirements of section 401(m) are satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and other benefits, rights, and features provided to a group of employees under the plan. See §1.401(a)(4)–9(c). An employee may not be included in more than one component plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(m) are applied separately with respect to each component plan for the plan year. Thus, for example, the actual contribution ratio and the amount of excess aggregate contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(m). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans*—(*1*) *Minimum coverage requirement.* The group of eligible employees described in §1.401(m)–1(f)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(*2*) *Commonality requirement.* The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual contribution ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method (e.g., salaried or hourly), coverage under the same contribution formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under §1.410(b)–4(b). Employees whose only common attribute is the same or similar actual contribution ratios, or another attribute having substantially the same effect as the same or similar actual contribution ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

[T.D. 8357, 56 FR 40534, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63432, Dec. 4, 1991; T.D. 8357, 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66175, Dec. 23, 1994; TD 8581, 60 FR 12416, Mar. 7, 1995]

§1.401(m)–2 Multiple use of alternative limitation.

(a) *In general.* The rules in this section prevent the multiple use of the alternative methods of compliance with sections 401 (k) and (m) contained in section 401(k)(3)(A)(ii)(II) and 401(m)(2)(A)(ii) respectively. Paragraph (b) of this section discusses the scope of this section and contains the general rule for determination of a multiple use of the alternative limitation. Paragraph (c) of this section contains rules for the correction of multiple use. The consequences of multiple use of the alternative methods of compliance are described in §1.401(m)–1(a)(1).

(b) *General rule for determination of multiple use*—(1) *In general.* (i) Multiple use of the alternative limitation occurs

if all of the conditions of this paragraph (b)(1) are satisfied:

(A) One or more highly compensated employees of the employer are eligible employees in both a cash or deferred arrangement subject to section 401(k) and a plan maintained by the employer subject to section 401(m).

(B) The sum of the actual deferral percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(k) and the actual contribution percentage of the entire group of eligible highly compensated employees under the plan subject to section 401(m) exceeds the aggregate limit of paragraph (b)(3) of this section.

(C) The actual deferral percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(k) exceeds the amount described in section 401(k)(3)(A)(ii)(I).

(D) The actual contribution percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(m) exceeds the amount described in section 401(m)(2)(A)(i).

(ii) The actual deferral percentage and actual contribution percentage of the group of eligible highly compensated employees are determined after use of qualified nonelective contributions and qualified matching contributions to meet the requirements of section 401(k)(3)(A)(ii) and after use of qualified nonelective contributions and elective contributions to meet the requirements of section 401(m)(2)(A). The actual deferral percentage and actual contribution percentage of the group of eligible highly compensated employees are determined after any corrective distribution or forfeiture of excess deferrals, excess contributions, or excess aggregate contributions and after any recharacterization of excess contributions required without regard to this section. Only plans and arrangements maintained by the same employer are taken into account under this paragraph (b)(1). If the employer maintains two or more plans after application of the rules under §1.401(k)– 1(g)(11), multiple use is tested separately with respect to each plan. Thus, for example, if an employer maintains a cash or deferred arrangement with matching contributions, under which elective contributions may be made under either an ESOP or a non-ESOP, multiple use is tested separately with respect to elective contributions and matching contributions under the ESOP, and with respect to elective contributions and matching contributions under the non-ESOP.

(2) *Alternative limitation.* For purposes of this section, the term ''alternative limitation'' means the 200 percent or 2 percentage point limits in sections 401(k)(3)(A)(ii)(ii) and 401(m)(2)(A)(ii).

(3) *Aggregate limit*—(i) *In general.* For purposes of this section, the aggregate limit is the greater of:

(A) The sum of—

(*1*) 1.25 times the greater of the relevant actual deferral percentage or the relevant actual contribution percentage, and

(*2*) Two percentage points plus the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage. In no event, however, may this amount exceed twice the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage; or

(B) The sum of—

(*1*) 1.25 times the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage, and

(*2*) Two percentage points plus the greater of the relevant actual deferral percentage or the relevant actual contribution percentage. In no event, however, may this amount exceed twice the greater of the relevant actual deferral percentage or the relevant actual contribution percentage.

(ii) *Relevant actual deferral percentage and relevant actual contribution percentage defined.* For purposes of paragraph (b)(3)(i) of this section, the term ''relevant actual deferral percentage'' means the actual deferral percentage of the group of nonhighly compensated employees eligible under the arrangement subject to section 401(k) for the plan year, and the term ''relevant actual contribution percentage'' means the actual contribution percentage of the group of nonhighly compensated employees eligible under the plan subject to section 401(m) for the plan year

beginning with or within the plan year of the arrangement subject to section 401(k).

(iii) *Examples*. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) Assume that Employer G maintains a plan that contains a cash or deferred arrangement under which the actual deferral percentages of highly compensated and nonhighly compensated employees are 5.5 and four percent respectively. The plan also permits employee contributions, and the actual contribution percentages for the two groups are 4.2 and three percent respectively. The multiple use of the alternative limitation is tested as follows:

(1) Greater of the relevant actual deferral percentage or the relevant actual contribution percentage	4.00
(2) 1.25 times (1)	5.00
(3) Lesser of the relevant actual deferral percentage or the relevant actual contribution percentage	3.00
(4) (3) plus two percentage points	5.00
(5) (2)+(4)	10.00
(6) 1.25 times (3)	3.75
(7) (1) plus two percentage points	6.00
(8) (6)+(7)	9.75
(9) Aggregate limit greater of (5) or (8)	10.00

(ii) In this case, the sum of the actual deferral percentage and the actual contribution percentage of highly compensated employees is 9.70 percent, which is less than the aggregate limit. Therefore, there is no multiple use of the alternative limitation.

Example 2. Employer F maintains a plan subject to section 401(k) with a plan year beginning January 1, and a plan subject to section 401(m) with a plan year beginning July 1. The plan subject to section 401(k) does not correct excess contributions by recharacterization. The first actual deferral percentage taken into account is that for the plan year beginning January 1, 1989. The first actual contribution percentage taken into account is that for the plan year beginning July 1, 1989.

Example 3. (i) Employer E maintains a plan that contains a cash or deferred arrangement and provides for matching contributions. The actual deferral and contribution percentages for a plan year are as follows:

	Actual deferral percentage	Actual contribution percentage
Highly compensated	3.6	1.69
Nonhighly compensated	1.8	1.35

(ii) The actual deferral percentage of the highly compensated employees exceeds the normal limit (1.25 times 1.8, or 2.25%) but not the alternative limit (two plus 1.8, but not more than twice 1.8, or 3.6%). The actual contribution percentage of the highly compensated employees does not exceed the normal limit (1.25 times 1.35, or 1.69%). Accordingly, the plan satisfies both the actual deferral and contribution percentage tests. Since the actual contribution percentage of the highly compensated employees does not exceed the normal limit, condition (iv) of paragraph (b)(1) of this section is not satisfied. Therefore, there is no multiple use of the alternative limitation.

(c) *Correction of multiple use*—(1) *In general*. If multiple use of the alternative limitation occurs with respect to two or more plans or arrangements maintained by an employer, it must be corrected by reducing the actual deferral percentage, the actual contribution percentage of highly compensated employees, or a combination of the two, in the manner described in paragraph (c)(3) of this section. Instead of making this reduction, the employer may eliminate the multiple use of the alternative limitation by making qualified nonelective contributions in accordance with §1.401(k)–1(b)(5) and (f)(1) or §1.401(m)–1(b)(5) and (e)(1).

(2) *Treatment of required reduction*. The required reduction is treated as an excess contribution under the arrangement subject to section 401(k) or excess aggregate contribution under the plan subject to section 401(m). However, if an excess contribution arising under this section is recharacterized as an employee contribution, the recharacterized amount is treated as an excess aggregate contribution.

(3) *Required reduction*. The amount of the reduction of the actual deferral percentage of the entire group of highly compensated employees eligible in the arrangement subject to section 401(k) is calculated in the manner described in §1.401(k)–1(f)(2) or the amount of the reduction of the actual contribution percentage of the entire group of highly compensated employees eligible in the plan subject to section 401(m) is calculated in the manner described in §1.401(m)–1(e)(2), as designated in the plan, so that there is no multiple use of the alternative limitation. The employer may elect to reduce the actual deferral ratios or the actual contribution ratios, as designated in the plan, either for all highly compensated employees under the plan or arrangements subject to reduction or

for only those highly compensated employees who are eligible in both the arrangement subject to section 401(k) and the plan subject to section 401(m).

(4) *Examples*. The principles of this paragraph (c) are illustrated by the following examples. In all cases, the employer maintains both an arrangement subject to section 401(k) and a plan subject to section 401(m). Assume that there is no income or loss allocable to the elective, employee, or matching contributions.

Example 1. (i) All employees of Employer Q are eligible in both an arrangement subject to section 401(k) and a plan subject to section 401(m). Both plans have a calendar plan year. The plans provide that multiple use of the alternative limitation will be corrected in the plan subject to section 401(m) and that any required reduction in actual contribution ratios will apply only to employees eligible to participate in both arrangements. Employer Q includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). See §1.401(k)–1(g)(2)(i). Employees X and Y are highly compensated. Each received compensation of $100,000, deferred $6,000, received a $3,000 matching contribution, and made employee contributions of $3,000. Actual deferral and contribution percentages under the arrangement and plan for the 1989 plan year are shown below. No excess deferrals, excess contributions, or excess aggregate contributions have yet been required to be distributed, forfeited, or recharacterized under the plan.

	Actual deferral percentage	Actual contribution percentage
Highly compensated	6	6
Nonhighly compensated	4	4

(ii) The aggregate limit and amount required, to be corrected are determined as follows:

Step 1: Determination of Aggregate Limit

(1) Greater of relevant actual deferral percentage or relevant actual contribution percentage	4.0
(2) 1.25 times (1)	5.0
(3) Lesser of relevant actual deferral percentage or relevant actual contribution percentage	4.0
(4) (3) plus two percentage points	6.0
(5) (2)+(4)	11.0
(6) 1.25 times (3)	5.0
(7) (1) plus two percentage points	6.0
(8) (6)+(7)	11.0
(9) Aggregate limit Greater of (5) or (8)	11.0

Step 2: Calculation of Correction Amount

(10) Actual deferral percentage of highly compensated	6.0
(11) Maximum permitted actual contribution percentage of highly compensated ((9)–(10))	5.0
(12) Amount taken into account in determining actual contribution percentage of highly compensated Employee X	$6,000
(13) Maximum amount permitted without use of alternative limitation ((11)×compensation of Employee X)	$5,000
(14) Excess aggregate contribution ((12)–(13))	$1,000

(iii) A similar correction must be made for Employee Y.

Example 2. Same as *Example 1*, but the plan corrects the multiple use in the arrangement subject to section 401(k) and provides that excess contributions are recharacterized. In this case, the aggregate limit for the plans will be 11 percent. Similarly, the excess contributions for Employees X and Y, determined in a manner analogous to that used in *Example 1*, will be $1,000. When this is recharacterized, the actual contribution percentage for these employees will increase to seven percent, resulting in an excess aggregate contribution of $1,000 that must be distributed.

Example 3. Same as *Example 1*, except that Employee Y is not eligible to participate in the arrangement subject to section 401(k). No reduction of Y's actual contribution ratio is required because Y is only in the plan subject to section 401(m). In order to reduce the actual contribution percentage of the entire group of highly compensated employees eligible for the plan subject to section 401(m) to five percent, the plan must reduce X's actual contribution percentage to four percent. X's employee and matching contributions are limited to $4,000. Therefore X has an excess aggregate contribution of $2,000.

(d) *Effective date*—(1) *General rule*. This section is effective for plan years beginning after December 31, 1988, or such later date provided in §1.402(m)–1(g).

(2) *Transition rule*. For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in sections 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a plan was qualified during those years. For plan years beginning before January 1, 1992, a plan

may be restructured only in accordance with §1.401(k)–1(h)(3)(iii) or §1.401(m)–1(g)(5)(ii).

[T.D. 8357, 56 FR 40543, Aug. 15, 1991, as amended at 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66179, Dec. 23, 1994]

§ 1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) *In general.* (1)(i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter.

(ii) The provisions of section 402(a) relate only to a distribution by a trust described in section 401(a) which is exempt under section 501(a) for the taxable year of the trust in which the distribution is made. With two exceptions, the distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities). First, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such distributions. For taxable years beginning after December 31, 1963, such distributions may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). Secondly, certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Furthermore, the exclusion provided by section 105(d) is applicable to a distribution from a trust described in section 401(a) and exempt under section 501(a) if such distribution constitutes wages or payments in lieu of wages for a period during which an employee is absent from work on account of a personal injury or sickness. See §1.72–15 for the rules relating to the tax treatment of accident or health benefits received under a plan to which section 72 applies.

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value.

(iv) If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years under section 501(a) (or under section 165(a) of the Internal Revenue Code of 1939 for years to which such section was applicable), the contributions of the employer which were includible in the gross income of the employee for the taxable year when made shall, in accordance with section 72(f), also be treated as part of the consideration paid by the employee.

(v) If the trust is not exempt at the time the distribution is received by or made available to the employee, see section 402(b) and paragraph (b) of §1.402(b)–1.

(vi) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14, see paragraph (h) of §1.72–15.

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. For the rule as to nontransferability of annuity contracts

issued after 1962, see paragraph (b)(2) of § 1.401–9. If, however, the contract distributed by such exempt trust is a retirement income, endowment, or other life insurance contract and is distributed after October 26, 1956, the entire cash value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds). If the contract distributed by such trust is a transferable annuity contract issued after 1962, or a retirement income, endowment, or other life insurance contract which is distributed after 1962 (whether or not transferable), then notwithstanding the preceding sentence the entire cash value of the contract is includible in the distributee's gross income, unless within such 60 days such contract is also made nontransferable.

(3) For the rules applicable to premiums paid by a trust described in section 401(a) and exempt under section 501(a) for the purchase of retirement income, endowment, or other contracts providing life insurance protection payable upon the death of the employee-participant, see paragraph (b) of § 1.72–16.

(4) For the rules applicable to the amounts payable by reason of the death of an employee under a contract providing life insurance protection, or an annuity contract, purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (c) of § 1.72–16.

(5) If pension or annuity payments or other benefits are paid or made available to the beneficiary of a deceased employee or a deceased retired employee by a trust described in section 401(a) which is exempt under section 501(a), such amounts are taxable in accordance with the rules of section 402(a) and this section. In case such amounts are taxable under section 72, the ''investment in the contract'' shall be determined by reference to the amount contributed by the employee and by applying the applicable rules of sections 72 and 101(b)(2)(D). In case the amounts paid to, or includible in the gross income of, the beneficiaries of the deceased employee or deceased retired employee constitute a distribution to which subparagraph (6) of this paragraph is applicable, the extent to which the distribution is taxable is determined by reference to the contributions of the employee, by reference to any prior distributions which were excludable from gross income as a return of employee contributions, and by applying the applicable rules of sections 72 and 101(b).

(6)(i) If the total distributions payable with respect to any employee under a trust described in section 401(a) which in the year of distribution is exempt under section 501(a) are paid to, or includible in the gross income of, the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, or death after such separation from service, the amount of such distribution, to the extent it exceeds the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The total distributions payable are includible in the gross income of the distributee within one taxable year if they are made available to such distributee and the distributee fails to make a timely election under section 72(h) to receive an annuity in lieu of such total distributions. The ''net amount contributed by the employee'' is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of section 72(f), 101(b), and subparagraph (3) of this paragraph, reduced by any amounts theretofore distributed to him which were excludable from gross income as a return of employee contributions. See, however, paragraph (b) of this section for rules relating to the exclusion of amounts representing net unrealized appreciation in the value of securities of the employer corporation. In addition, all

or part of the amount otherwise includible in gross income under this paragraph by a non-resident alien individual in respect of a distribution by the United States under a qualified pension plan may be excludable from gross income under section 402(a)(4). For rules relating to such exclusion, see paragraph (c) of this section. For additional rules relating to the treatment of total distributions described in this subdivision in the case of a nonresident alien individual, see sections 871 and 1441 and the regulations thereunder.

(ii) The term ''total distributions payable'' means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service or on account of his death after separation from the service. Thus, distributions made before a total distribution (for example, annuity payments received by the employee after retirement), will not defeat application of the capital gains treatment with respect to the total distributions received by a beneficiary upon the death of the employee after retirement. However, a distribution on separation from service will not receive capital gains treatment unless it constitutes the total amount in the employee's account at the time of his separation from service. If the total amount in the employee's account at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the distributee within one taxable year of the distributee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount, attributable to the last year of service, is credited to the account of the employee and distributed.

(iii) If an employee retires and commences to receive an annuity but subsequently, in some succeeding taxable year, is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(iv) If the ''total distributions payable'' are paid or includible in the gross income of several distributees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. The total distributions payable are paid within one taxable year of the distributees when, for example, a portion of such total is distributed in cash to one distributee and the balance is used to purchase an annuity contract which is distributed to the other distributee. However, if the share of any distributee is not paid or includible in his gross income within the same taxable year in which the shares of the other distributees are paid or includible in their gross income, none of the distributees is entitled to the capital gains treatment, since the total distributions payable are not paid or includible in the distributees' gross income within one taxable year. For example, if the total distributions payable are made available to each of two distributees and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share in installment payments from the trust, the capital gains treatment does not apply to either distributee.

(v) For regulations as to certain plan terminations, see § 1.402(e)–1.

(vi) The term ''total distributions payable'' does not include United States Retirement Plan Bonds held by a trust to the credit of an employee. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains retirement plan bonds registered in the name of such employee. Similarly, the proceeds of a retirement plan bond received as a part of the total amount to the credit of an employee will not be entitled to capital gains treatment. See section 405(e) and paragraph (a)(4) of § 1.405–3.

(vii) For purposes of determining whether the total distributions payable to an employee have been distributed

within one taxable year, the term ''total distributions payable'' includes amounts held by a trust to the credit of an employee which are attributable to contributions on behalf of the employee while he was a self-employed individual in the business with respect to which the plan was established. Thus, a distribution by a qualified trust is not a total distributions payable with respect to an employee if the trust retains amounts which are so attributable.

(viii) The term ''total distributions payable'' does not include any amount which has been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains amounts attributable to the funding of medical benefits described in section 401(h).

(7) The capital gains treatment provided by section 402(a)(2) and subparagraph (6) of this paragraph is not applicable to distributions paid to a distributee to the extent such distributions are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see §1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

(8) For purposes of this section, the term ''employee'' includes a self-employed individual who is treated as an employee under section 401(c)(1), and paragraph (b) of §1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4).

(b) *Distributions including securities of the employer corporation*—(1) *In general.* (i) If a trust described in section 401(a) which is exempt under section 501(a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the following extent:

(A) If the distribution constitutes a total distribution to which the regulations of paragraph (a)(6) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(B) If the distribution is other than a total distribution to which paragraph (a)(6) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludable under the regulations of (A) and (B) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction. However, if the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, such excess shall constitute a long-term or short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 402(a) and of this section, the term ''securities'' means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term ''securities of the employer corporation'' includes securities of a parent or subsidiary corporation (as defined in subsections (e) and

(f) of section 425) of the employer corporation.

(2) *Determination of net unrealized appreciation.* (i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the cost or other basis of such security to the trust shall be computed in accordance with whichever of the following rules is applicable:

(A) If a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

(B) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(C) In a case where neither *(a)* nor *(b)* of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(D)(*1*) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total cost of

securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(*2*) These methods of computing average cost may be illustrated by the following examples:

Example 1. A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1954 (the specified inventory date of the trust), the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is $100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1954	$101	$2,020
40	Jan. 10, 1953	102	4,080
20	Oct. 20, 1952	95	1,900
80		8,000	

Example 2. B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 31, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1952, 1,000 shares of class E stock of the employer corporation. During the calendar year 1953 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is $52 computed as follows:

	Shares	Total cost	Average cost
On hand Dec. 31, 1952	1,000	$50,000	$50
Distributed during 1953 at average cost of $50	100	5,000	(0)
	900	45,000	(0)
Purchased during 1953	120	8,000	(0)
On hand Dec. 31, 1953	1,020	53,040	52

(*3*) *Unrealized appreciation attributable to employee contributions.* In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer corporation which is attributable to contributions made by an employee:

(*i*) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in accordance with the regulations in subparagraph (2) of this paragraph;

(*ii*) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(*iii*) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the regulations of subparagraph (2) of this paragraph which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(*iv*) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in subparagraph (2)(ii) (*a*), (*b*), (*c*), or (*d*) of this paragraph, whichever is applicable. Thus, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such a location is inconsistent with the terms of the plan or trust.

(*v*) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the

trust of $100, consisting of employee contributions in the amount of $60 and employer contributions in the amount of $40, and on the date of distribution has a fair market value of $180. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is $48 computed as follows:

(1) Value of one share of stock on distribution date	$180
(2) Employee contributions	60
(3) Employer contributions	40
(4) Total contributions	100
(5) Net unrealized appreciation	80
(6) Portion of net unrealized appreciation attributable to employee contributions 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of $80 (item 5)	48

(*vi*) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (*v*) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be $132 computed as follows:

(a) Employee contributions	$60
(b) Employer contributions (taxable as ordinary income in the year the securities were distributed)	40
(c) Portion of net unrealized appreciation attributable to employer contributions (item 5) minus (item 6) (taxable as ordinary income in the year the securities were distributed)	32
(d) Basis of stock	132

(*4*) *Change in exempt status of trust.* For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years before the year of distribution, see paragraph (a) of this section.

(c) *Certain distributions by United States to nonresident alien individuals.* (1) This paragraph applies to a distribution—

(i) Which is made by the United States under a pension plan described in section 401(a);

(ii) Which is made in respect of services performed by an employee of the United States; and

(iii) Which is received by, or made available to, a nonresident alien individual (including a nonresident alien individual who is a beneficiary of a deceased employee) during a taxable year beginning after December 31, 1959.

The amount of such a distribution that is includible in the gross income of the nonresident alien individual under section 402(a) (1) or (2) shall not exceed an amount which bears the same ratio to the amount which would be includible in gross income if it were not for this paragraph, as—

(A) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made, reduced by the amount of such basic salary which was not includible in the employee's gross income by reason of being from sources without the United States, bears to

(B) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made.

See section 402(a)(4). See, also, paragraph (a) of this section for rules relating to the amount that is includible in gross income under section 402(a) (1) or (2) in the case of a distribution under a pension plan described in section 401(a).

(2) For purposes of applying section 402(a)(4) and this paragraph to distributions under the Civil Service Retirement Act (5 U.S.C. 2251), the term ''basic salary'' shall have the meaning provided in section 1(d) of such Act. In applying section 402(a)(4) and this paragraph to distributions under any other qualified pension plan of the United States, such term shall have a similar meaning. Thus, for example, ''basic salary'' does not, in any case, include bonuses, allowances, or overtime pay.

(3) The rules in this paragraph may be illustrated by the following examples:

Example 1. A, a retired employee of the United States who performed all of his services for the United States in a foreign country, receives, in respect of such services, a monthly pension of $200 under the Civil Service Retirement Act (a pension plan described in section 410(a)). A received an aggregate basic salary for his services for the United States of $100,000. A was a nonresident alien

individual during the whole of his employment with the United States and, therefore, his basic salary from the United States was not includible in his gross income by reason of being from sources without the United States. A would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include $60 of each monthly pension payment in his gross income. The amount that is includible in A's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while A is a nonresident alien individual, is computed as follows:

(i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4)	$60
(ii) Aggregate basic salary for services for United States	100,000
(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in A's gross income by reason of being from sources without the United States	0
(iv) Amount includible in A's gross income under section 402(a)(1) ((iii)÷(ii)×(i), or $0/$100,000×$60)	0

Example 2. B, a retired employee of the United States who performed services for the United States both in a foreign country and in the United States, receives, in respect of such services, a monthly pension of $240 under the Civil Service Retirement Act. B received an aggregate basic salary for his services for the United States of $120,000; $80,000 of which was for his services performed in the United States, and $40,000 of which was for his services performed in the foreign country. B was a nonresident alien individual during the whole of his employment with the United States and, consequently, the $40,000 basic salary for his services performed in the foreign country was not includible in his gross income by reason of being from sources without the United States. B would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include $165 of each monthly pension in his gross income. The amount that is includible in B's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while B is a nonresident alien individual, is computed as follows:

(i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4)	$165
(ii) Aggregate basic salary for services for United States	120,000
(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in B's gross income by reason of being from sources without the United States ($120,000 − $40,000)	80,000
(iv) Amount includible in B's gross income under section 402(a)(1)(iii)÷(ii)×(i), or $80,000/$120,000×$165)	110

(d) *Salary reduction, cash or deferred arrangements*—(1) *Inclusion in income.* Whether a contribution to an exempt trust or plan described in section 401(a) or 403(a) is made by the employer or the employee is determined on the basis of the particular facts and circumstances of each case. Nevertheless, an amount contributed to a plan or trust will, except as otherwise provided under paragraph (d)(2) of this section, be treated as contributed by the employee if it was contributed at the employee's election, even though the election was made before the year in which the amount was earned by the employee or before the year in which the amount became currently available to the employee. Any amount treated as contributed by the employee is includible in the gross income of the employee for the year in which the amount would have been received by the employee but for the election. Thus, for example, amounts contributed to an exempt trust or plan by reason of a salary reduction agreement under a cash or deferred arrangement are treated as received by the employee when they would have been received by the employee but for the election to defer. Accordingly, they are includible in the gross income of the employee for that year (except as provided under paragraph (d)(2) of this section). See §1.401(k)–1(a)(3)(iii) and (2)(i) for the meaning of currently available and cash or deferred arrangement, respectively.

(2) *Amounts not included in income*—(i) *Qualified cash or deferred arrangement.* Elective contributions as defined in §1.401(k)–1 (g)(3) for a plan year made by an employer on behalf of an employee pursuant to a cash or deferred election under a qualified cash or deferred arrangement, as defined in §1.401(k)–1(a)(4)(i), are not treated as received by or distributed to the employee or as employee contributions.

For plan years beginning after December 31, 1992, whether a cash or deferred election is made under a qualified cash or deferred arrangement is determined without regard to the special rules for certain collectively bargained plans contained in §1.401(k)–1(a)(7). As a result, elective contributions under these plans are treated as employee contributions for purposes of this section if the cash or deferred arrangement does not satisfy the actual deferral percentage test of section 401(k)(3) or otherwise fails to be a qualified cash or deferred arrangement.

(ii) *Matching contributions.* Matching contributions described in §1.401(m)–1(f)(12) and section 401(m)(4) are not treated as contributed by an employee merely because they are made by the employer as a result of an employee's election.

(iii) *Effect of certain one-time elections.* Amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) pursuant to the one-time irrevocable employee election to participate in a plan described in §1.401(k)–1(a)(3)(iv) are not treated as contributed by an employee. Similarly, amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) in which self-employed individuals may participate pursuant to the one-time irrevocable election described in §1.401(k)–1(a)(6)(ii)(C) are not treated as contributed by an employee.

(3) *Effective date and transition rules*—(i) *Effective date.* In the case of a plan or trust that does not include a salary reduction or cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to taxable years ending after that date.

(ii) *Transition rule for cash or deferred arrangements in existence on June 27, 1974*—(A) *General rule.* In the case of a plan or trust that includes a salary reduction or a cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, as defined in §1.401(k)–1(g)(12), plan years beginning after July 18, 1984). For plan years beginning prior to January 1, 1980 (or, in the case of a pre-ERISA money purchase plan, plan years beginning before July 19, 1984), the taxable year of inclusion in gross income of the employee of any amount so contributed by the employer to the trust is determined in a manner consistent with Rev. Rul. 56–497, 1956–2 CB 284, Rev. Rul. 63–180, 1963–2 CB 189, and Rev. Rul. 68–89, 1968–1 CB 402.

(B) *Meaning of cash or deferred arrangement in existence on June 27, 1974.* A cash or deferred arrangement is considered as in existence on June 27, 1974, if, on or before that date, it was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed pursuant to the terms of the arrangement as of that date.

(iii) *Reasonable interpretation for plan years beginning after 1979 and before 1992.* For plan years beginning after December 31, 1979 (or in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401(k) (as in effect during those years) may be relied upon to determine whether contributions were made under a qualified cash or deferred arrangement.

(iv) *Special rule for collectively bargained plans.* For plan years beginning before January 1, 1993, a nonqualified cash or deferred arrangement will be treated as satisfying section 401(k)(3) solely for purposes of paragraph (d)(2)(i) of this section if it is part of a plan (or portion of a plan) that automatically satisfies section 401(a)(4) under §1.401(k)–1(a)(7), relating to certain collectively bargained plans.

(v) *Special rule for governmental plans.* For plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously, in the case of governmental plans described in section 414(d), a nonqualified cash or deferred arrangement will be treated as satisfying section 401(k)(3) solely for purposes of paragraph (d)(2)(i) of this section if it is part of a plan adopted by a state or local government before May

6, 1986. For purposes of this paragraph (d)(3)(v), the term *governing body with authority to amend the plan* means the legislature, board, commission, council, or other governing body with authority to amend the plan.

[T.D. 6500, 25 FR 11675, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10021, Oct. 20, 1960; T.D. 6676, 28 FR 10142, Sept. 17, 1963; T.D. 6717, 29 FR 4092, Mar. 28, 1964; T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 6823, 30 FR 6340, May 6, 1965; T.D. 6885, 31 FR 7800, June 2, 1966; T.D. 6887, 31 FR 8786, June 24, 1966; T.D. 8217, 53 FR 29673, Aug. 8, 1988; T.D. 8357, 56 FR 40545, Aug. 15, 1991; T.D. 8357, 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66180, Dec. 23, 1994]

§ 1.402(a)(5)–1T Rollovers of partial distributions from qualified trusts and annuities. (Temporary)

Q–1: Can an employee or the surviving spouse of a deceased employee roll over to an individual retirement account or annuity, described in section 408 (a) or (b), the taxable portion of a partial distribution from a qualifiedtrust described in section 401(a), a qualified plan described in section 403(a), or a tax-sheltered annuity contract under section 403(b)?

A–1: Yes. For distributions made after July 18, 1984, the taxable portion of a partial distribution may be rolled over within 60 days of the distribution to an individual retirement account or annuity.

Q–2: Are there special requirements applicable to rollovers of partial distributions?

A–2: Yes. Section 402(a)(5)(D)(i) specifies that no part of a partial distribution may be rolled over unless the distribution is equal to at least 50 percent of the balance to the credit of the employee in the contract or plan immediately before the distribution, and the distribution is not one of a series of periodic payments. For purposes of this section, the balance to the credit of an employee does not include any accumulated deductible employee contributions (within the meaning of section 72(o)). In addition, in calculating the balance to the credit for purposes of the 50 percent test, qualified plans are not to be aggregated with other qualified plans and tax-sheltered annuity contracts are not to be aggregated with other tax-sheltered annuity contracts. Also, in applying the 50 percent test to a surviving spouse, the balance to the credit is the maximum amount the spouse is entitled to receive under the plan or contract, rather than the total balance to the credit of the employee. The rollover of a partial distribution may result in adverse tax consequences; see section 402(a)(5)(D) (iii) and (iv).

Q–3: Are there any other requirements applicable to rollovers of partial distribution?

A–3: Yes. Section 402(a)(5)(D)(i)(III) requires the employee to elect, in conformance with Treasury regulations, to treat a contribution of a partial distribution to an IRA as a rollover contribution. An election is made by designating, in writing, to the trustee or issuer of the IRA at the time of the contribution that the contribution is to be treated as a rollover contribution. This requirement of a written designation to the trustee or issuer of the IRA is effective for contributions paid to the trustee or issuer of the IRA after March 20, 1986. For contributions paid to the trustee or issuer before March 21, 1986, an election is made by computing the individual's income tax liability on the income tax return for the taxable year in which the distribution occurs in a manner consistent with not including the distribution (or portion thereof) in gross income. Both such elections are irrevocable, except that an election made on an income tax return filed before March 21, 1986 is revocable.

Q–4: Does the election requirement apply to rollovers of qualified total distributions or rollover contributions described in section 402(a) (5) or (7), 403(a)(4), 403(b)(8), 405(d)(3), or 408(d)(3) to individual retirement accounts and annuities (IRAs)?

A–4: Yes. No amounts may be treated as a rollover contribution to an IRA under section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 405(d)(3) (as amended by section 491(c) of the TRA of 1984), or 408(d)(3) unless the requirements described in Q & A–3 of this section are satisfied. Thus, once any portion of a total distribution is irrevocably designated as a rollover contribution, such

distribution is not taxable under section 402 or 403 and, therefore, is not eligible for the special capital gains and separate tax treatment under section 402 (a) and (e). Election requirements for rollover contributions to IRAs described in this Q &A–4 are subject to the same effective date rules set forth in Q &A–3.

[T.D. 8073, 51 FR 4320, Feb. 4, 1986]

§ 1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).

(a) *Taxation by reason of employer contributions made after August 1, 1969*—(1) *Taxation of contributions.* Section 402(b) provides rules for taxing an employee on contributions made on his behalf by an employer to an employees' trust that is not exempt under section 501(a). In general, any such contributions made after August 1, 1969, during a taxable year of the employer which ends within or with a taxable year of the trust for which it is not so exempt shall be included as compensation in the gross income of the employee for his taxable year during which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested at the time the contribution is made. The preceding sentence does not apply to contracts referred to in the transitional rule of paragraph (d)(1) (ii) or (iii) of this section. For the definition of the terms ''substantially vested'' and ''substantially nonvested'' see § 1.83–3(b).

(2) *Determination of amount of employer contributions.* If, for an employee, the actual amount of employer contributions referred to in paragraph (a)(1) of this section for any taxable year of the employee is not known, such amount shall be either an amount equal to the excess of—

(i) The amount determined in accordance with the formula described in § 1.403(b)–1(d)(4) as the end of such taxable year, over

(ii) The amount determined in accordance with the formula described in § 1.403(b)–1(d)(4) as of the end of the prior taxable year,

or the amount determined under any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan.

(b) *Taxability of employee when rights under nonexempt trust change from nonvested to vested*—(1) *In general.* If rights of an employee under a trust become substantially vested during a taxable year of the employee (ending after August 1, 1969), and a taxable year of the trust for which it is not exempt under section 501(a) ends with or within such year, the value of the employee's interest in the trust on the date of such change shall be included in his gross income for such taxable year, to the extent provided in paragraph (b)(3) of this section. When an employees' trust that was exempt under section 501(a) ceases to be so exempt, an employee shall include in his gross income only amounts contributed to the trust during a taxable year of the employer that ends within or with a taxable year of the trust in which it is not so exempt (to the same extent as if the trust had not been so exempt in all prior taxable years).

(2) *Value of an employee's interest in a trust.* (i) For purposes of this section, the term ''the value of an employee's interest in a trust'' means the amount of the employee's beneficial interest in the net fair market value of all the assets in the trust as of any date on which some or all of the employee's interest in the trust becomes substantially vested. The net fair market value of all the assets in the trust is the total amount of the fair market values (determined without regard to any lapse restriction, as defined in § 1.83–3(h)) of all the assets in the trust, less the amount of all the liabilities (including taxes) to which such assets are subject or which the trust has assumed (other than the rights of any employee in such assets), as of the date on which some or all of the employee's interest in the trust becomes substantially vested.

(ii) If a separate account in a trust for the benefit of two or more employees is not maintained for each employee, the value of an employee's interest in such trust shall be determined

in accordance with the formula described in § 403(b)–1(d)(4) or any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which the contributions are made and the method adopted by the employer for funding the benefits under the plan.

(iii) If there is no valuation of a nonexempt trust's assets on the date of the change referred to in paragraph (b)(1) of this section, the value of an employee's interest in such trust is determined by taking the weighted average of the values on the nearest valuation dates occurring before and after the date of such change. The average is to be determined in the manner described in § 20.2031–2(b)(1).

(3) *Extent to which value of an employee's interest is includible in gross income.* For purposes of paragraph (b)(1) of this section, there shall be included in the gross income of the employee for his taxable year in which his rights under the trust become substantially vested only that portion of the value of his interest in the trust that is attributable to contributions made by the employer after August 1, 1969. However, the preceding sentence shall not apply—

(i) To the extent such value is attributable to a contribution made on the date of such change, and

(ii) To the extent such value is attributable to contributions described in paragraph (d)(1) (ii) or (iii) of this section (relating to contributions made pursuant to a binding contract entered into before April 22, 1969).

For purposes of this (3), if the value of an employee's interest in a trust which is attributable to contributions made by the employer after August 1, 1969, is not known, it shall be deemed to be an amount which bears the same ratio to the value of the employee's interest as the contributions made by the employer after such date bear to the total contributions made by the employer.

(4) *Partial vesting.* For purposes of paragraph (b)(1) of this section, if only part of an employee's interest in the trust becomes substantially vested during any taxable year, then only the corresponding part of the value of the employee's interest in such trust is includible in his gross income for such year. In such a case, it is first necessary to compute, under the rules in paragraphs (b) (1) and (2) of this section, the amount that would be includdible if his entire interest had changed to a substantially vested interest during such a year. The amount that is includible under this paragraph (4) is the amount determined under the preceding sentence multiplied by the percent of the employee's interest which became substantially vested during the taxable year.

(5) *Basis.* The basis of any employee's interest in a trust to which this section applies shall be increased by the amount included in his gross income under this section.

(6) *Treatment as owner of trust.* In general, a beneficiary of a trust to which this section applies may not be considered to be the owner under subpart E, part I, subchapter J, chapter I of the Code of any portion of such trust which is attributable to contributions to such trust made by the employer after August 1, 1969, or to incidental contributions made by the employee after such date. However, where contributions made by the employee are not incidental when compared to contributions made by the employer, such beneficiary shall be considered to be the owner of the portion of the trust attributable to contributions made by the employee, if the applicable requirements of such subpart E are satisfied. For purposes of this paragraph (6), contributions made by an employee are not incidental when compared to contributions made by the employer if the employee's total contributions as of any date exceed the employer's total contributions on behalf of the employee as of such date.

(7) *Example.* The provisions in this paragraph may be illustrated by the following example:

Example. On January 1, 1968 M corporation establishes an employees' trust, which is not exempt under section 501(a), for some of its employees, including A, reserving the right to discontinue contributions at any time. M corporation contributes $5,000 on A's behalf to the trust on February 1, 1968. At the time of contribution 50 percent of A's interest was substantially vested. On January 1, 1971, and January 1, 1974, M corporation makes additional $5,000 contributions to the trust on A's behalf. A's interest in the trust changed from a 50 percent substantially vested to a

100 percent substantialy vested interest in the trust on December 31, 1974. Assume that the value of A's interest in the trust on December 31, 1974, which is attributable to employer contributions made after August 1, 1969, is calculated to be $11,000 under paragraph (b)(3) of this section. The amount includible in A's gross income for 1971 and 1974 is computed as follows:

(i) Amount of M corporation's contribution made on January 1, 1971, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times $5,000 contribution)—$2,500.

1974

(i) Amount of M corporation's contribution made on January 1, 1974, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times $5,000 contribution)—$2,500.

(ii) Amount which would have been includible if A's entire interest had changed to a substantially vested interest (value of employee's interest in the trust attributable to employer contributions made after August 1, 1969—$11,000.

(iii) Percent of A's interest that became substantially vested on December 31, 1974—50 percent.

(iv) Amount includible in A;s gross income for 1974 in respect of his percentage change from a substantially nonvested to a substantially vested interest in the trust (50 percent of $11,000)—$5,500.

(v) Total amount includible in A's gross income for 1974 ((i) plus (iv))—$8,000.

(c) *Taxation of distributions from trust not exempt under section 501(a)*—(1) *In general.* Any amount actually distributed or made available to any distributee by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be taxable under section 72 (relating to annuities) to the distributee in the taxable year in which it is so distributed or made available. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution. Such value is includible in the gross income of the distributee to the extent that such value exceeds the investment in the contract, determined by applying sections 72 and 101(b). The distributions by such a trust shall be taxed as provided in section 72 whether or not the employee's rights to the contributions become substantially vested beforehand. For rules relating to the treatment of employer contributions to a nonexempt trust as part of the consideration paid by the employee, see section 72(f). For rules relating to the treatment of the limited exclusion allowable under section 101(b)(2)(D) as additional consideration paid by the employee, see the regulations under that section.

(2) *Distributions before annuity starting date.* Any amount distributed or made available to any distributee before the annuity starting date (as defined in section 72(c)(4)) by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be treated as distributed in the following order—

(i) First, from that portion of the employee's interest in the trust attributable to contributions made by the employer after August 1, 1969 (other than those referred to in paragraph (d)(1) (ii) or (iii) of this section) that has not been previously includible in the employee's gross income, to the extent that such a distribution is permitted under the trust (or the plan of which the trust is a part);

(ii) Second, from that portion of the employee's interest in the trust attributable to contributions made by the employer on or before August 1, 1969 (or contributions referred to in paragraph (d)(1) (ii) or (iii) of this section);

(iii) Third, from the remaining portion of the employee's interest in the trust attributable to contributions made by the employer.

If the employee has made contributions to the trust, amounts attributable thereto shall be treated as distributed prior to any amounts attributable to the employer's contributions, to the extent provided by the trust (or the plan of which the trust is a part). However, the portion of such amounts attributable to income earned on the employee's contributions made after August 1, 1969, shall be treated as distributed prior to any return of such contributions.

(d) *Taxation by reason of employer contributions made on or before August 1, 1969.* (1) Except as provided in section 402(d) (relating to taxable years beginning before January 1, 1977), any contribution to a trust made by an employer on behalf of an employee—

(i) On or before August 1, 1969, or

(ii) After such date, pursuant to a binding contract (as defined in §1.83–3(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer on such date was essentially the same as under a binding written contract, during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a) shall be included in income of the employee for his taxable year during which the contribution is made, if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made, even though his interest becomes nonforfeitable later the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2)(i) An employee's beneficial interest in the contribution is nonforfeitable, within the meaning of sections 402(b), 403(c), and 404(a)(5) prior to the amendments made thereto by the Tax Reform Act of 1969 and section 403(b), at the time the contribution is made if there is no contingency under the plan that may cause the employee to lose his rights in the contribution. Similarly, an employee's rights under an annuity contract purchased for him by his employer change from forfeitable to nonforfeitable rights within the meaning of section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 at that time when, for the first time, there is no contingency which may cause the employee to lose his rights under the contract. For example, if under the terms of a pension plan, an employee upon termination of his services before the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is abligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable.

(ii) On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from or to be provided by, contributions made by the employer if his services should be terminated before retirement, his beneficial interest in such contributions is nonforfeitable.

(iii) The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provide only that the employee is alive on the dates the annuity payments are due, the employee's rights in the employer's contributions are nonforfeitable.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 7554, 43 FR 31922, July 24, 1978]

§1.402(c)–1 Taxability of beneficiary of certain foreign situs trusts.

Section 402(c) has the effect of treating, for purposes of section 402, the distributions from a trust which at the time of the distribution is located outside the United States in the same manner as distributions from a trust which is located in the United States. If the trust would qualify for exemption from tax under section 501(a) except for the fact that it fails to comply with the provisions of paragraph (a)(3)(i) of §1.401–1, which restricts

qualification to trusts created or organized in the United States and maintained here, section 402(a) and §1.402(a)–1 are applicable to the distributions from such a trust. Thus, for example, a total distribution from such a trust is entitled to the long-term capital gains treatment of section 402(a)(2), except in the case of a nonresident alien individual (see section 871 and 1441 and the regulations thereunder). However, if the plan fails to meet any requirement of section 401 and the regulations thereunder in addition to paragraph (a)(3)(i) of §1.401–1, section 402(b) and §1.402(b)–1 are applicable to the distributions from such a trust.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960]

§1.402(c)–2 Eligible rollover distributions; questions and answers.

The following questions and answers relate to the rollover rules under section 402(c) of the Internal Revenue Code of 1986, as added by sections 521 and 522 of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 401(a)(31), 402(f), 403(b)(8) and (10), and 3405(c), see §§1.401(a)(31)–1, 1.402(f)–1, and 1.403(b)–2, and §31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan?

Q–2: What is an *eligible retirement plan* and a *qualified plan*?

Q–3: What is an *eligible rollover distribution*?

Q–4: Are there other amounts that are not eligible rollover distributions?

Q–5: For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?

Q–6: What types of variations in the amount of a payment cause the payment to be independent of a series of substantially equal periodic payments and thus not part of the series?

Q–7: When is a distribution from a plan a required minimum distribution under section 401(a)(9)?

Q–8: How are amounts that are not includible in gross income allocated for purposes of determining the required minimum distribution?

Q–9: What is a distribution of a plan loan offset amount and is it an eligible rollover distribution?

Q–10: What is a qualified plan distributed annuity contract, and is an amount paid under such a contract a distribution of the balance to the credit of the employee in a qualified plan for purposes of section 402(c)?

Q–11: If an eligible rollover distribution is paid to an employee, and the employee contributes all or part of the eligible rollover distribution to an eligible retirement plan within 60 days, is the amount contributed not currently includible in gross income?

Q–12: How does section 402(c) apply to a distributee who is not the employee?

Q–13: Must an employee's (or spousal distributee's) election to treat a contribution of an eligible rollover distribution to an individual retirement plan as a rollover contribution be irrevocable?

Q–14: How is the $5,000 death benefit exclusion under section 101(b) treated for purposes of determining the amount that is an eligible rollover distribution?

Q–15: May an employee (or spousal distributee) roll over more than the plan administrator determines to be an eligible rollover distribution using an assumption described in §1.401(a)(31)–1, Q&A–18?

Q–16: Is a rollover from a qualified plan to an individual retirement account or individual retirement annuity treated as a rollover contribution for purposes of the one-year look-back rollover limitation of section 408(d)(3)(B)?

QUESTIONS AND ANSWERS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan?

A–1: (a) *General rule.* Under section 402(c), as added by UCA, any portion of a distribution from a qualified plan that is an eligible rollover distribution described in section 402(c)(4) may be rolled over to an eligible retirement plan described in section 402(c)(8)(B). For purposes of section 402(c) and this section, a rollover is either a direct rollover as described in §1.401(a)(31)–1, Q&A–3 or a contribution of an eligible rollover distribution to an eligible retirement plan that satisfies the time period requirement in section 402(c)(3) and Q&A–11 of this section and the designation requirement described in Q&A–13 of this section. See Q&A–2 of this section for the definition of an eligible retirement plan and a qualified plan.

(b) *Related Internal Revenue Code provisions*—(1) *Direct rollover option*. Section 401(a)(31), added by UCA, requires qualified plans to provide a distributee of an eligible rollover distribution the option to elect to have the distribution paid directly to an eligible retirement plan in a direct rollover. See § 1.401(a)(31)–1 for further guidance concerning this direct rollover option.

(2) *Notice requirement*. Section 402(f) requires the plan administrator of a qualified plan to provide, within a reasonable time before making an eligible rollover distribution, a written explanation to the distributee of the distributee's right to elect a direct rollover and the withholding consequences of not making that election. The explanation also is required to provide certain other relevant information relating to the taxation of distributions. See § 1.402(f)–1 for guidance concerning the written explanation required under section 402(f).

(3) *Mandatory income tax withholding*. If a distributee of an eligible rollover distribution does not elect to have the eligible rollover distribution paid directly from the plan to an eligible retirement plan in a direct rollover under section 401(a)(31), the eligible rollover distribution is subject to 20-percent income tax withholding under section 3405(c). See § 31.3405(c)–1 of this chapter for provisions relating to the withholding requirements applicable to eligible rollover distributions.

(4) *Section 403(b) annuities*. See § 1.403(b)–2 for guidance concerning the direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date*. Section 402(c), added by UCA, applies to eligible rollover distributions made on or after January 1, 1993, even if the event giving rise to the distribution occurred on or before January 1, 1993 (e.g. termination of the employee's employment with the employer maintaining the plan before January 1, 1993), and even if the eligible rollover distribution is part of a series of payments that began before January 1, 1993.

(2) *Regulatory effective date*. This section applies to any distribution made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, § 1.402(c)–2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, any or all of the provisions of this section may be substituted for the corresponding provisions of § 1.402(c)–2T, if any.

Q–2: What is an *eligible retirement plan* and a *qualified plan*?

A–2: An eligible retirement plan, under section 402(c)(8)(B), means a qualified plan or an individual retirement plan. For purposes of section 402(c) and this section, a qualified plan is an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or an annuity plan described in section 403(a). An individual retirement plan is an individual retirement account described in section 408(a) or an individual retirement annuity (other than an endowment contract) described in section 408(b).

Q–3: What is an *eligible rollover distribution*?

A–3: (a) *General rule*. Unless specifically excluded, an eligible rollover distribution means any distribution to an employee (or to a spousal distributee described in Q&A–12(a) of this section) of all or any portion of the balance to the credit of the employee in a qualified plan. Thus, except as specifically provided in Q&A–4(b) of this section, any amount distributed to an employee (or such a spousal distributee) from a qualified plan is an eligible rollover distribution, regardless of whether it is a distribution of a benefit that is protected under section 411(d)(6).

(b) *Exceptions*. An eligible rollover distribution does not include the following:

(1) Any distribution that is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods—

(i) The life of the employee (or the joint lives of the employee and the employee's designated beneficiary);

(ii) The life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary); or

(iii) A specified period of ten years or more;

(2) Any distribution to the extent the distribution is a required minimum distribution under section 401(a)(9); or

(3) The portion of any distribution that is not includible in gross income (determined without regard to the exclusion for net unrealized appreciation described in section 402(e)(4)). Thus, for example, an eligible rollover distribution does not include the portion of any distribution that is excludible from gross income under section 72 as a return of the employee's investment in the contract (e.g., a return of the employee's after-tax contributions), but does include net unrealized appreciation.

Q–4: Are there other amounts that are not eligible rollover distributions?

A–4: Yes. The following amounts are not eligible rollover distributions:

(a) Elective deferrals, as defined in section 402(g)(3), that, pursuant to §1.415–6(b)(6)(iv), are returned as a result of the application of the section 415 limitations, together with the income allocable to these corrective distributions.

(b) Corrective distributions of excess deferrals as described in §1.402(g)–1(e)(3), together with the income allocable to these corrective distributions.

(c) Corrective distributions of excess contributions under a qualified cash or deferred arrangement described in §1.401(k)–1(f)(4) and excess aggregate contributions described in §1.401(m)–1(e)(3), together with the income allocable to these distributions.

(d) Loans that are treated as deemed distributions pursuant to section 72(p).

(e) Dividends paid on employer securities as described in section 404(k).

(f) The costs of life insurance coverage (P.S. 58 costs).

(g) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(*b*) of this chapter.

Q–5: For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?

A–5: (a) *General rule.* Generally, whether a series of payments is a series of substantially equal periodic payments over a specified period is determined at the time payments begin, and by following the principles of section 72(t)(2)(A)(iv), without regard to contingencies or modifications that have not yet occurred. Thus, for example, a joint and 50-percent survivor annuity will be treated as a series of substantially equal payments at the time payments commence, as will a joint and survivor annuity that provides for increased payments to the employee if the employee's beneficiary dies before the employee. Similarly, for purposes of determining if a disability benefit payment is part of a series of substantially equal payments for a period described in section 402(c)(4)(A), any contingency under which payments cease upon recovery from the disability may be disregarded.

(b) *Certain supplements disregarded.* For purposes of determining whether a distribution is one of a series of payments that are substantially equal, social security supplements described in section 411(a)(9) are disregarded. For example, if a distributee receives a life annuity of $500 per month, plus a social security supplement consisting of payments of $200 per month until the distributee reaches the age at which social security benefits of not less than $200 a month begin, the $200 supplemental payments are disregarded and, therefore, each monthly payment of $700 made before the social security age and each monthly payment of $500 made after the social security age is treated as one of a series of substantially equal periodic payments for life. A series of payments that are not substantially equal solely because the amount of each payment is reduced upon attainment of social security retirement age (or, alternatively, upon commencement of social security early retirement, survivor, or disability benefits) will also be treated as substantially equal as long as the reduction in the actual payments is level and does not exceed the applicable social security benefit.

(c) *Changes in the amount of payments or the distributee.* If the amount (or, if applicable, the method of calculating

the amount) of the payments changes so that subsequent payments are not substantially equal to prior payments, a new determination must be made as to whether the remaining payments are a series of substantially equal periodic payments over a period specified in Q&A–3(b)(1) of this section. This determination is made without taking into account payments made or the years of payment that elapsed prior to the change. However, a new determination is not made merely because, upon the death of the employee, the spouse or former spouse of the employee becomes the distributee. Thus, once distributions commence over a period that is at least as long as either the first annuitant's life or 10 years (e.g., as provided by a life annuity with a five-year or ten-year-certain guarantee), then substantially equal payments to the survivor are not eligible rollover distributions even though the payment period remaining after the death of the employee is or may be less than the period described in section 402(c)(4)(A). For example, substantially equal periodic payments made under a life annuity with a five-year term certain would not be an eligible rollover distribution even when paid after the death of the employee with three years remaining under the term certain.

(d) *Defined contribution plans.* The following rules apply in determining whether a series of payments from a defined contribution plan constitute substantially equal periodic payments for a period described in section 402(c)(4)(A):

(1) *Declining balance of years.* A series of payments from an account balance under a defined contribution plan will be considered substantially equal payments over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. For example, a series of payments will be considered substantially equal payments over 10 years if the series is determined as follows. In year 1, the annual payment is the account balance divided by 10; in year 2, the annual payment is the remaining account balance divided by 9; and so on until year 10 when the entire remaining balance is distributed.

(2) *Reasonable actuarial assumptions.* If an employee's account balance under a defined contribution plan is to be distributed in annual installments of a specified amount until the account balance is exhausted, then, for purposes of determining if the period of distribution is a period described in section 402(c)(4)(A), the period of years over which the installments will be distributed must be determined using reasonable actuarial assumptions. For example, if an employee has an account balance of $100,000, elects distributions of $12,000 per year until the account balance is exhausted, and the future rate of return is assumed to be 8% per year, the account balance will be exhausted in approximately 14 years. Similarly, if the same employee elects a fixed annual distribution amount and the fixed annual amount is less than or equal to $10,000, it is reasonable to assume that a future rate of return will be greater than 0% and, thus, the account will not be exhausted in less than 10 years.

(e) *Series of payments beginning before January 1, 1993.* Except as provided in paragraph (c) of this Q&A, if a series of periodic payments began before January 1, 1993, the determination of whether the post-December 31, 1992 payments are a series of substantially equal periodic payments over a specified period is made by taking into account all payments made, including payments made before January 1, 1993. For example, if a series of substantially equal periodic payments beginning on January 1, 1983, is scheduled to be paid over a period of 15 years, payments in the series that are made after December 31, 1992, will not be eligible rollover distributions even though they will continue for only five years after December 31, 1992, because the pre- January 1, 1993 payments are taken into account in determining the specified period.

Q–6: What types of variations in the amount of a payment cause the payment to be independent of a series of substantially equal periodic payments and thus not part of the series?

A–6: (a) *Independent payments.* Except as provided in paragraph (b) of this Q&A, a payment is treated as independent of the payments in a series of substantially equal payments, and thus not part of the series, if the payment is

substantially larger or smaller than the other payments in the series. An independent payment is an eligible rollover distribution if it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the payment is made before, with, or after payments in the series. For example, if an employee elects a single payment of half of the account balance with the remainder of the account balance paid over the life expectancy of the distributee, the single payment is treated as independent of the payments in the series and is an eligible rollover distribution unless otherwise excepted. Similarly, if an employee's surviving spouse receives a survivor life annuity of $1,000 per month plus a single payment on account of death of $7,500, the single payment is treated as independent of the payments in the annuity and is an eligible rollover distribution unless otherwise excepted (e.g., $5,000 of the $7,500 might qualify to be excluded from gross income as a death benefit under section 101(b)).

(b) *Special rules*—(1) *Administrative error or delay*. If, due solely to reasonable administrative error or delay in payment, there is an adjustment after the annuity starting date to the amount of any payment in a series of payments that otherwise would constitute a series of substantially equal payments described in section 402(c)(4)(A) and this section, the adjusted payment or payments will be treated as part of the series of substantially equal periodic payments and will not be treated as independent of the payments in the series. For example, if, due solely to reasonable administrative delay, the first payment of a life annuity is delayed by two months and reflects an additional two months worth of benefits, that payment will be treated as a substantially equal payment in the series rather than as an independent payment. The result will not change merely because the amount of the adjustment is paid in a separate supplemental payment.

(2) *Supplemental payments for annuitants*. A supplemental payment from a defined benefit plan to annuitants (e.g., retirees or beneficiaries) will be treated as part of a series of substantially equal payments, rather than as an independent payment, provided that the following conditions are met—

(i) The supplement is a benefit increase for annuitants;

(ii) The amount of the supplement is determined in a consistent manner for all similarly situated annuitants;

(iii) The supplement is paid to annuitants who are otherwise receiving payments that would constitute substantially equal periodic payments; and

(iv) The aggregate supplement is less than or equal to the greater of 10% of the annual rate of payment for the annuity, or $750 or any higher amount prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the FEDERAL REGISTER. See §601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Final payment in a series*. If a payment in a series of payments from an account balance under a defined contribution plan represents the remaining balance to the credit and is substantially less than the other payments in the series, the final payment must nevertheless be treated as a payment in the series of substantially equal payments and may not be treated as an independent payment if the other payments in the series are substantially equal and the payments are for a period described in section 402(c)(4)(A) based on the rules provided in paragraph (d)(2) of Q&A–5 of this section. Thus, such final payment will not be an eligible rollover distribution.

Q–7: When is a distribution from a plan a required minimum distribution under section 401(a)(9)?

A–7: (a) *General rule*. Except as provided in paragraphs (b) and (c) of this Q&A, if a minimum distribution is required for a calendar year, the amounts distributed during that calendar year are treated as required minimum distributions under section 401(a)(9), to the extent that the total required minimum distribution under section 401(a)(9) for the calendar year has not been satisfied. Accordingly, these amounts are not eligible rollover distributions. For example, if an employee is required under section 401(a)(9) to receive a required minimum distribution for a calendar year of $5,000 and the employee receives a total

of $7,200 in that year, the first $5,000 distributed will be treated as the required minimum distribution and will not be an eligible rollover distribution and the remaining $2,200 will be an eligible rollover distribution if it otherwise qualifies. If the total section 401(a)(9) required minimum distribution for a calendar year is not distributed in that calendar year (e.g., when the distribution for the calendar year in which the employee reaches age 70½ is made on the following April 1), the amount that was required but not distributed is added to the amount required to be distributed for the next calendar year in determining the portion of any distribution in the next calendar year that is a required minimum distribution.

(b) *Distribution before age 70½.* Any amount that is paid before January 1 of the year in which the employee attains (or would have attained) age 70½ will not be treated as required under section 401(a)(9) and, thus, is an eligible rollover distribution if it otherwise qualifies.

(c) *Special rule for annuities.* In the case of annuity payments from a defined benefit plan, or under an annuity contract purchased from an insurance company (including a qualified plan distributed annuity contract (as defined in Q&A–10 of this section)), the entire amount of any such annuity payment made on or after January 1 of the year in which an employee attains (or would have attained) age 70½ will be treated as an amount required under section 401(a)(9) and, thus, will not be an eligible rollover distribution.

Q–8: How are amounts that are not includible in gross income allocated for purposes of determining the required minimum distribution?

A–8: If section 401(a)(9) has not yet been satisfied by the plan for the year with respect to an employee, a distribution is made to the employee that exceeds the amount required to satisfy section 401(a)(9) for the year for the employee, and a portion of that distribution is excludible from gross income, the following rule applies for purposes of determining the amount of the distribution that is an eligible rollover distribution. The portion of the distribution that is excludible from gross income is first allocated toward satisfaction of section 401(a)(9) and then the remaining portion of the required minimum distribution, if any, is satisfied from the portion of the distribution that is includible in gross income. For example, assume an employee is required under section 401(a)(9) to receive a minimum distribution for a calendar year of $4,000 and the employee receives a $4,800 distribution, of which $1,000 is excludible from income as a return of basis. First, the $1,000 return of basis is allocated toward satisfying the required minimum distribution. Then, the remaining $3,000 of the required minimum distribution is satisfied from the $3,800 of the distribution that is includible in gross income, so that the remaining balance of the distribution, $800, is an eligible rollover distribution if it otherwise qualifies.

Q–9: What is a distribution of a plan loan offset amount, and is it an eligible rollover distribution?

A–9: (a) *General rule.* A distribution of a plan loan offset amount, as defined in paragraph (b) of this Q&A, is an eligible rollover distribution if it satisfies Q&A–3 of this section. Thus, an amount equal to the plan loan offset amount can be rolled over by the employee (or spousal distributee) to an eligible retirement plan within the 60-day period under section 402(c)(3), unless the plan loan offset amount fails to be an eligible rollover distribution for another reason. See §1.401(a)(31)–1, Q&A–16 for guidance concerning the offering of a direct rollover of a plan loan offset amount. See §31.3405(c)–1, Q&A–11 of this chapter for guidance concerning special withholding rules with respect to plan loan offset amounts.

(b) *Definition of plan loan offset amount.* For purposes of section 402(c), a distribution of a plan loan offset amount is a distribution that occurs when, under the plan terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in a participant's accrued benefit). A distribution of a plan loan offset amount can occur in a variety of circumstances, e.g., where the terms governing a plan loan require that, in the

event of the employee's termination of employment or request for a distribution, the loan be repaid immediately or treated as in default. A distribution of a plan loan offset amount also occurs when, under the terms governing the plan loan, the loan is cancelled, accelerated, or treated as if it were in default (e.g., where the plan treats a loan as in default upon an employee's termination of employment or within a specified period thereafter). A distribution of a plan loan offset amount is an actual distribution, not a deemed distribution under section 72(p).

(c) *Examples*. The rules with respect to a plan loan offset amount in this Q&A–9, §1.401(a)(31)–1, Q&A–16 and §31.3405(c)–1, Q&A–11 of this chapter are illustrated by the following examples:

Example 1. (a) In 1996, Employee A has an account balance of $10,000 in Plan Y, of which $3,000 is invested in a plan loan to Employee A that is secured by Employee A's account balance in Plan Y. Employee A has made no after-tax employee contributions to Plan Y. Plan Y does not provide any direct rollover option with respect to plan loans. Upon termination of employment in 1996, Employee A, who is under age 70½ , elects a distribution of Employee A's entire account balance in Plan Y, and Employee A's outstanding loan is offset against the account balance on distribution. Employee A elects a direct rollover of the distribution.

(b) In order to satisfy section 401(a)(31), Plan Y must pay $7,000 directly to the eligible retirement plan chosen by Employee A in a direct rollover. When Employee A's account balance was offset by the amount of the $3,000 unpaid loan balance, Employee A received a plan loan offset amount (equivalent to $3,000) that is an eligible rollover distribution. However, under §1.401(a)(31)–1, Q&A–16 Plan Y satisfies section 401(a)(31), even though a direct rollover option was not provided with respect to the $3,000 plan loan offset amount.

(c) No withholding is required under section 3405(c) on account of the distribution of the $3,000 plan loan offset amount because no cash or other property (other than the plan loan offset amount) is received by Employee A from which to satisfy the withholding. Employee A may roll over $3,000 to an eligible retirement plan within the 60 day period provided in section 402(c)(3).

Example 2. (a) The facts are the same as in *Example 1*, except that the terms governing the plan loan to Employee A provide that, upon termination of employment, Employee A's account balance is automatically offset by the amount of any unpaid loan balance to repay the loan. Employee A terminates employment but does not request a distribution from Plan Y. Nevertheless, pursuant to the terms governing the plan loan, Employee A's account balance is automatically offset by the amount of the $3,000 unpaid loan balance.

(b) The $3,000 plan loan offset amount attributable to the plan loan in this example is treated in the same manner as the $3,000 plan loan offset amount in *Example 1*.

Example 3. (a) The facts are the same as in *Example 2*, except that, instead of providing for an automatic offset upon termination of employment to repay the plan loan, the terms governing the plan loan require full repayment of the loan by Employee A within 30 days of termination of employment. Employee A terminates employment, does not elect a distribution from Plan Y, and also fails to repay the plan loan within 30 days. The plan administrator of Plan Y declares the plan loan to Employee A in default and executes on the loan by offsetting Employee A's account balance by the amount of the $3,000 unpaid loan balance.

(b) The $3,000 plan loan offset amount attributable to the plan loan in this example is treated in the same manner as the $3,000 plan loan offset amount in *Example 1* and in *Example 2*. The result in this *Example 3* is the same even though the plan administrator treats the loan as in default before offsetting Employee A's accrued benefit by the amount of the unpaid loan.

Example 4. (a) The facts are the same as in *Example 1*, except that Employee A elects to receive the distribution of the account balance that remains after the $3,000 offset to repay the plan loan, instead of electing a direct rollover of the remaining account balance.

(b) In this case, the amount of the distribution received by Employee A is $10,000, not $3,000. Because the amount of the $3,000 offset attributable to the loan is included in determining the amount that equals 20 percent of the eligible rollover distribution received by Employee A, withholding in the amount of $2,000 (20 percent of $10,000) is required under section 3405(c). The $2,000 is required to be withheld from the $7,000 to be distributed to Employee A in cash, so that Employee A actually receives a check for $5,000.

Example 5. The facts are the same as in *Example* 4, except that the $7,000 distribution to Employee A after the offset to repay the loan consists solely of employer securities within the meaning of section 402(e)(4)(E). In this case, no withholding is required under section 3405(c) because the distribution consists solely of the $3,000 plan loan offset amount and the $7,000 distribution of employer securities. This is the result because the total amount required to be withheld does not exceed the sum of the cash and the

fair market value of other property distributed, excluding plan loan offset amounts and employer securities. Employee A may roll over the employer securities and $3,000 to an eligible retirement plan within the 60-day period provided in section 402(c)(3).

Example 6. Employee B, who is age 40, has an account balance in Plan Z, a profit sharing plan qualified under section 401(a) that includes a qualified cash or deferred arrangement described in section 401(k). Plan Z provides for no after-tax employee contributions. In 1990, Employee B receives a loan from Plan Z, the terms of which satisfy section 72(p)(2), and which is secured by elective contributions subject to the distribution restrictions in section 401(k)(2)(B). In 1996, the loan fails to satisfy section 72(p)(2) because Employee B stops repayment. In that year, pursuant to section 72(p), Employee B is taxed on a deemed distribution equal to the amount of the unpaid loan balance. Under Q&A–4 of this section, the deemed distribution is not an eligible rollover distribution. Because Employee B has not separated from service or experienced any other event that permits the distribution under section 401(k)(2)(B) of the elective contributions that secure the loan, Plan Z is prohibited from executing on the loan. Accordingly, Employee B's account balance is not offset by the amount of the unpaid loan balance at the time Employee B stops repayment on the loan. Thus, there is no distribution of an offset amount that is an eligible rollover distribution in 1996.

Q–10: What is a qualified plan distributed annuity contract, and is an amount paid under such a contract a distribution of the balance to the credit of the employee in a qualified plan for purposes of section 402(c)?

A–10: (a) *Definition of a qualified plan distributed annuity contract*. A qualified plan distributed annuity contract is an annuity contract purchased for a participant, and distributed to the participant, by a qualified plan.

(b) *Treatment of amounts paid as eligible rollover distributions*. Amounts paid under a qualified plan distributed annuity contract are payments of the balance to the credit of the employee for purposes of section 402(c) and are eligible rollover distributions, if they otherwise qualify. Thus, for example, if the employee surrenders the contract for a single sum payment of its cash surrender value, the payment would be an eligible rollover distribution to the extent it is includible in gross income and not a required minimum distribution under section 401(a)(9). This rule applies even if the annuity contract is distributed in connection with a plan termination. See §1.401(a)(31)–1, Q&A–17 and §31.3405(c)–1, Q&A–13 of this chapter concerning the direct rollover requirements and 20-percent withholding requirements, respectively, that apply to eligible rollover distributions from such an annuity contract.

Q–11: If an eligible rollover distribution is paid to an employee, and the employee contributes all or part of the eligible rollover distribution to an eligible retirement plan within 60 days, is the amount contributed not currently includible in gross income?

A–11: Yes, the amount contributed is not currently includible in gross income, provided that it is contributed to the eligible retirement plan no later than the 60th day following the day on which the employee received the distribution. If more than one distribution is received by an employee from a qualified plan during a taxable year, the 60-day rule applies separately to each distribution. Because the amount withheld as income tax under section 3405(c) is considered an amount distributed under section 402(c), an amount equal to all or any portion of the amount withheld can be contributed as a rollover to an eligible retirement plan within the 60-day period, in addition to the net amount of the eligible rollover distribution actually received by the employee. However, if all or any portion of an amount equal to the amount withheld is not contributed as a rollover, it is included in the employee's gross income to the extent required under section 402(a), and also may be subject to the 10-percent additional income tax under section 72(t). See §1.401(a)(31)–1, Q&A–14, for guidance concerning the qualification of a plan that accepts a rollover contribution.

Q–12: How does section 402(c) apply to a distributee who is not the employee?

A–12: (a) *Spousal distributee*. If any distribution attributable to an employee is paid to the employee's surviving spouse, section 402(c) applies to the distribution in the same manner as if the spouse were the employee. The same rule applies if any distribution attributable to an employee is paid in accordance with a qualified domestic

relations order (as defined in section 414(p)) to the employee's spouse or former spouse who is an alternate payee. Therefore, a distribution to the surviving spouse of an employee (or to a spouse or former spouse who is an alternate payee under a qualified domestic relations order), including a distribution of ancillary death benefits attributable to the employee, is an eligible rollover distribution if it meets the requirements of section 402(c)(2) and (4) and Q&A–3 through Q&A–10 and Q&A–14 of this section. However, a qualified plan (as defined in Q&A–2 of this section) is not treated as an eligible retirement plan with respect to a surviving spouse. Only an individual retirement plan is treated as an eligible retirement plan with respect to an eligible rollover distribution to a surviving spouse.

(b) *Non-spousal distributee.* A distributee other than the employee or the employee's surviving spouse (or a spouse or former spouse who is an alternate payee under a qualified domestic relations order) is not permitted to roll over distributions from a qualified plan. Therefore, those distributions do not constitute eligible rollover distributions under section 402(c)(4) and are not subject to the 20-percent income tax withholding under section 3405(c).

Q–13: Must an employee's (or spousal distributee's) election to treat a contribution of an eligible rollover distribution to an individual retirement plan as a rollover contribution be irrevocable?

A–13: (a) *In general.* Yes. In order for a contribution of an eligible rollover distribution to an individual retirement plan to constitute a rollover and, thus, to qualify for current exclusion from gross income, a distributee must elect, at the time the contribution is made, to treat the contribution as a rollover contribution. An election is made by designating to the trustee, issuer, or custodian of the eligible retirement plan that the contribution is a rollover contribution. This election is irrevocable. Once any portion of an eligible rollover distribution has been contributed to an individual retirement plan and designated as a rollover distribution, taxation of the withdrawal of the contribution from the individual retirement plan is determined under section 408(d) rather than under section 402 or 403. Therefore, the eligible rollover distribution is not eligible for capital gains treatment, five-year or ten-year averaging, or the exclusion from gross income for net unrealized appreciation on employer stock.

(b) Direct rollover. If an eligible rollover distribution is paid to an individual retirement plan in a direct rollover at the election of the distributee, the distributee is deemed to have irrevocably designated that the direct rollover is a rollover contribution.

Q–14: How is the $5,000 death benefit exclusion under section 101(b) treated for purposes of determining the amount that is an eligible rollover distribution?

A–14: To the extent that a death benefit is a distribution from a qualified plan, the portion of the distribution that is excluded from gross income under section 101(b) is not an eligible rollover distribution. See §1.401(a)(31)-1, Q&A–18 for guidance concerning assumptions that a plan administrator may make with respect to whether and to what extent a distribution of a survivor benefit is excludible from gross income under section 101(b).

Q–15: May an employee (or spousal distributee) roll over more than the plan administrator determines to be an eligible rollover distribution using an assumption described in §1.401(a)(31)-1, Q&A–18?

A–15: Yes. The portion of any distribution that an employee (or spousal distributee) may roll over as an eligible rollover distribution under section 402(c) is determined based on the actual application of section 402 and other relevant provisions of the Internal Revenue Code. The actual application of these provisions may produce different results than any assumption described in §1.401(a)(31)–1, Q&A–18 that is used by the plan administrator. Thus, for example, even though the plan administrator calculates the portion of a distribution that is a required minimum distribution (and thus is not made eligible for direct rollover under section 401(a)(31)), by assuming that there is no designated beneficiary, the portion of

the distribution that is actually a required minimum distribution and thus not an eligible rollover distribution is determined by taking into account the designated beneficiary, if any. If, by taking into account the designated beneficiary, a greater portion of the distribution is an eligible rollover distribution, the distributee may rollover the additional amount. Similarly, even though a plan administrator assumes that a distribution from a qualified plan is the only death benefit with respect to an employee that qualifies for the $5,000 death benefit exclusion under section 101(b), to the extent that the death benefit exclusion is allocated to a different death benefit, a greater portion of the distribution may actually be includible in gross income and, thus, be an eligible rollover distribution, and the surviving spouse may roll over the additional amount if it otherwise qualifies.

Q–16: Is a rollover from a qualified plan to an individual retirement account or individual retirement annuity treated as a rollover contribution for purposes of the one-year look-back rollover limitation of section 408(d)(3)(B)?

A–16: No. A distribution from a qualified plan that is rolled over to an individual retirement account or individual retirement annuity is not treated for purposes of section 408(d)(3)(B) as an amount received by an individual from an individual retirement account or individual retirement annuity which is not includible in gross income because of the application of section 408(d)(3).

[T.D. 8619, 60 FR 49208, Sept. 22, 1995, as amended by T.D. 8880, 65 FR 21315, Apr. 21, 2000]

§ 1.402(d)–1 Effect of section 402(d).

(a) If the requirements of section 402(d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 501(a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such contributions. For taxable years beginning after December 31, 1963, such contributions, when received, may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). See paragraph (b) of § 1.403(c)–1. The intent and purpose of section 402(d) is to give those employees, covered under certain non-exempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts described in section 401(a) and exempt under section 501(a), except that the capital gains treatment referred to in section 402(a)(2) does not apply.

(b) Every person claiming the benefit of section 402(d) must be able to demonstrate to the satisfaction of the Commissioner that all of the provisions of such section are met. The taxpayer must produce sufficient evidence to prove:

(1) That, before October 21, 1942, he was employed by the particular employer making the contribution in question and was at such time definitely covered by a written agreement, entered into before October 21, 1942, between himself and the employer, or between the employer and the trustee of a trust established by the employer before October 21, 1942, and that the contribution by the employer was made pursuant to such agreement. The fact that an employee may have been potentially covered is not sufficient. Evidence that the employment was entered into, or the agreement executed, ''as of'' a date before October 21, 1942, or that the agreement or trust instrument which did not theretofore meet the requirements of section 402(d) was modified or amended after October 20, 1942, so as to come within the provisions of such section, will not satisfy the requirements of section 402(d).

(2) That such contribution, pursuant to the terms of such agreement, was to be applied for the purchase of an annuity contract for the taxpayer. In the case of a contribution by the employer of an annuity contract purchased by such employer and transferred by him to the trustee of the trust, evidence should be presented to prove that such

contract was purchased for the taxpayer by the employer pursuant to the terms of a written agreement between the employer and the employee or between the employer and the trustee, entered into before October 21, 1942.

(3) That under the written terms of the trust agreement the taxpayer is not entitled during his lifetime, except with the consent of the trustee, to any payments other than annuity payments under the annuity contract or contracts purchased by the trustee or by the employer and transferred to the trustee, and that the trustee may grant or withhold such consent free from control by the taxpayer, the employer, or any other person. However, such control will not be presumed from the fact that the trustee is himself an officer or employee of the employer. As used in section 402(d) the phrase ''if * * * under the terms of the trust agreement the employee is not entitled'' means that the trust instrument must make it impossible for the prohibited distribution to occur whether by operation or natural termination of the trust, whether by power of revocation or amendment, other than with the consent of the trustee, whether by the happening of a contingency, by collateral arrangement, or any other means. It is not essential that the employer relinquish all power to modify or terminate the trust but it must be impossible, except with the consent of the trustee, to be received by the taxpayer contracts purchased by the trustee, or by the employer and transferred to the trustee, to be received by the taxpayer directly or indirectly, other than as annuity payments.

(4) The nature and amount of such contribution and the extent to which income taxes have been paid thereon before January 1, 1949, and not credited or refunded.

(5) If it is claimed that section 402(d) applies to amounts contributed to a trust after June 1, 1949, the taxpayer must prove to the satisfaction of the Commissioner that the trust did not, on June 1, 1949, qualify for exemption under section 165(a) of the Internal Revenue Code of 1939. Where an employer buys an annuity contract which is transferred to the trustee, the date of the purchase of the annuity contract and not the date of the transfer to the trustee is the controlling date in determining whether or not the contribution was made to the trust after June 1, 1949.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7801, June 2, 1966]

§ 1.402(e)–1 Certain plan terminations.

Distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of an employees' trust described in section 401(a) which is exempt under section 501(a) shall be considered distributions on account of separation form service for purposes of section 402(a)(2) if the employer who established the trust is a corporation, and the termination of the plan is incident to the complete liquidation of the corporation before August 16, 1954, regardless of whether such liquidation is incident to a reorganization as defined in section 368.

[T.D. 6500, 25 FR 11680, Nov. 26, 1960]

§ 1.402(f)–1 Required explanation of eligible rollover distributions; questions and answers.

The following questions and answers concern the written explanation requirement imposed by section 402(f) of the Internal Revenue Code of 1986 relating to distributions eligible for rollover treatment. Section 402(f) was amended by section 521(a) of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 403(b)(8) and (10), and 3405(c), see §§ 1.401(a)(31)–1, 1.402(c)–2, 1.403(b)–2, and 31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What are the requirements for a written explanation under section 402(f)?

Q–2: When must the plan administrator provide the section 402(f) notice to a distributee?

Q–3: Must the plan administrator provide a separate section 402(f) notice for each distribution in a series of periodic payments that are eligible rollover distributions?

Q–4: May a plan administrator post the section 402(f) notice as a means of providing it to distributees?

QUESTIONS AND ANSWERS

Q–1: What are the requirements for a written explanation under section 402(f)?

A–1: (a) *General rule*. Under section 402(f), as amended by UCA, the plan administrator of a qualified plan is required, within a reasonable period of time before making an eligible rollover distribution, to provide the distributee with the written explanation described in section 402(f) (section 402(f) notice). The section 402(f) notice must be designed to be easily understood and must explain the following: the rules under which the distributee may elect that the distribution be paid in the form of a direct rollover to an eligible retirement plan; the rules that require the withholding of tax on the distribution if it is not paid in a direct rollover; the rules under which the distributee may defer tax on the distribution if it is contributed in a rollover to an eligible retirement plan within 60 days of the distribution; and if applicable, certain special rules regarding the taxation of the distribution as described in section 402(d) (averaging with respect to lump sum distributions) and (e) (other rules including treatment of net unrealized appreciation). See §1.401(a)(31)–1, Q&A–7 for additional information that must be provided if a plan provides a default procedure regarding the election of a direct rollover.

(b) *Model section 402(f) notice*. The plan administrator will be deemed to have complied with the requirements of paragraph (a) of this Q&A–1 relating to the contents of the section 402(f) notice if the plan administrator provides the applicable model section 402(f) notice published by the Internal Revenue Service for this purpose in a revenue ruling, notice, or other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(*b*) of this chapter.

(c) *Delegation to Commissioner*. The Commissioner, in revenue rulings, notices, and other guidance, published in the Internal Revenue Bulletin, may modify, or provide any additional guidance with respect to, the notice requirement of this section. See §601.601(d)(2)(ii)(*b*) of this chapter.

(d) *Effective date*—(1) *Statutory effective date*. Section 402(f) applies to eligible rollover distributions made after December 31, 1992.

(2) *Regulatory effective date*. This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, §1.402(c)–2T, Q&A–11 through 15 (as it appeared in the April 1, 1995 edition of 26 CFR part 1), apply. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan administrator or payor may satisfy the requirements of section 402(f) by substituting any or all provisions of this section for the corresponding provisions of §1.402(c)–1T, Q&A–11 through 15, if any.

Q–2: When must the plan administrator provide the section 402(f) notice to a distributee?

A–2: The plan administrator must provide the section 402(f) notice to a distributee at a time that satisfies either paragraph (a) or (b) of this Q&A–2.

(a) This paragraph (a) is satisfied if the plan administrator provides a distributee with the section 402(f) notice no less than 30 days and no more than 90 days before the date of a distribution. However, if the distributee, after having received the section 402(f) notice, affirmatively elects a distribution, a plan will not fail to satisfy section 402(f) merely because the distribution is made less than 30 days after the section 402(f) notice was provided to the distributee, provided the plan administrator clearly indicates to the distributee that the distributee has a right to consider the decision of whether or not to elect a direct rollover for at least 30 days after the notice is provided. The plan administrator may use any method to inform the distributee of the relevant time period, provided that the method is reasonably designed to attract the attention of the distributee. For example, this information could be either provided in the section 402(f) notice or stated in a separate document (*e.g.*, attached to the election form) that is provided at the same

time as the notice. For purposes of satisfying the requirement in the first sentence of paragraph (a) of this Q&A–2, the plan administrator may substitute the annuity starting date, within the meaning of §1.401(a)–20, Q&A–10, for the date of the distribution.

(b) This paragraph (b) is satisfied if the plan administrator—

(1) Provides a distributee with the section 402(f) notice;

(2) Provides the distributee with a summary of the section 402(f) notice within the time period described in paragraph (a) of this Q&A–2; and

(3) If the distributee so requests after receiving the summary described in paragraph (b)(2) of this Q&A–2, provides the section 402(f) notice to the distributee without charge and no less than 30 days before the date of a distribution (or the annuity starting date), subject to the rules for the distributee's waiver of that 30-day period. The summary described in paragraph (b)(2) of this Q&A–2 must set forth a summary of the principal provisions of the section 402(f) notice, must refer the distributee to the most recent version of the section 402(f) notice (and, in the case of a notice provided in any document containing information in addition to the notice, must identify that document and must provide a reasonable indication of where the notice may be found in that document, such as by index reference or by section heading), and must advise the distributee that, upon request, a copy of the section 402(f) notice will be provided without charge.

Q–3: Must the plan administrator provide a separate section 402(f) notice for each distribution in a series of periodic payments that are eligible rollover distributions?

A–3: No. In the case of a series of periodic payments that are eligible rollover distributions, the plan administrator is permitted to satisfy section 402(f) with respect to each payment in the series by providing the section 402(f) notice prior to the first payment in the series, in accordance with the rules in Q&A–1 and Q&A–2 of this section, and providing the notice at least once annually for as long as the payments continue. However, see §1.401(a)(31)–1, Q&A–12 for additional guidance if the plan administrator intends to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applicable to all subsequent payments in the series (absent a subsequent change of election).

Q–4: May a plan administrator post the section 402(f) notice as a means of providing it to distributees?

A–4: No. The posting of the section 402(f) notice will not be considered provision of the notice. The written notice must be provided individually to any distributee of an eligible rollover distribution within the time period described in Q&A–2 and Q&A–3 of this section.

Q–5: Will the requirements of section 402(f) be satisfied if a plan administrator provides a distributee with the section 402(f) notice or the summary of the notice described in paragraph (b)(2) of Q&A–2 of this section other than through a written paper document?

A–5: A plan administrator may provide a distributee with the section 402(f) notice or the summary of that notice described in paragraph (b)(2) of Q&A–2 of this section either on a written paper document or through an electronic medium reasonably accessible to the distributee. A notice or summary provided through an electronic medium must be provided under a system that satisfies the following requirements:

(a) The system must be reasonably designed to provide the notice or summary in a manner no less understandable to the distributee than a written paper document.

(b) At the time the notice or summary is provided, the distributee must be advised that the distributee may request and receive the notice on a written paper document at no charge, and, upon request, that document must be provided to the distributee at no charge.

Q–6: Are there examples that illustrate the provisions of Q&A–2 and Q&A–5 of this section?

A–6: The following examples illustrate the provisions of Q&A–2 and Q&A–5 of this section:

Example 1. (i) A qualified plan (Plan A) permits participants to request distributions by e-mail. Under Plan A's system for such

transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match that in Plan A's records in order for the transaction to proceed. If a participant requests a distribution from Plan A by e-mail and the distribution is an eligible rollover distribution, the plan administrator provides the participant with a section 402(f) notice by e-mail. The plan administrator also advises the participant that he or she may request the section 402(f) notice on a written paper document and that, if the participant requests the notice on a written paper document, it will be provided at no charge. To proceed with the distribution by e-mail, the participant must acknowledge receipt, review, and comprehension of the section 402(f) notice.

(ii) In *Example 1*, Plan A does not fail to satisfy the notice requirement of section 402(f) merely because the notice is provided to the participant other than through a written paper document.

Example 2. (i) A qualified plan (Plan B) permits participants to request distributions through the Plan B web site (Internet or intranet). Under Plan B's system for such transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match that in Plan B's records in order for the transaction to proceed. A participant may request a distribution from Plan B by following the applicable instructions on the Plan B web site. After the participant has requested a distribution that is an eligible rollover distribution, the participant is automatically shown a page on the web site containing a section 402(f) notice. Although this page of the web site may be printed, the page also advises the participant that he or she may request the section 402(f) notice on a written paper document by calling a telephone number indicated on the web page and that, if the participant requests the notice on a written paper document, it will be provided at no charge. To proceed with the distribution by e-mail, the participant must acknowledge receipt, review, and comprehension of the section 402(f) notice.

(ii) In this *Example 2*, Plan B does not fail to satisfy the notice requirement of section 402(f) merely because the notice is provided to the participant other than through a written paper document.

Example 3. (i) A qualified plan (Plan C) permits participants to request distributions through Plan C's automated telephone system. Under Plan C's system for such transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match that in Plan C's records in order for the transaction to proceed. Plan C provides the section 402(f) notice in the summary plan description, the most recent version of which was distributed to participants in 1997. A participant may request a distribution from Plan C by following the applicable instructions on the automated telephone system. In 1999, a participant, using Plan C's automated telephone system, requests a distribution that is an eligible rollover distribution. The automated telephone system refers the participant to the most recent version of the section 402(f) notice which was provided in the summary plan description, informs the participant where the section 402(f) notice may be located in the summary plan description, and provides an oral summary of the material provisions of the section 402(f) notice. The system also advises the participant that the participant may request the section 402(f) notice on a written paper document and that, if the participant requests the notice on a written paper document, it will be provided at no charge. Before proceeding with the distribution, the participant must acknowledge receipt, review, and comprehension of the summary. Under Plan C's system for processing such transactions, the participant's distribution will be made no more than 90 days and no fewer than 30 days after the participant requests the distribution and receives the summary of the section 402(f) notice (unless the participant waives the 30-day period).

(ii) In this *Example 3*, Plan C does not fail to satisfy the notice requirement of section 402(f) merely because Plan C provides a summary of the section 402(f) notice or merely because the summary is provided to the participant other than through a written paper document.

Example 4. (i) Same facts as *Example 3*, except that, pursuant to Plan C's system for processing such transactions, a participant who so requests is transferred to a customer service representative whose conversation with the participant is recorded. The customer service representative provides the summary of the section 402(f) notice by reading from a prepared text.

(ii) In this *Example 4*, Plan C does not fail to satisfy the notice requirement of section 402(f) merely because Plan C provides a summary of the section 402(f) notice or merely because the summary of the section 402(f) notice is provided to the participant other than through a written paper document.

Example 5. (i) Same facts as *Example 3*, except that Plan C does not provide the section 402(f) notice in the summary plan description. Instead, the automated telephone system reads the section 402(f) notice to the participant.

(ii) In this *Example 5*, Plan C does not satisfy the notice requirement of section 402(f) because oral delivery alone of the section 402(f) notice through the automated telephone system is not sufficient.

Example 6. (i) The facts are the same as in *Example 1*, except that Participant D requested a distribution by e-mail, then terminated employment, and, following the termination, no longer has reasonable access to Plan A e-mail.

(ii) In this *Example 6*, Plan A does not satisfy the notice requirement of section 402(f) because the electronic medium through which the notice is provided is not reasonably accessible to Participant D. Plan A must provide the section 402(f) notice to Participant D in a written paper document or by an electronic means that is reasonably accessible to Participant D.

[T.D. 8619, 60 FR 49213, Sept. 22, 1995, as amended by T.D. 8873, 65 FR 6005, Feb. 8, 2000]

§ 1.402(g)–0 Limitation on exclusion for elective deferrals, table of contents.

This section contains the captions that appear in § 1.402(g)–1.

§ 1.402(g)–1 Limitation on exclusion for elective deferrals.

(a) In general.
(b) Elective deferrals.
(c) Certain one-time irrevocable elections.
(d) Applicable limit.
(1) In general.
(2) Special adjustment for elective deferrals with respect to a section 403(b) annuity contract.
(3) Special adjustment for elective deferrals with respect to a section 403(b) annuity contract for certain long-term employees.
(4) Example.
(e) Treatment of excess deferrals.
(1) Plan qualification.
(i) Effect of excess deferrals.
(ii) Treatment of excess deferrals as employer contributions.
(iii) Definition of excess deferrals.
(2) Correction of excess deferrals after the taxable year.
(3) Correction of excess deferrals during taxable year.
(4) Plan provisions.
(5) Income allocable to excess deferrals.
(i) General rule.
(ii) Method of allocating income.
(iii) Alternative method of allocating income.
(iv) Safe harbor method of allocating gap period income.
(6) Coordination with distribution or recharacterization of excess contributions.
(7) No employee or spousal consent required.
(8) Tax treatment.
(i) Corrective distributions on or before April 15 after close of taxable year.
(ii) Special rule for 1987 and 1988 excess deferrals.
(iii) Distributions of excess deferrals after correction period.
(9) No reduction of required minimum distribution.
(10) Partial correction.
(11) Examples.
(f) Community property laws.
(g) Effective date.
(1) In general.
(2) Deferrals under collective bargaining agreements.
(3) Transition rule.
(4) Partnership cash or deferred arrangements.

[T.D. 8357, 56 FR 40545, Aug. 15, 1991]

§ 1.402(g)–1 Limitation on exclusion for elective deferrals.

(a) *In general.* The excess of an individual's elective deferrals for any taxable year over the applicable limit for the year may not be excluded from gross income under sections 402(a)(8), 402(h)(1)(B), 403(b), 408(k)(6), or 501(c)(18). Thus, an individual's elective deferrals in excess of the applicable limit for a taxable year (i.e., the individual's excess deferrals for the year) must be included in gross income for the year.

(b) *Elective deferrals.* An individual's elective deferrals for a taxable year are the sum of the following:

(1) Any elective contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent not includible in the individual's gross income for the taxable year on account of section 402(a)(8) (before applying the limits of section 402(g) or this section).

(2) Any employer contribution to a simplified employee pension (as defined in section 408(k)) to the extent not includible in the individual's gross income for the taxable year on account of section 402(h)(1)(B) (before applying the limits of section 402(g) or this section).

(3) Any employer contribution to an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) to the extent not includible in the individual's gross income for the taxable year on account of section 403(b) (before applying the limits of section 402(g) or this section).

(4) Any employee contribution designated as deductible under a trust described in section 501(c)(18) to the extent deductible from the individual's income for the taxable year on account of section 501(c)(18) (before appying the limits of section 402(g) or this section). For purposes of this section, the employee contribution is treated as though it were excluded from the individual's gross income.

(c) *Certain one-time irrevocable elections*. An employer contribution is not treated as an elective deferral under paragraph (b) of this section if the contribution is made pursuant to a one-time irrevocable election made by the employee:

(1) In the case of an annuity contract under section 403(b), at the time of initial eligibility to participate in the salary reduction agreement;

(2) In the case of a qualified cash or deferred arrangement, at a time when, under §1.401(k)–1(a)(3)(iv), the election is not treated as a cash or deferred election;

(3) In the case of a trust described in section 501(c)(18), at the time of initial eligibility to have the employer contribute on the employee's behalf to the trust.

(d) *Applicable limit*—(1) *In general*. Except as adjusted under paragraphs (d)(2) and (d)(3) of this section, the applicable limit for an individual's taxable year beginning in the 1987 calendar year is $7,000. This amount is increased for the taxable year beginning in 1988 and subsequent calendar years in the same manner as the $90,000 amount is adjusted under section 415(d).

(2) *Special adjustment for elective deferrals with respect to a section 403(b) annuity contract*. The applicable limit for an individual who makes elective deferrals described in paragraph (b)(3) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraph (d)(1) of this section by the amount of the individual's elective deferrals described in paragraph (b)(3) of this section for the taxable year. This adjustment cannot cause the applicable limit for any taxable year to exceed $9,500.

(3) *Special adjustment for elective deferrals with respect to a section 403(b) annuity contract for certain long-term employees*. The applicable limit for an individual who is a qualified employee (as defined in section 402(g)(8)(C)) and has elective deferrals described in paragraph (b)(3) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraphs (d)(1) and (d)(2) of this section in accordance with section 402(g)(8)(A).

(4) *Example*. The provisions of this paragraph (d) are illustrated by the following example.

Example. Employer X maintains a cash or deferred arrangement under section 401(k), and offers its employees section 403(b) contracts to which elective deferrals may be made. For the 1987 taxable year, three of X's employees, A, B, and C, contribute $3,500, $1,000, and $8,500, respectively, as elective deferrals under the section 403(b) contract. The maximum amounts that A, B, and C may contribute to the cash or deferred arrangement are $6,000, $7,000, and $1,000, respectively. B may only contribute $7,000 under the cash or deferred arrangement because the special adjustment under paragraph (d)(2) of this section applies only to section 403(b) annuity contracts. B could, of course, contribute up to $2,500 under the section 403(b) contract (to the extent otherwise permitted), in addition to the $7,000 under the cash or deferred arrangement.

(e) *Treatment of excess deferrals*—(1) *Plan qualification*—(i) *Effect of excess deferrals*. For plan years beginning before January 1, 1988, a plan, annuity contract, simplified employee pension, or trust does not fail to meet the requirements of section 401(a), section 403(b), section 408(k), or section 501(c)(18), respectively, merely because excess deferrals are made with respect to the plan, contract, pension, or trust. For plan years beginning after December 31, 1987, see section 401(a)(30) and §1.401(a)–30 for the effect of excess deferrals on the qualification of a plan or trust under section 401(a). For purposes of determining whether a plan or trust complies in operation with section 401(a)(30), excess deferrals that are distributed under paragraph (e)(2) or (3) of this section are disregarded. Similar rules apply to annuity contracts under

section 403(b), simplified employee pensions under section 408(k), and plans or trusts under section 501(c)(28).

(ii) *Treatment of excess deferrals as employer contributions.* For other purposes of the Code, including sections 401(a)(4), 401(k)(3), 404, 409, 411, 412, and 416, excess deferrals must be treated as employer contributions even if they are distributed in accordance with paragraph (e)(2) or (3) of this section. However, excess deferrals of a nonhighly compensated employee are not taken into account under section 401(k)(3) (the actual deferral percentage test) to the extent the excess deferrals are prohibited under section 401(a)(30). Excess deferrals are also treated as employer contributions for purposes of section 415 unless distributed under paragraph (e)(2) or (3) of this section.

(iii) *Definition of excess deferrals.* The term ''excess deferrals'' means the excess of an individual's elective deferrals for any taxable year, as defined in § 1.402(g)–1(b), over the applicable limit under section 402(g)(1) for the taxable year.

(2) *Correction of excess deferrals after the taxable year.* A plan may provide that if any amount is included in the gross income of an individual under paragraph (a) of this section for a taxable year:

(i) Not later than the first April 15 (or such earlier date specified in the plan) following the close of the individual's taxable year, the individual may notify each plan under which deferrals were made of the amount of the excess deferrals received by that plan. A plan may provide that an individual is deemed to have notified the plan of excess deferrals to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. A plan may instead provide that the employer may notify the plan on behalf of the individual under these circumstances.

(ii) Not later than the first April 15 following the close of the taxable year, the plan may distribute to the individual the amount designated under paragraph (e)(2)(i) of this section (and any income allocable to that amount).

(3) *Correction of excess deferrals during taxable year*—(i) A plan may provide that an individual who has excess deferrals for a taxable year may receive a corrective distribution of excess deferrals during the same year. This corrective distribution may be made only if all of the following conditions are satisfied:

(A) The individual designates the distribution as an excess deferral. A plan may provide that an individual is deemed to have designated the distribution to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. A plan may instead provide that the employer may make the designation on behalf of the individual under these circumstances.

(B) The correcting distribution is made after the date on which the plan received the excess deferral.

(C) The plan designates the distribution as a distribution of excess deferrals.

(ii) The provisions of this paragraph (e)(3) are illustrated by the following example:

Example. S is a 62 year old individual who participates in Employer Y's qualified cash or deferred arrangement. In January 1991, S withdraws $5,000 from Y's cash or deferred arrangement. From February through September, S defers $900 per month. On October 1, S leaves Employer Y and becomes employed by Employer Z (unrelated to Y). During the remainder of 1991, S defers $1,800 under Z's qualified cash or deferred arrangement. In January 1992, S realizes that S has deferred a total of $9,000 in 1991, and therefore has a $525 excess deferral ($9,000 minus $8,475, the applicable limit for 1991). An additional $525 must be distributed to S before April 15, 1992, to correct the excess deferral. The $5,000 withdrawal did not correct the excess deferral because it occurred before the excess deferral was made.

(4) *Plan provisions.* In order to distribute excess deferrals pursuant to paragraphs (e)(2) or (e)(3) of this section, a plan must contain language permitting distribution of excess deferrals. A plan may require the notification in paragraphs (e)(2) and (e)(3) of this section to be in writing and may require that the employee certify or otherwise establish that the designated

amount is an excess deferral. A plan need not permit distribution of excess deferrals.

(5) *Income allocable to excess deferrals*—(i) *General rule*. The income allocable to excess deferrals is equal to the sum of the allocable gain or loss for the taxable year of the individual and, if the plan so provides, the allocable gain or loss for the period between the end of the taxable year and the date of distribution (the ''gap period'').

(ii) *Method of allocating income*. A plan may use any reasonable method for computing the income allocable to excess deferrals, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under a plan for the plan year, and is used by the plan for allocating income to participants' accounts. See § 1.401(a)(4)–1(c)(8).

(iii) *Alternative method of allocating income*. A plan may allocate income to excess deferrals by multiplying the income for the taxable year (and the gap period, if the plan so provides) allocable to elective contributions by a fraction. The numerator of the fraction is the excess deferrals by the employee for the taxable year. The denominator of the fraction is equal to the sum of:

(A) The total account balance of the employee attributable to elective contributions as of the beginning of the taxable year, plus

(B) The employee's elective contributions for the taxable year (and the gap period, if the plan so provides).

(iv) *Safe harbor method of allocating gap period income*. Under the safe harbor method, income on excess deferrals for the gap period is equal to 10 percent of the income allocable to excess deferrals for the taxable year (calculated under the method described in paragraph (e)(5)(iii) of this section), multiplied by the number of calendar months that have elapsed since the end of the taxable year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(6) *Coordination with distribution or recharacterization of excess contributions*. The amount of excess deferrals that may be distributed under this paragraph (e) with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. In the event of a reduction under this paragraph (e)(6), the amount of excess contributions includible in the gross income of the employee and reported by the employer as a distribution of excess contributions is reduced by the amount of the reduction under this paragraph (e)(6). See § 1.401(k)–1(f)(5)(i). In no case may an individual receive from a plan as a corrective distribution for a taxable year under paragraph (e)(2) or (e)(3) of this section an amount in excess of the individual's total elective deferrals under the plan for the taxable year.

(7) *No employee or spousal consent required*. A corrective distribution of excess deferrals (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) or 417.

(8) *Tax treatment*—(i) *Corrective distributions on or before April 15 after close of taxable year*. A corrective distribution of excess deferrals within the period described in paragraph (e)(2) or (e)(3) of this section is excludable from the employee's gross income. However, the income allocable to excess deferrals is includible in the employee's gross income for the taxable year in which the allocable income is distributed. The corrective distribution of excess deferrals (and income) is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A.

(ii) *Special rule for 1987 and 1988 excess deferrals*. Income on excess deferrals for 1987 or 1988 that were timely distributed on or before April 17, 1989, may be reported by the recipient either in the year described in paragraph (e)(8)(i) of this section, or in the year in which the employee would have received the

elective deferrals had the employee originally elected to receive the amounts in cash.

(iii) *Distributions of excess deferrals after correction period.* If excess deferrals (and income) for a taxable year are not distributed within the period described in paragraphs (e)(2) and (e)(3) of this section, they may only be distributed when permitted under section 401(k)(2)(B). These amounts are includible in gross income when distributed, and are treated for purposes of the distribution rules otherwise applicable to the plan as elective deferrals (and income) that were excludable from the individual's gross income under section 402(g). Thus, any amount includible in gross income for any taxable year under this section that is not distributed by April 15 of the following taxable year is not treated as an investment in the contract for purposes of section 72 and is includible in the employee's gross income when distributed from the plan. Excess deferrals that are distributed under this paragraph (e)(8)(iii) are treated as employer contributions for purposes of section 415 when they are contributed to the plan.

(9) *No reduction of required minimum distribution.* A distribution of excess deferrals (and income) under paragraphs (e)(2) and (e)(3) of this section is not treated as a distribution for purposes of determining whether the plan meets the minimum distribution requirements of section 401(a)(9).

(10) *Partial correction.* Any distribution under paragraphs (e)(2) or (e)(3) of this section of less than the entire amount of excess deferrals (and income) is treated as a pro rata distribution of excess deferrals and income.

(11) *Examples.* The provisions of this paragraph are illustrated by the following examples. Assume in *Examples 1* and *2* that there is no income or loss allocable to the elective deferrals.

Example 1. Employee A is a 60-year old highly compensated employee who participates in Employer M's cash or deferred arrangement. During the period of January through September of 1988, A contributed $7,000 to the arrangement in elective deferrals. During the same period A also contributed $813 in elective deferrals under a plan of an unrelated employer. In December of 1988, A made a withdrawal of $1,000 from Employer M's plan but did not designate this as a withdrawal of an excess deferral. In January of 1989, A notifies Employer M of an excess deferral, specifying a distribution of $500 for 1988. To correct the excess deferrals, A must receive this additional $500 even though A has already withdrawn $1,000 for 1988. A may exclude from income in 1988 only $7,313. However, if the $500 is distributed by April 25, 1989, the distribution is excludable from A's gross income in 1989. Even if A withdraws the $500, M must take into account the entire $7,000 in computing A's actual deferral percentage for 1988.

Example 2. (i) Corporation X maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of X's employees are eligible to participate in the plan. The employees' compensation, contributions, and actual deferral ratios are shown in the following table:

Employee	Compensation	Contribution	Actual deferral ratio (percent)
A	$140,000	$7,000	5.0
B	70,000	7,000	10.0
C	70,000	7,000	10.0
D	45,000	2,250	5.0
E	40,000	4,000	10.0
F	35,000	1,750	5.0
G	35,000	350	1.0
H	30,000	3,000	10.0
I	17,500	0	0
J	17,500	0	0.0

(ii) Employees A, B, and C are highly compensated employees within the meaning of section 414(q). Employees D, E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentages for the highly compensated employees and nonhighly compensated employees are 8.33 percent and 4.43 percent, respectively. These percentages do not satisfy the requirements of section 401(k)(3)(A)(ii). The actual deferral percentage for the highly compensated employees may not exceed 6.43 percent.

(iii) The plan reduces the actual deferral ratios of B and C to 7.14 percent by distributing $2,002 ($7,000 − .0714×$70,000) to each in January 1990. Section 401(k)(3)(A)(ii) is therefore satisfied.

(iv) In February 1990, B notifies X that B made elective deferrals of $2,000 under a qualified cash or deferred arrangement maintained by an unrelated employer in 1989, and requests distribution of $2,000 from X's plan. However, since B has already received a distribution of $2,002 to meet the ADP test, no additional amounts are required or are permitted to be distributed as excess deferrals by this plan, and the prior distribution of excess contributions has corrected the excess deferrals. But X must report $2,000 as a distribution of an excess deferral and $2 as a distribution of an excess contribution.

Example 3. Employee T has excess deferrals of $1,000. The income attributable to excess deferrals is $100. T properly notifies the employer, and requests a distribution of the excess deferral (and income) on February 1. The plan distributes $1,000 to T by April 15. Because the plan did not distribute any additional amount as income, $909 is treated as a distribution of excess deferrals, and $91 is treated as a distribution of earnings. With respect to amounts remaining in the account, $91 is treated as an elective deferral and is not included in T's investment in the contract. Because it was not distributed by the required date, the $91 is includible in gross income upon distribution as well as in the year of deferral.

(f) *Community property laws.* This section is applied without regard to community property laws.

(g) *Effective date*—(1) *In general.* Except as otherwise provided, the provisions of this section are effective for taxable years beginning after December 31, 1986.

(2) *Deferrals under collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the provisions of this section do not apply to contributions made pursuant to the collective bargaining agreement for taxable years beginning before the earlier of January 1, 1989, or the date on which the agreement terminates (determined without regard to any extension thereof after February 28, 1986). These contributions under a collective bargaining agreement are taken into account for purposes of applying this section to elective deferrals under plans not described in this paragraph (g)(2).

(3) *Transition rule.* For taxable years beginning before January 1, 1992, a plan or an individual may rely on a reasonable interpretation of the rules set forth in section 402(g), as in effect during those years.

(4) *Partnership cash or deferred arrangements.* For purposes of section 402(g), employer contributions for any plan year beginning after December 31, 1986, and before January 1, 1989, under an arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf will be treated as elective contributions only if the arrangement was intended to satisfy and did satisfy the nondiscrimination test of section 401(k)(3) and § 1.401(k)–1(b) for the plan year.

[T.D. 8357, 56 FR 40546, Aug. 15, 1991, as amended by T.D. 8581, 59 FR 66180, Dec. 23, 1994]

§ 1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.

(a) An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid, whether or not his rights to the contract are forfeitable, if the annuity contract is purchased under a plan which meets the requirements of section 404(a)(2). For purposes of the preceding sentence, it is immaterial whether the employer deducts the amounts paid for the contract under such section 404(a)(2). See § 1.403(b)–1 for rules relating to annuity contracts which are not purchased under qualified plans but which are purchased by organizations described in section 501(c)(3) and exempt under section 501(a) or which are purchased for employees who perform services for certain public schools.

(b) The amounts received by or made available to any employee referred to in paragraph (a) of this section under such annuity contract shall be included in gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities), except that certain total distributions described in section 403(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see § 1.403(a)–2. However, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(c) If upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of

the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under section 403(a) shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)–1.

(d) An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased under a qualified annuity plan. For the rules as to nontransferability of such contracts issued after December 31, 1962, see § 1.401–9. For the rules relating to the taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72–16. Section 403(a) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

(e) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(f) For purposes of this section and § 1.403(a)–2, the term ''employee'' includes a self-employed individual who is treated as an employee under section 401(c)(1) and paragraph (b) of § 1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4). For the rules relating to annuity plans covering self-employed individuals, see section 404(a)(2) and §§ 1.404(a)–8 and 1.401–10 through 1.401–13.

(g) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in § 1.401–14, see paragraph (h) of § 1.72–15.

[T.D. 6500, 25 FR 11680, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 6783, 29 FR 18359, Dec. 24, 1964; T.D. 6885, 31 FR 7801, June 2, 1966]

§ 1.403(a)–2 Capital gains treatment for certain distributions.

(a) If the total amounts payable with respect to any employee for whom an annuity contract has been purchased by an employer under a plan which—

(1) Is a plan described in section 403(a)(1) and § 1.403(a)–1, and

(2) Requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan,

are paid to, or includible in gross income of, the payee within one taxable year of the payee by reason of the employee's death or other separation from the service, or death after such separation from the service, such total payments, to the extent they exceed the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The ''net amount contributed by the employee'' is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72(f), 101(b), and paragraph (d) of § 1.403(a)–1, reduced by any amounts theretofore distributed to him which were excludable from his gross income as a return of employee contributions. For example, if under an annuity contract purchased under a plan described in this section, the total distributions payable to the employee's widow are paid to her in the year in which the employee dies, in the amount of $8,000, and if $5,000 thereof is excludable under section 101(b), and if the employee made contributions of $600 and had received no payments, the remaining amount of $2,400 will be considered a gain from the sale or exchange of a capital asset held for more than six months.

(b)(1) The term ''total amounts'' means the balance to the credit of an employee with respect to all annuities under the annuity plan which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service. If an employee commences to receive annuity payments on retirement and then a lump sum payment is made to his widow upon his death, the capital gains treatment applies to the lump sum payment, but it does not apply to amounts received before the time the ''total amounts'' become payable. However, if the total amount to the credit of the employee at the time of his death or other separation from

the service or death after separation from the service is paid or includible in the gross income of the payee within one taxable year of the payee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount is credited to the employee and paid to the payee.

(2) If more than one annuity contract is received under the plan, the capital gains treatment does not apply to any amount received on the surrender thereof unless all contracts under the plan with respect to a particular employee are surrendered either at the time of the employee's death or other separation from the service or death after separation from the service. Thus, if an employee receives two contracts on separation from the service and surrenders one of them in the year of separation and receives payments under the other until his death, the capital gains treatment is applicable to the balance paid to his beneficiary on his death if paid within one taxable year of the beneficiary. The amount received by the employee on surrender of the contract in the year of his separation from the service, however, would not receive capital gains treatment since the balance to the credit of the employee with respect to all amounts under the plan did not become payable at that time.

(3) If an employee retires and commences to receive an annuity but subsequently in some succeeding taxable year, he is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(4) If the ''total amounts'' payable under all annuity contracts under the plan with respect to a particular employee are paid or includible in the gross income of several payees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. Thus, if the balance to the credit of a deceased employee under all annuity contracts provided under an annuity plan becomes payable to two payees, the capital gains treatment is applicable provided the ''total amounts'' payable are received by or includible in the gross income of both payees within the same taxable year. However, if the ''total amounts'' payable are made available to each payee and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share as an annuity, the capital gains treatment does not apply to either payee.

(5) For purposes of determining whether the total amounts payable to an employee have been paid within one taxable year, the term ''total amounts'' includes amounts under a plan which are attributable to contributions on behalf of an individual while he was self-employed in the business with respect to which the plan was established. Thus, the ''total amounts'' payable are not paid within one taxable year if amounts remain payable which are so attributable.

(6) The term ''total amounts'' does not include any amount which has been placed in a separate account for the funding of benefits described in section 401(h). Thus, a distribution under a qualified annuity plan may constitute a distribution of the total amounts payable with respect to an employee even though amounts attributable to the funding of section 401(h) medical benefits as defined in paragraph (a) of § 1.401–14 are not so distributed.

(c) The provisions of this section are not applicable to any amounts paid to a payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see § 1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

[T.D. 6500, 25 FR 11681, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, Apr. 14, 1964]

§ 1.403(b)–1 Taxability of beneficiary under annuity purchased by a section 501(c)(3) organization or public school.

(a) *Amounts paid by employer during taxable years beginning before January 1, 1958*—(1) *In general.* If an amount is paid during a taxable year of an employee (or a retired or former employee) beginning before January 1, 1958, toward the purchase for such employee of an annuity contract and such purchase is not part of an annuity plan which meets the requirements of section 404(a)(2), then such amount is not required to be included in the gross income of such employee for such taxable year—

(i) If such amount is paid by an employer which, at the time of the payment, is an organization described in section 501(c)(3) and exempt from tax under section 501(a), and

(ii) If the purchase of the annuity contract is merely a supplement to the past or current compensation of such employee (within the meaning of subparagraph (2) of this paragraph).

For purposes of this paragraph, it is immaterial whether or not the employee's rights to the annuity contract are forfeitable.

(2) *Supplement to past or current compensation.* For purposes of this paragraph, whether the purchase of an annuity contract is merely a ''supplement to past or current compensation'' is to be determined by all the surrounding facts and circumstances. One of the pertinent facts to be taken into consideration is the ratio of the consideration paid by the employer for an employee's contract to the amount of his past or current compensation. For example, if the annual premium paid for an employee's contract is $1,000 and his annual salary is $10,000, the ratio indicates that the premium paid for the contract is merely a supplement to the employee's current compensation. If, however, an employee receives no current compensation, or the annual premiums paid for his annuity contract approximate his annual salary, the amount paid for his contract will be considered to be current compensation and taxable to the employee in the year in which it is paid by the employer. Other pertinent considerations are whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's annual salary, or whether it is purchased at his request in lieu of an increase in current compensation to which he otherwise might be entitled. In such cases, the amount paid for the contract shall also be considered to be current compensation.

(b) *Amounts paid by employer during taxable years beginning after December 31, 1957*—(1) *In general.* If amounts are contributed by an employer during a taxable year of an employee (or a retired or former employee) beginning after December 31, 1957, toward the purchase for such employee of an annuity contract and such purchase is not part of an annuity plan which meets the requirements of section 404(a)(2), then, to the extent such amounts do not exceed the exclusion allowance for such taxable year, they are not required to be included in the gross income of such employee for such taxable year, if at the time of the contribution—

(i) The employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

(ii) The employer is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing, and the employee is performing (or has performed) services for an educational institution (as defined in section 151(e)(4)), and

(iii) The employee's rights under the annuity contract are nonforfeitable except for failure to pay future premiums.

See paragraph (d) of this section for rules relating to the computation of an employee's exclusion allowance for a taxable year.

(2) *Forfeitable rights which change to nonforfeitable rights.* If an employee's rights under an annuity contract change from forfeitable to nonforfeitable rights, the amount which, under section 403(d), is includible in the gross income of such employee by reason of such change (computed without regard to subparagraph (1) of this paragraph) shall, for purposes of subparagraph (1) of this paragraph, be considered an amount contributed by the employer for such annuity contract as of the

time the employee's rights under the contract change to nonforfeitable rights. Such amount will, therefore, be excludable from the employee's gross income for the taxable year in which the change occurs to the extent that it is so excludable under the rules contained in this section. In determining the extent to which such amount is excludable, this section shall be applied in the same manner as in the case of current employer contributions. Thus, no part of such amount is excludable if the employer is not an employer described in subparagraph (1) of this paragraph at the time the employee's rights under the annuity contract change from forfeitable to nonforfeitable rights. In addition, such amount will be excludable only to the extent it does not exceed the employee's exclusion allowance for the taxable year in which the change occurs. Since such an amount is considered as an amount contributed by the employer at the time the change occurs, it is immaterial whether the employer was an employer described in subparagraph (1) of this paragraph at the time the actual contributions were made.

(3) *Agreement to take a reduction in salary or to forego an increase in salary.* (i) There is no requirement that the purchase of an annuity contract for an employee must be merely a ''supplement to past or current compensation'' in order for the exclusion provided by this paragraph to apply to employer contributions for such annuity contract. Thus, the exclusion provided by this paragraph is applicable to amounts contributed by an employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary, or to forego an increase in salary, but only to the extent such amounts are earned by the employee after the agreement becomes effective. Such an agreement must be legally binding and irrevocable with respect to amounts earned while the agreement is in effect. Except as provided in subdivision (ii) of this subparagraph, the employee must not be permitted to make more than one agreement with the same employer during any taxable year of such employee beginning after December 31, 1963; the exclusion provided by this paragraph shall not apply to any amounts which are contributed under any further agreement made by such employee during the same taxable year beginning after such date. However, the employee may be permitted to terminate the entire agreement with respect to amounts not yet earned.

(ii) An individual who is employed by an organization described in section 415(c)(4) may make a salary reduction agreement for his taxable year beginning in 1976 or 1977 at any time before the end of the 1976 or 1977 taxable year, respectively, without the agreement's being considered a new agreement within the meaning of this subparagraph. The agreement for 1976 may be made on or before June 15, 1977, and the agreement for 1977 may be made on or before April 17, 1978. This special rule only applies if the individual makes a statement of intention in accordance with §11.415(c)(4)–1(b) electing, or determines his income tax liability for the taxable year in a way which is consistent with, one of the alternative limitations under section 415(c)(4) for 1976 or 1977 (as the case may be). The salary reduction agreement for 1976 may be made effective with respect to any amount earned during the taxpayer's most recent one-year period of service (as defined in paragraph (f) of this section) ending not later than the end of the 1976 taxable year, notwithstanding subdivision (i) of this subparagraph. Similarly, the salary reduction agreement for 1977 may be made effective with respect to such period of service ending not later than the end of the 1977 taxable year. If the salary reduction agreement for 1976 is entered into at any time after December 31, 1976, or if the salary reduction agreement for 1977 is entered into at any time after December 31, 1977, an amended Form W–2 must be filed on behalf of the individual.

(iii) The rules of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A is an employee of X Organization (an employer described in section 501(c)(3) and exempt from tax under section 501(a)) for the entire calendar year 1964. A uses the calendar year as a taxable year. A's annual salary as of January 1, 1964, is $12,000. On February 1, 1964, A and his employer enter a binding and irrevocable agreement

whereby A is to take a 10-percent reduction in salary (from $1,000 per month to $900 per month) and X Organization is to contribute $100 per month for an annuity contract described in section 403(b). The agreement also provides that A may terminate the entire agreement with respect to amounts not yet earned. Since the agreement to reduce A's salary and invest the amount of such reduction in an annuity contract was made after A earned his salary for January, A's current compensation for January is $1,000 even though the agreement may provide that X Organization shall contribute $100 with respect to January for the benefit of A for an annuity contract described in section 403(b). For February and subsequent months ending before July 1, 1964, X Organization contributes $100 per month for A's annuity. Thus, A's current compensation for each of these months is $900, and the $100 which is contributed during such months by X Organization for an annuity contract for A is an employer contribution to which the exclusion provided in this paragraph applies. On July 1, 1964, A becomes entitled to a salary increase of $200 per month and, pursuant to the agreement of February 1, 1964, X Organization contributes 10 percent of such increase or an additional $20 per month for a section 403(b) annuity. For July and subsequent months ending before October 1, 1964, X Organization contributes $120 per month for A's annuity. Thus, A's current compensation for each of these months is $1,080, and the $120 which is contributed during such months by X Organization for an annuity contract for A is an employer contribution to which the exclusion provided in this paragraph applies. On November 1, 1964, A terminates the entire agreement with respect to amounts not yet earned. Since the termination occurred after A earned his salary for the month of October, the contribution for October is an employer contribution to which the exclusion provided in this paragraph applies. For the months November and December, A's full salary of $1,200 per month is includible in his gross income whether or not his employer makes contributions for a section 403(b) annuity.

(4) *Two or more annuity contracts.* If, during a taxable year of an employee, this paragraph applies to amounts contributed (including amounts which are considered to be contributed under subparagraph (2) of this paragraph) by his employer for two or more annuity contracts for such employee, such two or more annuity contracts shall, for such taxable year, be considered a single contract for purposes of applying the rules contained in this paragraph.

(5) *Employees performing services for public schools.* For purposes of this section, a person shall be considered an employee who performs services for an educational institution (as defined in section 151(e)(4)) if he is performing services as an employee directly or indirectly for such an institution. Thus, for example, the principal, clerical employees, custodial employees, and teachers at a public elementary school are employees performing services directly for such an educational institution. An employee who performs services involving the operation or direction of a State's, or political subdivision's, education program as carried on through educational institutions (as defined in section 151(e)(4)) is an employee performing services indirectly for such institutions. An employee participating in an ''in-home'' teaching program is included since such program is merely an extension of the activities carried on by such educational institutions. On the other hand, a person occupying an elective or appointive public office is not an employee performing services for an educational institution unless such office is one to which an individual is elected or appointed only if he has received training, or is experienced, in the field of education. The term ''public office'' includes any elective or appointive office of a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing. Thus, for example, a regent or trustee of a State university or a member of a board of education is not an employee performing services for an educational institution. On the other hand, a commissioner or superintendent of education will generally be considered an employee performing services for an educational institution.

(c) *Taxation of amounts received under annuity contracts*—(1) *In general.* The amounts received by or made available to any employee under an annuity contract to which paragraph (a) or (b) of this section applies shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964,

section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to any such employee under such an annuity contract. For taxable years beginning after December 31, 1963, amounts received or made available to any such employee under such annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(2) *Taxation of beneficiaries*. If, upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under subparagraph (1) of this paragraph shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)–1.

(3) *Life insurance protection*. An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased as an annuity contract to which paragraph (a) or (b) of this section applies. For the rules as to nontransferability of such contracts issued after December 31, 1962, see § 1.401–9. For the rules relating to the taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72–16. Section 403(b) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

(d) *Exclusion allowance*—(1) *In general*. For purposes of paragraph (b) of this section, an employee's exclusion allowance for a taxable year is an amount equal to the excess, if any, of—

(i) The amount determined by multiplying *(a)* 20 percent of such employee's includible compensation in respect of such taxable year, by *(b)* such employee's total number of years of service as of the close of such taxable year, over

(ii) The aggregate of (*a*) the amounts which have been contributed by the employer for annuity contracts for such employee and which were excludable from the gross income of the employee for any taxable year prior to the taxable year for which the exclusion allowance is being determined, and (*b*) the amounts of compensation excludable from the gross income of the employee under section 457(a) (relating to eligible State deferred compensation plans) for any prior taxable year that is taken into account as a year of service under paragraph (f) of this section. Compensation deferred under an eligible State deferred compensation plan shall be taken into account as described in subdivision (ii) of this subparagraph even if the entity sponsoring the eligible plan is not the employer purchasing the annuity contract with respect to which the employee's exclusion allowance is to be determined. See paragraph (e) of this section for the definition of an employee's includible compensation in respect of a taxable year and paragraph (f) of this section for rules for computing an employee's total number of years of service for an employer.

(2) *More than one employer*. If, during a taxable year of an employee, amounts are contributed for annuity contracts for such employee by two or more employers described in paragraph (b)(1) (i) or (ii) of this section, a separate exclusion allowance shall be computed with respect to each employer. In such a case, therefore, there shall not be taken into account, in computing the exclusion allowance with respect to one employer, the ''includible compensation'' received by the employee from any other employer, the employee's years of service with any other employer, or amounts which have been contributed by any other employer for annuity contracts for such employee.

(3) *Amounts previously contributed by the employer which were excludable from the employee's gross income*. In computing, for purposes of subparagraph (1)(ii) of this paragraph, the aggregate of the amounts which have been contributed by an employer for annuity contracts for an employee and which were excludable from the gross income of the employee for any taxable year prior to the taxable year for which the

exclusion allowance is being determined, there shall be included all contributions made by the employer for the benefit of the employee—

(i) Which, under section 402(a) or section 403(a), were excludable from the employee's gross income for any such prior taxable year by reason of being contributions to a trust described in section 401(a) and exempt from tax under section 501(a) or contributions toward the purchase of an annuity contract under a plan which meets the requirements of section 404(a)(2) (whether forfeitable or nonforfeitable); or

(ii) Which, under section 405(d), were excludable from the employee's gross income for any such prior taxable year by reason of being contributions toward the purchase of United States bonds under a plan which meets the requirements of section 405(a)(1); or

(iii) Which were excludable from the employee's gross income for any such prior taxable year by reason of being contributions described in paragraph (a) or (b) of this section; or

(iv) *(a)* Which were excludable from the employee's gross income for the taxable year when made solely by reason of the fact that the employee's rights to such contributions were forfeitable at the time they were made (and not for any of the reasons described in subdivisions (i), (ii), and (iii) of this subparagraph);

(b) With respect to which the employee's rights changed to nonforfeitable rights prior to the taxable year for which the exclusion allowance is being determined; and

(c) Which were not, under section 403(d) and without regard to paragraph (b) of this section, includible in the employee's gross income for the taxable year in which his rights to such contributions changed from forfeitable to nonforfeitable rights.

For purposes of subdivisions (i) and (iii) of this subparagraph, all references to provisions of the Internal Revenue Code of 1954 and to provisions of the regulations under such Code shall also be considered references to the corresponding provisions of prior law and regulations. See subparagraph (4) of this paragraph for rules relating to the allocation of employer contributions to an employee where the actual contributions are not allocated among individual employees; or

(v) Which were contributions to a section 403(b) annuity contract for a prior taxable year and which exceeded the limitations of section 415(c)(1) applicable to the employee. See §1.415–6(e)(1)(ii) for a more detailed discussion of this rule. See also §1.415–9(c) for rules relating to the treatment of certain contributions to a section 403(b) annuity contract which are excess contributions because of the aggregation of the annuity contract with a qualified plan.

(4) *Determination of excludable amounts by allocation of contributions.* If, for any employee, the actual amounts of employer contributions to a defined benefit plan described in subparagraph (3) of this paragraph are not known, such amounts shall be determined under the formula described in this subparagraph or under any other method utilizing recognized actuarial principles which are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan. If the formula described in this subparagraph is to be used, the contributions made by the employer for the benefit of the employee as of the end of any taxable year shall be deemed to be the product of the quantities described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph. Such quantities are—

(i) The projected annual amount of the employee's pension (as of the end of the taxable year) to be provided at normal retirement age from employer contributions, based upon the provisions of the plan in effect at such time and upon the assumption of the employee's continued employment with his present employer at his then current salary rate.

(ii) The value, from Table I below, at normal retirement age of an annuity of $1.00 per annum payable in equal monthly installments during the life of the employee, based upon the normal retirement age as defined in the plan.

(iii) The amount from Table II below (representing the level annual contribution which will accumulate to $1.00 at normal retirement age) for the

sum of *(a)* the number of years remaining from the end of the taxable year to normal retirement age and *(b)* the lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time.

(iv) The lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time.

TABLE I—VALUE AT NORMAL RETIREMENT AGES OF ANNUITY OF $1.00 PER ANNUM PAYABLE IN EQUAL MONTHLY INSTALLMENTS DURING THE LIFE OF THE EMPLOYEE

[For taxable years beginning after July 1, 1986]

Ages	Values
40	11.49
41	11.40
42	11.31
43	11.22
44	11.12
45	11.01
46	10.91
47	10.79
48	10.68
49	10.56
50	10.43
51	10.30
52	10.18
53	10.04
54	9.89
55	9.75
56	9.60
57	9.44
58	9.28
59	9.13
60	8.96
61	8.79
62	8.62
63	8.44
64	8.25
65	8.08
66	7.88
67	7.70
68	7.50
69	7.29
70	7.10
71	6.88
72	6.68
73	6.46
74	6.25
75	6.03
76	5.82
77	5.61
78	5.40
79	5.20
80	4.99

NOTE: If the normal form of retirement benefit under the plan is other than a straight life annuity, the value from Table I above should be divided by the figure set forth below opposite the normal form of retirement benefit provided by the plan:

Annuity for 5 years certain and life thereafter	0.97
Annuity for 10 years certain and life thereafter	0.90
Annuity for 15 years certain and life thereafter	0.80
Annuity for 20 years certain and life thereafter	0.70
Life annuity with installment refund	0.80
Life annuity with cash refund[1]	0.75

[1] The term ''cash refund'' refers to refund of accumulated employer contributions, and does not refer to refund of employee contributions only, often referred to as ''modified cash refund''.

TABLE II—LEVEL ANNUAL CONTRIBUTION WHICH WILL ACCUMULATE TO $1.00 AT END OF NUMBER OF YEARS

[For taxable years beginning after July 1, 1986]

Number of years	Amounts
1	$1.0000
2	.4808
3	.3080
4	.2219
5	.1705
6	.1363
7	.1121
8	.0940
9	.0801
10	.0690
11	.0601
12	.0527
13	.0465
14	.0413
15	.0368
16	.0330
17	.0296
18	.0267
19	.0241
20	.0219
21	.0198
22	.0180
23	.0164
24	.0150
25	.0137
26	.0125
27	.0114
28	.0105
29	.0096
30	.0088
31	.0081
32	.0075
33	.0069
34	.0063
35	.0058
36	.0053
37	.0049
38	.0045
39	.0042
40	.0039
41	.0036
42	.0033
43	.0030
44	.0028
45	.0026
46	.0024

TABLE II—LEVEL ANNUAL CONTRIBUTION WHICH WILL ACCUMULATE TO $1.00 AT END OF NUMBER OF YEARS—Continued

[For taxable years beginning after July 1, 1986]

Number of years	Amounts
47	.0022
48	.0020
49	.0019
50	.0017

(5) *Election to have allowance determined under section 415 rules.* Under section 415(c)(4)(D), an employee may elect to have the provisions of section 415(c)(4)(C) (relating to special limitations for annuity contracts purchased by educational organizations, hospitals and home health service agencies) apply for a taxable year. If the employee so elects, his exclusion allowance is the maximum amount under section 415 that could be contributed by the employer for the benefit of the employee if the annuity contract for the benefit of the employee were treated as a defined contribution plan maintained by the employer. Thus, the exclusion allowance for the taxable year of an employee who makes the election may not exceed the limitation on contributions and other additions (as described in §1.415–6) applicable to the employee for that taxable year. See §1.415–7 for provisions applicable in the event an employer maintains a defined benefit plan and a defined contribution plan for the same employee. See §1.415–8 for provisions applicable in the event an employer maintains more than one defined contribution plan covering the same employee.

(e) *Includible compensation*—(1) *In general.* For purposes of computing, under paragraph (d) of this section, an employee's exclusion allowance for a taxable year, such employee's includible compensation in respect of such taxable year means the amount of compensation from the employer—

(i) Which was earned during the most recent period (ending not later than the close of the employee's taxable year for which the exclusion allowance is being determined) that, under paragraph (f) of this section, may be counted as one-year of service,

(ii) Which is includible in the employee's gross income, and

(iii) In the case of an employee of an employer described in paragraph (b)(1)(ii) of this section, which is attributable to services performed for an educational institution (as defined in section 151(e)(4)).

See subparagraph (2) of this paragraph for special rules for determining the amount of compensation which is includible in the employee's gross income.

(2) *Special rules for determining the amount of compensation includible in the employee's gross income.* For purposes of subparagraph (1) of this paragraph, the amount of compensation which is includible in the employee's gross income shall be computed without regard to the exclusions allowed by section 105(d) (relating to wage continuation plans) and section 911 (relating to earned income from sources without the United States). Therefore, although amounts received by the employee from the employer while he is absent from work on account of personal injuries or sickness may be excludable from his gross income under section 105(d), such amounts are, nevertheless, considered as includible in his gross income for purposes of computing his includible compensation. On the other hand, in computing the amount which is includible in the gross income of the employee for purposes of subparagraph (1) of this paragraph, there shall not be included any amount which is contributed by the employer for an annuity contract to which paragraph (b) of this section applies. Thus, although the amount of any employer contributions for an annuity contract to which paragraph (b) of this section applies is, to the extent it exceeds in any taxable year the employee's exclusion allowance for such year, includible in the employee's gross income for that year, such amount is not considered as includible in the employee's gross income for purposes of computing his includible compensation for that year.

(3) *Period during which compensation must be earned.* For purposes of computing an employee's exclusion allowance for a taxable year, there may not be taken into account, as includible compensation, any compensation

which was earned by the employee during a taxable year ending after the taxable year for which the exclusion allowance is being determined. On the other hand, an employee's includible compensation may include all or part of his compensation earned during a taxable year prior to the taxable year for which the exclusion allowance is being determined. Such a situation can occur, for example, when an employer purchases an annuity contract for a retired employee, or when an employer purchases an annuity contract for a part-time employee whose most recent one-year period of service (within the meaning of paragraph (f) of this section) extends over more than one taxable year of such employee. For purposes of this subparagraph, it is immaterial when the compensation is actually received by the employee or for what taxable year it is includible in his gross income.

(4) *Status of employer*. In computing an employee's exclusion allowance for a taxable year, there is not taken into account, as includible compensation, any compensation which was earned during a period when the employer was not an employer described in paragraph (b)(1) (i) or (ii) of this section since under paragraph (f)(2) of this section an employee is not considered to be in the service of the employer for any such period. On the other hand, it is immaterial whether the employer is an employer described in paragraph (b)(1) (i) or (ii) of this section at the time the compensation is actually received by the employee. Thus, if an employee receives compensation during his 1961 taxable year for services performed during his 1960 taxable year, such compensation can qualify as includible compensation if his employer was an employer described in paragraph (b)(1) (i) or (ii) of this section during 1960, even though such employer was not such an employer during 1961. See, also, paragraph (b) of this section which provides that the exclusion allowance is only applicable with respect to contributions which are made by an employer at a time when such employer is an employer described in paragraph (b)(1) (i) or (ii) of this section.

(f) *Years of service*—(1) *In general*. In computing an employee's exclusion allowance for a taxable year, it is necessary to determine such employee's number of years of service for the employer as of the close of such taxable year. For this purpose, the number of years of service of an employee for an employer shall be determined in accordance with the rules set forth in this paragraph. In addition, such rules are applicable in determining, for purposes of paragraph (e) of this section, an employee's most recent one-year period of service.

(2) *Exempt status requirement*. For purposes of determining an employee's number of years of service for an employer and his most recent one-year period of service for such employer, an employee shall not be considered to be employed by the employer, or to be in the service of the employer, during any period that the employer is not an employer described in paragraph (b)(1) (i) or (ii) of this section, or, in the case of an employee of an employer described in paragraph (b)(1)(ii) of this section, during any period when the employee is not performing services for an educational institution (as defined in section 151(e)(4)). The rule in this subparagraph may be illustrated by the following example: A was employed on a full-time basis by the X scientific organization during the whole of 1959 and 1960 and during half of 1961. Both A and the X Organization use the calendar year as their taxable year. The X Organization was an organization described in section 501(c)(3) and exempt from tax under section 501(a) during the years 1959 and 1961, but not during the year 1960. For purposes of determining A's exclusion allowance for 1961, he is considered to have 1½ years of service (his service during 1959 and 1961) and his most recent one-year period of service ending not later than the close of 1961 consists of his service during 1961 (which is equal to ½ year of service) and his service during the last half of 1959 (which is equal to another ½ year of service).

(3) *Service included*. For purposes of computing an employee's exclusion allowance for a taxable year, there may be taken into account, in determining

his number of years of service, all service performed by him as of the close of such taxable year. Therefore, whenever possible, service performed during each of the employee's taxable years should be considered separately in arriving at his total number of years of service. For example, if an employee who reports his income on a calendar year basis is employed on a full-time basis on July 1, 1959, and continues on a full-time basis through December 31, 1960, his number of years of service as of the close of his 1960 taxable year should, if possible, be computed as follows:

(a) Number of years of service performed during 1959 taxable year	½
(b) Number of years of service performed during 1960 taxable year	1
(c) Total number of years of service as of close of 1960 taxable year (*(a)+(b)*)	1½

However, in determining what constitutes a full year of service, the employer's annual work period, and not the employee's taxable year, is the standard of measurement. For example, in determining whether a professor is employed full time, the number of months in the school's academic year shall be the standard of measurement.

(4) *Full-time employee for full year.* (i) Each full year during which an individual was employed full time shall be considered as one year of service. In determining whether an individual is employed full-time, the amount of work which he is required to perform shall be compared with the amount of work which is normally required of individuals holding the same position with the same employer and who generally derive the major portion of their personal service income from such position.

(ii)*(a)* In measuring the amount of work required of individuals holding a particular position, any method that reasonably and accurately reflects such amount may be used. For example, the number of hours of classroom instruction is only an indication of the amount of work required, but it may be used as a measure.

(b) In determining whether positions with the same employer are the same, all of the facts and circumstances concerning the positions shall be considered, including the work performed, the methods by which compensation is computed, and the descriptions (or titles) of the positions. For example, an assistant professor employed in the English department of a university will be considered a full-time employee if the amount of work that he is required to perform is the same as the amount of work normally required of assistant professors of English at that university who derive the main portion of their personal service income from such position.

(c) In case an individual's position is not the same as another with his employer, the rules of this paragraph shall be applied by considering the same position with similar employers or similar positions with the same employer.

(iii) A full year of service for a particular position means the usual annual work period of individuals employed full-time in that general type of employment at the place of employment. For example, if a doctor employed by a hospital works throughout the 12 months of a year except for a one-month vacation, such doctor will be considered as being employed for a full year, if the other doctors at that hospital work 11 months of the year with a one-month vacation. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, an instructor at that university who teaches those semesters will be considered as working a full year.

(5) *Other employees.* (i) An individual shall be treated as having a fraction of a year of service for each year during which he was a full-time employee for part of the year or for each year during which he was a part-time employee for the entire year or for a part of the year.

(ii) In determining the fraction which represents the fractional year of service for an individual employed full time for part of a year, the numerator shall be the number of weeks (or months) during which the individual was a full-time employee in a position during that year, and the denominator shall be the number of weeks (or months) which is considered under subparagraph (4)(iii) of this paragraph as the usual annual work period for that position. For example, if an instructor is employed full time by a university for the 1959 spring semester (which

lasts from February 1959 through May 1959), and the academic year of the university is 8 months long, beginning in October 1958, and ending in May 1959, then he is considered as having completed ⅝ of a year of service.

(iii) In determining the fraction which represents the fractional year of service of an individual who is employed part time for a full year, the numerator shall be the amount of work required to be performed by the individual, and the denominator shall be the amount of work normally required of individuals who hold the same position. The amount of work required to be performed by the individual and the amount of work normally required of individuals holding the same position shall be determined in accordance with the principles of subparagraph (4) of this paragraph. Thus, if a practicing physician teaches one course at a local medical school 3 hours per week for two semesters and other faculty members at that medical school teach 9 hours per week for two semesters, then the practicing physician is considered as having completed ⅓ of a year of service.

(iv) In determining the fraction representing the fractional year of service of an individual who is employed part time for part of a year, it is necessary to compute the fractional year of service if the individual were a part-time employee for a full year, and the fractional year of service if the individual were a full-time employee for the part of a year. The two fractions shall be multiplied and the product is the fractional year of service of such individual who is employed part time for part of a year. For example, if an attorney who is a specialist in a subject teaches a course in that subject for 3 hours per week for one semester at a nearby law school, and the full-time instructors at that law school teach 12 hours per week for two semesters, then the fractional part of a year of service for such part-time instructor is computed as follows: The fractional year of service if the instructor were a part-time employee for a full year is 3/12 (number of hours employed divided by the usual number of hours of work required for that position); the fractional year of service if the instructor were a full-time employee for part of a year is ½ (period worked or one semester, divided by usual work period, or 2 semesters). These fractions are multiplied to obtain the fractional year of service: 3/12 times ½, or 3/24 (⅛).

(6) *Less than one year of service considered as one year.* If, at the close of a taxable year, an employee has, under the rules in this paragraph, a period of service of less than one year, such employee shall, nevertheless, be considered to have one year of service for purposes of computing his exclusion allowance for that taxable year. Such period of service of less than one year shall also be considered to be such employee's most recent one-year period of service for purposes of determining his includible compensation.

(7) *Most recent one-year period of service.* (i) In determining, for purposes of paragraph (e) of this section (relating to includible compensation), an employee's most recent one-year period of service, there is first taken into account all service performed by the employee during the taxable year for which the exclusion allowance is being determined. For this purpose, therefore, an employee's most recent one-year period of service may not be the same as his employer's most recent annual work period. The rule in this subdivision may be illustrated by the following example: A, a professor who reports his income on a calendar year basis, is employed by a university on a full-time basis during the university's 1959–1960 and 1960–1961 academic years (October through May). For purposes of computing A's exclusion allowance for his 1960 taxable year, his most recent one-year period of service consists of his service performed during January through May, 1960 (which is part of the 1959–1960 academic year) and his service performed during October through December 1960 (which is part of the 1960–1961 academic year).

(ii) In the case of a part-time employee or a full-time employee who is employed for only part of a year, it will be necessary to aggregate his most recent periods of service to determine his most recent one-year period of service. In such a case, there is first taken into account his service during the taxable year for which the exclusion allowance

is being determined; then there is taken into account his service during his next preceding taxable year and so forth until his service equals, in the aggregate, one year of service. For example, if an employee, who reports his income on the calendar year basis, is employed on a full-time basis during the months July through December 1959 (½ year of service), July through December 1960 (½ year of service), and October through December 1961 (¼ year of service), his most recent one-year period of service for purposes of computing his exclusion allowance for 1961 consists of his service during 1961 (¼ year of service), his service during 1960 (½ year of service), and his service during the months October through December 1959 (¼ year of service).

(g) *Illustration of computation of exclusion allowance.* The exclusion provided under paragraph (b) of this section may be illustrated by the following example: A, a professor who reports his income on the calendar year basis, became a full-time employee of X University on October 1, 1958 (beginning of X University's 1958–1959 academic year) and continued as a full-time employee for the academic years 1958–1959, 1959–1960, and 1960–1961. X University was, during all such academic years, an organization described in section 501(c)(3) and exempt from tax under section 501(a). X University's academic year runs for a period of 8 months: October through May. A received an annual salary, all of which was includible in his gross income, of $8,000 for the 1958–1959 academic year, $8,800 for the 1959–1960 academic year, and $9,600 for the 1960–1961 academic year. Starting in 1958, X University contributed amounts toward the purchase of annuity contracts for A and such purchase was not part of a qualified annuity plan. X University paid, as premiums for such contracts, $1,000 in 1958, $2,000 in 1959, $2,400 in 1960, and $1,400 in 1961. The amount of such premiums which is excludable from A's gross income for the year in which paid is computed as follows:

1958

(1) Amount contributed by employer for annuity contracts in 1958	$1,000.00
(2) Includible compensation for most recent one-year period of service (since A was employed for only ⅜ of a year at the close of 1958, this period is counted as most recent one-year period of service) ⅜ × $8,000	$3,000.00
(3) 20% × includible compensation	$600.00
(4) Number of years of service (although A was employed for less than a year, he is considered to have one-year of service)	1
(5) Item (4) × item (3)	$600.00
(6) Contributions excludable in prior taxable years of A	None
(7) Amount excludable from A's gross income for 1958 ((5)—(6))	$600.00
(8) Amount includible in A's gross income for 1958 ((1) − (7))	$400.00

1959

(9) Amount contributed by employer for annuity contracts in 1959	$2,000.00
(10) Includible compensation for most recent one-year period of service. (⅜ × $8,800+⅝×$8,000)	$8,800.00
(11) 20% × includible compensation	$1,660.00
(12) Number of years of service	1⅜
(13) Item (12) × item (11)	$2,282.50
(14) Contributions excludable in prior taxable years of A (item 7))	$600.00
(15) Amount excludable from A's gross income for 1959 ((13) − (14))	$1,682.50
(16) Amount includible in A's gross income for 1959 ((9) − (15))	$317.50

1960

(17) Amount contributed by employer for annuity contracts in 1960	$2,400.00
(18) Includible compensation for most recent one-year period of service (⅜×$9,600+⅝×$8,800)	$9,100.00
(19) 20% × includible compensation	$1,820.00
(20) Number of years of service	2⅜
(21) Item (20) × item (19)	$4,322.50
(22) Contributions excludable in prior taxable years ((7) + (15))	$2,282.50
(23) Amount excludable from A's gross income for 1960 ((21) − (22))	$2,040.00
(24) Amount includible in A's gross income for 1960 ((17) − (23))	$360.00

1961

(25) Amount contributed by employer for annuity contracts in 1961	$1,400.00
(26) Includible compensation for most recent one-year period of service (⅝ × $9,600+⅜×$9,600)	$9,600.00
(27) 20% × includible compensation	$1,920.00
(28) Number of years of service	3
(29) Item (28) × item (27)	$5,760.00
(30) Contributions excludable in prior taxable years ((7) + (15) + (23))	$4,322.50
(31) Amount excludable from A's gross income for 1961 (item (25) since it is less than (29) − (30))	$1,400.00
(32) Amount includable in A's gross income for 1961 ((25) − (31))	None

[T.D. 6783, 29 FR 18360, Dec. 24, 1964, as amended by T.D. 6885, 31 FR 7802, June 2, 1966; T.D. 7748, 46 FR 1696, Jan. 7, 1981; T.D. 7836, 47 FR 42337, Sept. 27, 1982; T.D. 8115, 51 FR 45736, Dec. 19, 1986]

§ 1.403(b)–2 Eligible rollover distributions; questions and answers.

The following questions and answers relate to eligible rollover distributions from annuities, custodial accounts, and retirement income accounts described in section 403(b) of the Internal Revenue Code of 1986, as amended by sections 521 and 522 of the Unemployment Compensation Amendments of 1992 (Public Law 102–318, 106 Stat. 290) (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 402(f), and 3405(c), see §§ 1.401(a)(31)–1, 1.402(c)–2, 1.402(f)–1, and § 31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan from annuities, custodial accounts, and retirement income accounts described in section 403(b)?

Q–2: Is a section 403(b) annuity required to provide the direct rollover option described in section 401(a)(31) as a distribution option?

Q–3: Is the payor of a section 403(b) annuity required to provide a distributee of an eligible rollover distribution with an explanation of the direct rollover option?

Q–4: When do sections 403 (b)(8) and (b)(10), as amended by UCA, and this § 1.403(b)–2 apply to distributions from section 403(b) annuities?

QUESTIONS AND ANSWERS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan from annuities, custodial accounts, and retirement income accounts described in section 403(b)?

A–1: Under section 403(b)(8), as amended by UCA, any eligible rollover distribution from a section 403(b) annuity is permitted to be rolled over to an eligible retirement plan. For purposes of this section, a section 403(b) annuity includes an annuity contract, a custodial account, and a retirement income account described in section 403(b). For purposes of section 403(b)(8) and this section, an eligible retirement plan means another section 403(b) annuity or an individual retirement plan (as defined in § 1.402(c)(2), Q&A–2 but does not include a qualified plan (as defined in § 1.402(c)–2), Q&A–2. Except to the extent otherwise provided in this section, an eligible rollover distribution from a section 403(b) annuity is an eligible rollover distribution described in section 402(c) (2) and (4) and § 1.402(c)–2, Q&A–3 through Q&A–10 and Q&A–14, except that the distribution is from section 403(b) annuity rather than a qualified plan. Thus, for example, to the extent that corrective distributions described in § 1.402(c)–2, Q&A–4 are properly made from a section 403(b) annuity, such distributions are not eligible rollover distributions. Similarly, in the case of annuity distributions from an annuity contract described in section 403(b), the entire amount of any such annuity payment made on or after January 1 of the year in which an employee attains (or would have attained) age 70½ will be treated as an amount required under section 401(a)(9) and, thus, will not be an eligible rollover distribution. The rules with respect to rollovers in sections 402 (c)(1), (c)(3), and (c)(9) and § 1.402(c)–2, Q&A–11 through Q&A–13 and Q&A–15 also apply to eligible rollover distributions from section 403(b) annuities.

Q–2: Is a section 403(b) annuity required to provide the direct rollover option described in section 401(a)(31) as a distribution option?

A–2: (a) *General rule.* Yes. Pursuant to section 403(b)(10), section 403(b) does not apply to an annuity contract, custodial account, or retirement income account unless the annuity contract, custodial account, or retirement income account provides that if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan (as defined in Q&A–1 of this section) and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. For purposes of determining whether a section 403(b) annuity has satisfied this direct rollover requirement, the provisions of § 1.401(a)(31)–1 apply to the section 403(b) annuity as though it were a plan qualified under section 401(a) unless otherwise provided in this section. For example, as described in § 1.401(a)(31)–1, Q&A–15 a direct rollover from a section 403(b) annuity to another section 403(b) annuity is a distribution and a rollover and not a transfer of funds between

section 403(b) annuities and, thus, is not subject to the applicable law governing transfers of funds between section 403(b) annuities. In applying the provisions of §1.401(a)(31)–1, the payor of the eligible rollover distribution is treated as the plan administrator.

(b) *Mandatory withholding*. As in the case of an eligible rollover distribution from a qualified plan, if a distributee of an eligible rollover distribution from a section 403(b) annuity does not elect to have the eligible rollover distribution paid directly to an eligible retirement plan in a direct rollover, the eligible rollover distribution is subject to 20-percent income tax withholding imposed under section 3405(c). See §31.3405(c)–1 of this chapter for provisions regarding the withholding requirements relating to eligible rollover distributions.

Q–3: Is the payor of a section 403(b) annuity required to provide the distributee of an eligible rollover distribution with an explanation of the direct rollover option?

A–3: Yes. In order to ensure that the distributee of an eligible rollover distribution from a section 403(b) annuity has a meaningful right to elect a direct rollover, the distributee must be informed of the option. Thus, within a reasonable time period before making an eligible rollover distribution, the payor must provide an explanation to the distributee of his or her right to elect a direct rollover and the income tax withholding consequences of not electing a direct rollover. For purposes of satisfying the reasonable time period, the qualified plan timing rule provided in §1.402(f)–1, Q&A–2 does not apply to section 403(b) annuities. However, a payor of a section 403(b) annuity will be deemed to have provided the explanation within a reasonable time period if the payor complies with the time period in that rule.

Q–4: When do sections 403(b)(8) and (b)(10), as amended by UCA, and this §1.403(b)–2 apply to distributions from section 403(b) annuities?

A–4: (a) *General rule*—(1) *Statutory effective date*. Section 403(b)(8), as amended by UCA, and section 403(b)(10), as amended by UCA, apply to distributions made on or after January 1, 1993. In addition, the underlying section 403(b) annuity document must be amended at the time provided in, and the section 403(b) annuity must operate in accordance with the requirements of §1.401(a)(31)–1, Q&A–19. Section 522 of UCA provides a special effective date for governmental section 403(b) annuities. This special effective date is specified in §1.403(b)–2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1).

(2) *Regulatory effective date*. This section applies to distributions made on or after October 19, 1995. For distributions made on or after January 1, 1993 and before October 19, 1995, §1.403(b)–2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for distributions made on or after January 1, 1993 but before October 19, 1995, a section 403(b) annuity may satisfy section 403(b)(10) by substituting any or all provisions of this section for the corresponding provisions of §1.403(b)–2T, if any.

[T.D. 8619, 60 FR 49214, Sept. 22, 1995, as amended by T.D. 8880, 65 FR 21315, Apr. 21, 2000]

§1.403(c)–1 Taxability of beneficiary under a nonqualified annuity.

(a) *Taxability of vested interest in premiums*. If after August 1, 1969, an employer (whether or not exempt under section 501(a)) pays premiums for an annuity contract for the benefit of an employee, the amount of such premiums shall be included as compensation in the gross income of the employee for the taxable year during which such premiums are paid, but only to the extent that the employees's rights in such premiums are substantially vested (as defined in §1.83–3(b)) at the time such premiums are paid. The preceding sentence shall not apply to contracts referred to in the transitional rule of paragraph (d) (1), (ii), or (iii) of this section, or to premiums subject to §1.403(a)–1(a) or excludible under §1.403(b)–1(b). If any employer has purchased annuity contracts and transfered them to a trust (other than one described in section 401(a)) that is to provide annuity contracts or benefits for his employees, the amounts so paid shall be treated as contributions to a trust described in section 402(b). For the rules relating to the taxation

of the cost of life insurance protection when rights in a life insurance contract are substantially nonvested, see §1.83–1(a)(2).

(b) *Taxability of employee when rights under annuity contract change from nonvested to vested*—(1) *In general*. If, during a taxable year of an employee ending after August 1, 1969, the rights of such employee under an annuity contract purchased for him by an employer (whether or not exempt under section 501(a) or 521(a)) become substantially vested, the value of the annuity contract on the date of such change shall be included in the employee's gross income for such year, to the extent provided in paragraph (b)(2) of this section. The preceding sentence shall not apply, however, to an annuiity contract purchased and held as part of a plan which met at the time of such purchase, and continues to meet, the requirements of section 404(a)(2) or an annuity contract referred to in paragraph (d) (ii) or (iii) of this section. For purposes of this section, the value of an annuity contract on the date the employee's rights become substantially vested means the cash surrender value of such contract on such date.

(2) *Extent to which value of annuity contract is includible in employee's gross income*. For purposes of paragraph (b)(1) of this section, the only amount includible in the gross income of the employee is that the portion of the value of the contract on the date of the change that is attributable to premiums which were paid by the employer after August 1, 1969, and which were not excludible from the employer's gross income under §1.403(b)–1(b). However, the includible portion does not include—

(i) The value attributable to a premium paid on the date of such change, and

(ii) The value attributable to premiums described in the transitional rule of paragraph (d)(1) (ii) or (iii) of this section.

See §1.403(b)–1(b)(2) for the treatment of an amount otherwise includible in gross income under section 403(c) as an employer contribution for purposes of the exclusion under section 403(b).

(3) *Partial vesting*. If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract becomes substantially vested, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (b)(1) and (2) of this section but without regard to any exclusion allowable under §1.403(b)–1(b), the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a substantially vested interest during such year. The amount that is includible under this (3) (without regard to the section 403(b) exclusion) is equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which became substantially vested during the taxable year.

(c) *Amounts paid or made available under an annuity contract*. The amounts paid or made available to the employee under an annuity contract subject to this section shall be included in the gross income of the employee for the taxable year in which paid or made available, as provided in section 72 (relating to annuities). Such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(d) *Taxability of beneficiary under a nonqualified annuity on or before August 1, 1969*. (1) Except as provided in section 402(d) (relating to taxable years beginning before Janaury 1, 1977), if an employer purchases an annuity contract and if the amounts paid for the contract.

(i) On or before August 1, 1969, or

(ii) After such date, if pursuant to a binding written contract (as defined in §1.83–8(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969 and under which the obligation of the employer is essentially the same as under a binding written contract, are not subject to paragraph (a) of §1.403(a)–1 or paragraph (a) of §1.403–1, the amount of such contribution shall, to the extent it is not excludible under paragraph (b) of §1.403(b)–1, be included in the income of the employee for the taxable year during which such contribution is made if, at at the time the contribution is made, the employee's rights under the annuity contract are nonforfeitable, except for failure to pay future premiums. If the annuity contract was purchased by an employer which is not exempt from tax under section 501(a) or section 521(a), and if the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later the amount of such contribution is not required to be included in the income of the employee at the time his rights under the contract become nonforfeitable. On the other hand, if the annuity contract is purchased by an employer which is exempt from tax under section 501(a) or section 521(a), all or part of the value of the contract may be includible in the employee's gross income at the time his rights under the contract become nonforfeitable (see section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 and the regulations thereunder). As to what constitutes nonforfeitable rights of an employee, see §1.402(b)–1(d)(2). The amounts received by or made available to the employee under the annuity contract shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before Janaury 1, 1964, sections 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(2) If an employer has purchased annuity contracts and transferred them to a trust, or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 402(d) (see paragraph (a) of §1.402(D)–1, the amount so paid or contributed is not required to be included in the income of the employee, but any amount received by or made available to the employee under the annuity contract shall be includible in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to the employee under the annuity contract. For taxable years beginning after December 31, 1963, amounts received by or made available to the employee under the annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 72 unless the employee has paid income tax for any taxable year beginning before January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not creditid or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 72.

(3) For taxable years beginning before January 1, 1958, the provisions contained in section 403(c) prior to the amendment made thereto by the Tax Reform Act of 1969 were included in section 403(b) of the Internal Revenue Code of 1954. Therefore, the regulations contained in this paragraph shall, for such taxable years, be considered as the regulations under section 403(b) as in effect for such taxable years. For the rules with respect to contributions paid after August 1, 1969, see paragraphs (a), (b), and (c) of this section.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 7554, 43 FR 31924, July 24, 1978]

§ 1.403(d)–1 Taxability of employee when rights under contracts purchased by exempt organizations change from forfeitable to nonforfeitable.

(a) *In general.* The provisions of section 403(d), repealed by section 321(b) of the Tax Reform Act of 1969 (83 Stat. 571), applied for taxable years beginning after December 31, 1957, only with respect to amounts paid for an annuity contract—

(1) On or before August 1, 1969, or

(2) After such date, if pursuant to a binding written contract (as defined in § 1.83–8(b)(2)) entered into before April 22, 1969, or

(3) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer is essentially the same as under a binding written contract.

If, during a taxable year of an employee beginning after December 31, 1957, the rights of such employee under an annuity contract purchased for him by an employer which is exempt from tax under section 501(a) or 521(a) change from forfeitable to nonforfeitable rights, then (except in the case of contracts to which § 1.403(c)—1(b) applies for taxable years ending after August 1, 1969) the value of such annuity contract on the date of such change shall be included in the employee's gross income for such taxable year, to the extent provided in paragraph (b) of this section. However, the preceding sentence does not apply to an annuity contract purchased and held as part of a plan that at the time of such purchase and at all times thereafter meets the requirements of section 404(a)(2). For purposes of this section, the value of an annuity contract on the date the employee's rights change from forfeitable to nonforfeitable rights means the cash surrender value of such contract on such date. As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)–1(d)(2). For the rules with respect to amounts paid after August 1, 1969, under an annuity contract purchased for an employee by an employer which is exempt from tax under section 501(a) or 521(a), see generally section 403(c) and the regulations thereunder.

(b) *Extent to which value of annuity contract is includible in employee's gross income.* For purposes of paragraph (a) of this section, there shall be included in the gross income of an employee for his taxable year in which his rights under an annuity contract change from forfeitable to nonforfeitable rights only an amount equal to the portion of the value of such contract on the date of such change (1) that is attributable to contributions:

(i) Which were made by the employer while it was exempt from tax under section 501(a) or 521(a);

(ii) Which were made after December 31, 1957; and

(iii) Which were not, at the time they were made, excludable from the employee's gross income under paragraph (a) of § 1.403(b)–1;

and (2) that is not excludable from the employee's gross income under paragraph (b) of § 1.403(b)–1. Thus, although amounts are contributed by an employer after December 31, 1957, toward the purchase for an employee of an annuity contract and, at the time of the contribution, such employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), the value of such annuity contract attributable to such contributions would not be includible in the employee's gross income for the taxable year in which his rights under the contract change to nonforfeitable rights if such amounts were contributed during a taxable year of the employee beginning before January 1, 1958, and were, therefore, excludable

from the employee's gross income under paragraph (a) of §1.403(b)–1. Similarly, the value of such an annuity contract is not includible in the gross income of the employee for the year in which the change occurs to the extent that it is excludable under paragraph (b) of §1.403(b)–1. See paragraph (b)(2) of §1.403(b)–1 which provides that the amount otherwise includible in gross income under section 403(d) is considered to be a contribution by the employer for purposes of the exclusion provided in paragraph (b) of §1.403(b)–1. In addition, the portion of the value of an annuity contract attributable to contributions made by the employer while it was not exempt from tax under either section 501(a) or 521(a) is not includible in the gross income of the employee at the time his rights under the contract change to nonforfeitable rights even though the employer is exempt from tax under section 501(a) or 521(a) at the time of such change. On the other hand, the value of the annuity contract purchased by an organization exempt from tax under section 501(a) or 521(a) may be includible in the gross income of an employee for the year during which his rights under the contract change to nonforfeitable rights even though such organization is not exempt on the date of such change.

(c) *Partial vesting*—(1) *General rule*. If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract changes from a forfeitable to a nonforfeitable interest, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (a) and (b) of this section but without regard to any exclusion allowable under paragraph (b) of §1.403(b)–1, the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a nonforfeitable interest during such year. The amount that is includible (without regard to any exclusion allowed by paragraph (b) of §1.403(b)–1) in the gross income of the employee for the taxable year in which the change occurs is an amount equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which changed to a nonforfeitable interest during the taxable year. If at the time the employee's interest changes to a nonforfeitable interest, the employer is an organization described in section 501(a)(3) and exempt from tax under section 501(a), then the amount that is includible in the employee's gross income under this subparagraph is considered as an employer contribution to which the exclusion provided in paragraph (b) of §1.403(b)–1 applies (see paragraph (b)(2) of §1.403(b)–1).

(2) *Example*. The provisions in paragraph (c)(1) of this section may be illustrated by the following example:

Example. X organization purchased an annuity contract for A, one of its employees who reports his income on a calendar year basis. X contributed ⅓ of of amount necessary to purchase the contract before January 1, 1958, and the remaining ⅔ after December 31, 1957. At the time of the contributions, X was an organization exempt from tax under section 501(a) and A's rights under the contract were forfeitable. The annuity contract was not purchased as part of a qualified plan and A made no contributions toward the purchase of the contract. On December 31, 1965, 50 percent of A's interest in the contract changed from a forfeitable to a nonforfeitable interest, and on December 31, 1968, the remaining 50 percent of A's interest in the contract changed to a nonforfeitable interest. The cash surrender value of the contract was $9,900 on December 31, 1965, and $12,000 on December 31, 1968. The amount includible in A's gross income for 1965 and 1968 is computed as follows—

1965

(i) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1965, attributable to contributions made after December 31, 1957), ⅔ × $9,900, $6,600.

(ii) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1965, 50 percent.

(iii) Amount includible in A's gross income for 1965 ((ii) × (i)), $3,300.

1968

(iv) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value

of contract on December 31, 1968, attributable to contributions made after December 31, 1957), ⅔ $12,000, $8,000.

(v) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1968, 50 percent.

(vi) Amount includible in A's gross income for 1968 ((v) × (iv)), $4,500.

If, on December 31, 1965, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the $3,300 as is not excludable under paragraph (b) of §1.403(b)–1 is includible in A's gross income for 1965. Similarly, if, on December 31, 1968, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the $4,000 as is not excludable under paragraph (b) of §1.403(b)–1 is includible in A's gross income for 1968.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6783, 29 FR 18365, Dec. 24, 1964, as amended by T.D. 7554, 43 FR 31925, July 24, 1978]

§1.404(a)–1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

(a)(1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404(a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see §1.404(a)–12). For taxable years beginning after 1962, certain self-employed individuals may be covered by pension, annuity, or profit-sharing plans. For the rules relating to the deduction of contributions on behalf of such individuals, see paragraph (a)(2) of §1.404(a)–8 and §1.404(e)–1.

(2) Section 404(a) does not apply to a plan which does not defer the receipt of compensation. Furthermore, section 404(a) does not apply to deductions for contributions under a plan which is solely a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare, or similar benefit plan, or a combination thereof. For example, if under a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan, and the deductibility of the contributions to it is determined under section 162. As to the deductibility of such contributions, see §1.162–9.

(3) If, however, the contributions to a pension, profit-sharing, stock bonus, or other plan of deferred compensation can be used to provide any of the benefits referred to in subparagraph (2) of this paragraph, then, except as provided in section 404(c), section 404(a) applies to the entire contribution to the plan. Thus, if in the example described in subparagraph (2) of this paragraph, the employer's contribution on behalf of each employee is set up as a separate account, and if any amount which remains in an employee's account at the time of retirement is paid to him at such time, the deductibility of the contributions to the plan is determined under section 404(a). For the regulations for determining whether the benefits referred to in subparagraph (2) of this paragraph can be included in a qualified pension or profit-sharing plan, see §1.401–1(b).

(4) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(b) In order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404(a) for the

amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 316. See also §§1.162–6 and 1.162–8. In addition to the limitations referred to above, deductions under section 404(a) are also subject to further conditions and limitations particularly provided therein.

(c) Deductions under section 404(a) are generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting. Exceptions are made in the case of overpayments as provided in paragraphs (1), (3), and (7) of section 404(a), and, as provided by section 404(a)(6), in the case of payments made by a taxpayer on the accrual method of accounting not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof). This latter provision is intended to permit a taxpayer on the accrual method to deduct such accrued contribution or compensation in the year of accrual, provided payment is actually made not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof), but this provision is not applicable unless, during the taxable year on account of which the contribution is made, the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year. See section 461 and the regulations thereunder. There is another exception in the case of certain taxpayers who are required to make additional contributions as a result of the Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 134), and the regulations thereunder.

[T.D. 6500, 25 FR 11682, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10144, Sept. 17, 1963]

§ 1.404(a)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for employees. (Temporary)

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of contributions or compensation under section 404(a)?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(a) shall govern the deduction of contributions paid and compensation paid or incurred by the employer under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits to employees, their spouses, or their dependents. See section 404(b) and §1.404(b)–1T. Section 404 (a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay

by a taxpayer that has elected the application of such section. For rules relating to the deduction of contributions paid or accured with respect to a welfare benefit fund, see section 419, § 1.419–1T and § 1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 301.9100–16T of this chapter and § 1.463–1T.

[T.D. 8073, 51 FR 4320, Feb. 4, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.404(a)–2 Information to be furnished by employer claiming deductions; taxable years ending before December 31, 1971.

(a) For the first taxable year for which a deduction from gross income is claimed under section 404(a) (1), (2), (3), or (7), the employer must file the following information (unless such information has been previously filed in accordance with the regulations under section 23(p) of the Internal Revenue Code of 1939) for each plan involved to establish that it meets the requirements of section 401(a) or 404(a)(2), and that deductions claimed do not exceed the amount allowable under paragraphs (1), (2), (3), and (7) of section 404(a), as the case may be:

(1) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, specimen copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(2) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise), the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable and a summary of the provisions and rules relating to—

(i) Employee eligibility requirements for participation in the plan,

(ii) Employee contributions,

(iii) Employer contributions,

(iv) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(v) The medium of funding (e. g., self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly insured, the medium of contributions and the kind of investments, and

(vi) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(3) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their nondeferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans):

(i) Name.

(ii) Whether an officer.

(iii) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(iv) Whether the principal duties consist in supervising the work of other employees.

(v) Year of birth.

(vi) Length of service for employer to the close of the year.

(vii) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components:

(A) Basic compensation and overtime pay,

(B) Other direct payments, such as bonuses and commissions,

(C) Compensation paid other than in cash, such as goods, services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(viii) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under each other plan of deferred compensation.

(ix) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components:

(A) Amounts originally allocated in the year, and

(B) Amounts reallocated in the year.

(x) Amounts of employee contributions during the year under the plan,

(xi) If a pension or annuity plan,

(A) The retirement age and date and the form of the retirement benefit,

(B) The annual rate or amount of the retirement benefit, and

(C) The aggregate of all of the employee's contributions under the plan,

all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan.

(4) The following totals:

(i) Total nondeferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(ii) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto), less employee contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components:

(A) Amount originally allocated in the year, and

(B) Amount reallocated in the year.

(5) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(i) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.).

(ii) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subdivision (i) of this subparagraph.

(iii) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subdivision (i) or (ii) of this subparagraph.

(iv) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(v) All employees ineligible for coverage under the plan other than those employees included in subdivision (i), (ii), (iii), or (iv) of this subparagraph, specifying the reason applicable to the group.

(vi) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subdivisions (i) to (v), inclusive, of this subparagraph.

(vii) All employees eligible for coverage but not covered under the plan.

(viii) All employees covered under the plan.

(ix) All employees of the employer, which should be the sum of subdivisions (vi), (vii), and (viii) of this subparagraph.

If it is claimed that the requirements of section 401(a)(3)(A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(6) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(7) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held.

(8) A statement of the applicable limitations under section 404(a) (1), (2), (3), or (7) and an explanation of the method of determining such limitations, a summary of the data, and a statement of computations necessary to determine the allowable deductions for the taxable year. Also, in the case of a pension or annuity plan, a summary of the costs or liabilities and adjustments for the year under the plan based on the application of the methods, factors, and assumptions used under the plan, in sufficient detail to permit ready verification of the reasonableness thereof.

(9) A statement of the contributions paid under the plan for the taxable year showing the date and amount of each payment. Also, a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components:

(i) For contributions paid in the taxable year before giving effect to the provisions of paragraph (7) of section 404(a).

(ii) For contributions paid in prior taxable years beginning after December 31, 1941, in accordance with the carryover provisions of paragraphs (1) and (3) of section 404(a), before giving effect to the provisions of paragraph (7) thereof, and in accordance with the carryover provisions of section 404(d).

(iii) Any reductions or increases in the deductions in accordance with the provisions of paragraph (7) of section 404(a). However, if the information in this subdivision is filed prior to the filing of the information required by subparagraph (8) of this paragraph, then, in determining the limit of deduction under paragraph (7) of section 404(a), the applicable percentage of the compensation otherwise paid or accrued during the year may be used.

(b) For taxable years subsequent to the year for which all of the applicable information under paragraph (a) of this section (or corresponding provisions of prior regulations) has been filed, information is to be filed only to the following extent:

(1) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in paragraph (a) (1), (2), or (7) of this section are based, a detailed statement explaining the change and its effect is to be filed only for the taxable year in which the change is put into effect. However, if there is no such change, unless otherwise requested by the district director, merely a statement that there is no such change is to be filed.

(2) The information specified in paragraph (a)(3) of this section which has been filed for a taxable year, unless otherwise requested by the district director and so long as the plan and the method and basis of allocations are not changed, is to be filed for subsequent years only to the extent of showing in the tabulation such information with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(3) The information specified in paragraph (a) (4), (5), (6), (8), and (9) of this section.

In the case of corporate employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1961. In the case of other employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1962.

(c) If a deduction is claimed under section 404(a)(5) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the

deduction is not allowable under the other paragraphs of section 404(a), that the amount paid is an ordinary and necessary expense or an expense for the production of income, and that the employees' rights to, or derived from, such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid. In the case of corporate employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1961. In the case of other employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1962.

(d) For the purpose of the information required by this section, contributions paid in a taxable year shall include those deemed to be so paid in accordance with the provisions of section 404(a)(6) and shall exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section, ''taxable year'' refers to the taxable year of the employer and, unless otherwise requested by the district director, a ''year'' which is not specified as a ''taxable year'' may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year with respect to which deductions are being claimed provided the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed, except that, unless sooner requested by the district director, such information, other than that specified in paragraph (a)(4)(i) and (9) of this section, may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

(e) In any case all the information and data required by this section must be filed in the office of the district director in which the employer files his tax returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 401(a). The district director may, in addition, require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401. For taxable years ending on or before December 31, 1961, the district director may waive the filing of such information required by this section which he finds unnecessary in a particular case. For taxable years ending after December 31, 1961, the Commissioner may waive the filing of such information.

(f) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

(g) In the case of a plan which covers employees, some or all of whom are self-employed individuals and with respect to which a deduction is claimed under section 404(a) (1), (2), (3), or (7), paragraphs (a) and (b) of this section, and the provision of paragraph (d) of this section relating to the time for filing the information required by this section, shall not apply, but in lieu of the information required to be submitted by paragraphs (a) and (b) of this section, the employer shall, with the return for the taxable year in which the deduction is claimed, submit the information required by the form provided by the Internal Revenue Service for such purpose.

(h) When a custodial account forms a part of a plan for which a deduction is claimed under section 404(a) (1), (2), (3), or (7), the information which under this section is to be submitted with respect to a qualified trust must be submitted with respect to such custodial account. Thus, for purposes of this section—

(1) The term ''trust'' includes custodial account,

(2) The term ''trustee'' includes custodian, and

(3) The term ''trust indenture'' includes custodial agreement.

(i) Except as provided under § 1.503(d)–1(a) and § 601.201 of this chapter (Statement of Procedural Rules) in the case of a request for the determination of qualification of a trust under section 401 and exemption under section 501, paragraphs (a) through (h) of this section shall not apply for taxable years ending on or after December 31, 1971. For information to be furnished for taxable years ending on or after December 31, 1971, see § 1.404(a)–2A.

[T.D. 6500, 25 FR 11683, Nov. 26, 1960, as amended by T.D. 6599, 27 FR 4475, May 10, 1962; T.D. 6676, 28 FR 10144, Sept. 17, 1963; T.D. 7165, 37 FR 5025, Mar. 9, 1972; T.D. 7168, 37 FR 5491, Mar. 16, 1972]

§ 1.404(a)–2A Information to be furnished by employer; taxable years ending on or after December 31, 1971, and before December 31, 1975.

(a) *In general*. For any taxable year ending on or after December 31, 1971, any employer who maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation shall file the forms prescribed by this section. An employer (including a self-employed individual) maintaining such a plan shall furnish such information as is required by the forms and the instructions relating thereto. The forms shall be filed in the manner and at the time prescribed under paragraph (c) of this section. See § 1.404(a)–2 with respect to information to be furnished for taxable years ending before December 31, 1971. For purposes of this section, in the case of a plan of several employers described in § 1.401–1(d), each employer shall be deemed to be maintaining a separate plan corresponding to the plan of which the trust is a part. For information required to be furnished with respect to a funded deferred compensation plan maintained by an employer who is exempt from tax under section 501(a), see § 1.6033–2(a)(2)(ii)(i).

(b) *Forms*. The forms prescribed by this section are:

(1) Form 4848, generally relating to information concerning the qualification of the plan, and deductions for contributions made on behalf of employees or self-employed individuals,

(2) Form 4849, generally relating to the financial position of the trust, fund, or custodial or fiduciary account which is a part of the plan, and

(3) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Forms 2950 and 2950SE, relating to the identification of plans to which an employer has made a contribution and information with respect to a deduction for a contribution made on behalf of a self-employed individual, respectively.

(c) *Filing requirements*. (1) Form 4848 shall be filed by the employer for each taxable year during which he maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation. Such form shall be filed on or before the 15th day of the 5th month following the close of the employer's taxable year. For rules relating to the extension of time for filing, see section 6081 and the regulations thereunder and the instructions for Form 4848.

(2) Form 4849 shall be filed by the employer as an attachment to Form 4848 for each taxable year during which he maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation unless the employer (i) has been notified in writing that Form 4849 will be filed by the fiduciary for such plan as an attachment to Form 990-P or (ii) is not required to file Form 4849 under the instructions relating thereto.

(3) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Form 2950 shall be filed with the employer's tax return for any such taxable year during which a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation is maintained.

(4) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Form 2950SE shall be filed by each self-employed individual with his income tax return for any such taxable year in which he claims a deduction for contributions made on his behalf.

(d) *Additional information*. In addition to the information otherwise required

to be furnished by this section, the district director may require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401.

(e) *Records.* Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

[T.D. 7165, 37 FR 5025, Mar. 9, 1972, as amended by T.D. 7223, 37 FR 24748, Nov. 21, 1972; T.D. 7551, 43 FR 29292, July 7, 1978]

§ 1.404(a)–3 Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 401(a); application of section 404(a)(1).

(a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a) (1) or (2) if the further conditions provided therein are also satisfied. As used in this section, a ''pension trust'' means a trust forming part of a pension plan and an ''annuity plan'' means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. This section is also applicable to contributions to a foreign situs pension trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States. For the meaning of ''pension plan'' as used in this section, see paragraph (b)(1)(i) of § 1.401–1. Where disability pensions, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 404(a) (1) or (2). See paragraph (b)(2) of § 1.72–16 as to taxability to employees of cost of incidental life insurance protection. Similarly, where medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14 are provided for retired employees, their spouses, or their dependents under the plan, deductions on account of such subordinate benefits are also covered under section 404(a) (1) or (2). In order to be deductible under section 404(a)(1), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 501(a). Contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). See § 1.404(a)–7 for rules relating to the limitation on the amount deductible in such a succeeding taxable year of the employer. See § 1.404(a)–8 as to conditions for deductions under section 404(a)(2) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section 404(a)(1). The limitations provided in section 404(a)(1) are, with an exception provided for certain years under subparagraph (A) thereof (see § 1.404(a)–4), based on the actuarial costs of the plan.

(b) In determining costs for the purpose of limitations under section 404(a)(1), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract. In no event shall costs for the purpose of section 404(a)(1) exceed costs based on assumptions and methods which are reasonable in view of the provisions and coverage of the plan, the funding medium, reasonable

expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement (whether or not discounted) which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations, an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years. Unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost arising from experience in the next preceding taxable year which was more favorable than the assumptions on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) The amount of a contribution to a pension or annuity plan that is deductible under section 404(a) (1) or (2) depends upon the methods, factors, and assumptions which are used to compute the costs of the plan and the limitation of section 404(a)(1) which is applied. Since the amount that is deductible for one taxable year may affect the amount that is deductible for other taxable years, the methods, factors, and assumptions used in determining costs and the method of determining the limitation which have been used for determining the deduction for a taxable year for which the return has been filed shall not be changed for such taxable year, except when the Commissioner determines that the methods, factors, assumptions, or limitations were not proper, or except when a change is necessitated by reason of the use of different methods, factors, assumptions, or limitations for another taxable year. However, different methods, factors, and assumptions, or a different method of determining the limitation, if they are proper, may be used in determining the deduction for a subsequent taxable year.

(d) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under the plan are deductible by the employer under section 162 (relating to trade or business expenses), or 212 (relating to expenses for production of income) to the extent that they are ordinary and necessary.

(e) In case deductions are allowable under section 404(a)(3), as well as under section 404(a) (1) or (2), the limitations under section 404(a) (1) and (3) are determined and applied without giving effect to the provisions of section 404(a)(7) but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

(f)(1) Amounts contributed by an employer under the plan for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14 must satisfy the general requirements which are applicable to deductions allowable under section 404 and which are set forth in § 1.404(a)–1 including, for example, the requirements described in paragraph (b) of such section. Accordingly, such amounts must constitute an ordinary and necessary expense relating to either the trade or business or the production of income and must not, when added to all other compensation paid by the employer to the employee on whose behalf such a contribution is made, constitute more than reasonable compensation. However, in determining the amount which is deductible with respect to contributions to provide retirement benefits under the plan, amounts contributed for the funding of medical benefits described in section 401(h) shall not be taken into consideration.

(2) The amounts deductible with respect to employer contributions to fund medical benefits described in section 401(h) shall not exceed the total cost of providing such benefits. The total cost of providing such benefits shall be determined in accordance with any generally accepted actuarial method which is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The amount deductible for any taxable year with respect to such cost shall not exceed the greater of—

(i) An amount determined by distributing the remaining unfunded costs of

past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each employee, or

(ii) 10 percent of the cost which would be required to completely fund or purchase such medical benefits.

In determining the amount deductible, an employer must apply either subdivision (i) of this subparagraph for all employees or subdivision (ii) of this subparagraph for all employees. If contributions paid by an employer in a taxable year to fund such medical benefits under a pension or annuity plan exceed the limitations of this subparagraph but otherwise satisfy the conditions for deduction under section 404, then the excess contributions are carried over and are deductible in succeeding taxable years of the employer which end with or within taxable years of the trust for which it is exempt under section 501(a) in order of time to the extent of the difference between the amount paid and deductible in each succeeding year and the limitation applicable to such year under this subparagraph. For purposes of subdivision (i) of this subparagraph, if the remaining future service of an employee is one year or less, it shall be treated as one year.

[T.D. 6500, 25 FR 11685, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 7165, 37 FR 5025, Mar. 9, 1972]

§ 1.404(a)–4 Pension and annuity plans; limitations under section 404(a)(1)(A).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), the initial limitation under section 404(a)(1)(A) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year (other than one described in paragraph (d) of this section) for which the 5-percent figure is not reduced as provided in this section. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return an actuarial certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year. Such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404(a)(1)(C). Whenever requested by the district director, a similar certification and statement shall be submitted for the year or years specified in such request. The district director will make periodical examinations of such data at not less than 5-year intervals. Based upon such examinations the Commissioner will reduce the limitation under section 404(a)(1)(A) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the district director with a request for a change in the limitation. See, however, paragraph (d) of this section with respect to taxable years to which the limitation under section 404(a)(1)(A) does not apply.

(c) For the purpose of limitations under section 404(a)(1)(A), ''compensation otherwise paid or accrued'' means all of the compensation paid or accrued

except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). Where two or more pension or annuity plans cover the same employee, under section 404(a)(1)(A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5-percent limitation applies, deductions under section 404(a)(1)(A) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under section 404(a)(1)(A) even where these are greater than the applicable limitations under section 404(a)(1)(B) or section 404(a)(1)(C).

(d) The limitation under section 404(a)(1)(A) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

[T.D. 6500, 25 FR 11685, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–5 Pension and annuity plans; limitations under section 404(a)(1)(B).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), under section 404(a)(1)(B), deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost attributable to such individuals shall be distributed evenly over a period of at least five taxable years. See, however, paragraph (e) of this section with respect to taxable years to which the limitation under section 404(a)(1)(B) does not apply.

(b) The statutory limitation for any taxable year under section 404(a)(1)(B) is any excess of the amount of the costs described in paragraph (a) of this section for the year over the amount allowable as a deduction under section 404(a)(1)(A).

(c) For this purpose, such excess, adjusted for prior experience, may be computed for each year as follows, all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid, after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under section 404(a)(1)(B) for the year by multiplying

the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under section 404(a)(1)(B) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 1.404(a)–3) and provided subparagraph (5) of this paragraph is not less than five times the annual rate of compensation in effect at the beginning of the year.

(d) Instead of determining the excess deductible under section 404(a)(1)(B) by the method shown in paragraph (c), such excess may be based upon cost determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan, the funding medium, and other applicable considerations.

(e) The limitation under section 404(a)(1)(B) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

[T.D. 6500, 25 FR 11686, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–6 Pension and annuity plans; limitations under section 404(a)(1)(C).

(a) *Application to a taxable year of the employer which ends with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2).* (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust for which it is exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2). See paragraph (b) of this section for rules relating to the limitation under section 404(a)(1)(C) for other taxable years of the employer.

(2) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), in lieu of amounts deductible under the limitations of section 404(a)(1)(A) and section 404(a)(1)- (B), deductions may be allowed under section 404(a)(1)(C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. ''Normal cost'' for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost

as of the date the past service or supplementary credits are provided under the plan. For this purpose, the normal cost may be determined by any generally accepted actuarial method and may be expressed either as (i) the aggregate of level amounts with respect to each employee covered under the plan, (ii) a level percentage of payroll with respect to each employee covered under the plan, or (iii) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but it is subject to adjustments for prior favorable experience. See § 1.404(a)–3. In any case, past service or supplementary costs shall not be included in the limitation for any year in which the amount required to fund fully or to purchase such past service or supplementary credits has been deducted, since no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

(b) *Application to a taxable year of the employer which does not end with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2).* (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which end after the trust or plan has terminated. Since contributions paid in such taxable years of the employer are not deductible under section 404(a) (1) or (2) (except as provided in section 404(a)(6)), the limitation under section 404(a)(1)(C) for such taxable years relates only to the amount of any excess contributions that may be carried over to such taxable years under section 404(a)(1)(D).

(2) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), deductions may be allowed under section 404(a)(1)(C) for taxable years of the employer to which this paragraph applies to the extent of limitations based on past service or supplementary costs of providing benefits under the plan. For definition of the ''past service or supplementary cost at any time'', see paragraph (a)(2) of this section.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. The limitation under section 404(a)(1)(C) is subject, however, to adjustments for prior favorable experience. In any case, no amounts are deductible under section 404(a)(1)(C) for any year to which this paragraph applies if the amount required to fund fully or to purchase the past service or supplementary credits has been deducted in prior taxable years of the employer.

[T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–7 Pension and annuity plans; contributions in excess of limitations under section 404(a)(1); application of section 404(a)(1)(D).

When contributions paid by an employer in a taxable year to or under a pension or annuity plan exceed the limitations applicable under section 404(a)(1) but otherwise satisfy the conditions for deduction under section 404(a) (1) or (2), then in accordance with section 404(a)(1)(D), the excess contributions are carried over and are deductible in succeeding taxable years of the employer in order of time pursuant to the following rules:

(a) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2), such excess contributions are

deductible to the extent of the difference between the amount paid and deductible in such succeeding taxable year and the limitation applicable to such year under section 404(a)(1) (A), (B), or (C).

(b) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated, such excess contributions are deductible to the extent of the limitation applicable to such year under section 404(a)(1)(C) (see paragraph (b) of § 1.404(a)–6).

The provisions of section 404(a)(1)(D) are to be applied before giving effect to the provisions of section 404(a)(7) for any year. The carryover provisions of section 404(a)(1)(D), before effect has been given to section 404(a)(7), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1954:

Taxable Year Ending Dec. 31, 1954	
Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000
Taxable Year Ending Dec. 31, 1955	
Amount of contributions paid in year	$25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000
Taxable Year Ending Dec. 31, 1956	
Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

§ 1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).

(a) If contributions are paid by an employer under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(2) if the further conditions provided therein are satisfied. For the meaning of ''annuity plan'' as used here, see § 1.404(a)–3. In order that contributions by the employer may be deducted under section 404(a)(2), all of the following conditions must be satisfied:

(1) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, survivorship benefits incidental and directly related to such annuities, or medical benefits described in section 401(h) as defined in paragraph (a) of § 1.404(h)–1) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries.

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements set forth in section 401(a) (3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), and (19). In the case of a plan which covers a self-employed individual, the contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it also meets the requrements of section 401(a), (9), (10), (17), and (18) and of section 401(d) (other than paragraph (1)). In the case of a plan which covers a shareholder-employee within the meaning of section 1379(d), the contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it also meets the requirements of section 401(a) (17) and (18). See section 401(a) and the regulations thereunder for the requirements and the applicable effective dates of the respective paragraphs set forth in section 401(a). Any contributions of an employer which are paid in a taxable year of the employer ending with or within a year of the plan for which it meets the applicable requirements of section 401 may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the plan for

which it meets the requirements set out in section 401 (a) and (d). See section 401(b) and the regulations thereunder for special rules allowing certain plan amendments to be given retroactive effect. See section 404(a)(6) for a special rule for determining the time when a contribution is deemed to have been made.

(3) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, survivorship benefits incidental and directly related to such annuities, or medical benefits described in section 401(h) as defined in paragraph (a) of §1.401(h)–1 under the plan. For the purpose of this condition, ''refunds of premiums'' means payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where—

(i) All credits are applied regularly, as they are determined, toward the premiums next due under the contracts before any further employer contributions are so applied, and

(ii) Under the arrangement,

(A) No refund of premiums may be made during continuance of the plan unless applied as aforesaid, and

(B) If refunds of premiums may be made after discontinuance or termination, whichever is applicable, of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service before its discontinuance or termination have been purchased, such refunds will be applied in the taxable year of the employer in which received, or in the next succeeding taxable year, to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 401(a)(4). If the plan also includes medical benefits described in section 401(h) as defined in paragraph (a) of §1.401(h)–1, any refund of premiums attributable to such benefits must, in accordance with these rules, be applied toward the purchase of medical benefits described in section 401(h).

(4) Any amounts described in subparagraph (3) of this paragraph which are attributable to contributions on behalf of a self-employed individual must be applied toward the purchase of retirement benefits. Amounts which are so applied are not contributions and thus are not taken into consideration in determining—

(i) The amount deductible with respect to contributions on his behalf, nor

(ii) In the case of an owner-employee, the maximum amount of contributions that may be made on his behalf.

(b) Where the above conditions are satisfied, the amounts deductible under section 404(a)(2) are governed by the limitations provided in section 404(a)(1). See §§1.404(a)–3 to 1.404(a)–7, inclusive.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42321, Aug. 23, 1977]

§1.404(a)(8)–1T Deductions for plan contributions on behalf of self-employed individuals. (Temporary)

Q: How does the amendment to section 404(a)(8)(D), made by section 713(d)(6) of the Tax Reform Act of 1984 (TRA of 1984), affect section 404(a)(8)(C)?

A: In applying the rules of section 404(a)(8)(C), the Service will treat the amendment to section 404(a)(8)(D) as also having been made to section 404(a)(8)(C), pending enactment of technical corrections to TRA of 1984. The effect of treating the amendment as having also been made to section 404(a)(8)(C) is to increase the amount of contributions on behalf of a self-employed individual that will be treated as satisfying section 162 or 212. Generally, therefore, a contribution on behalf of a self-employed individual is treated as satisfying section 162 or 212 if it is not in excess of the individual's earned income for the year, determined

without regard to the deduction allowed by section 404 for the self-employed individual's contribution.

[T.D. 8073, 51 FR 4321, Feb. 4, 1986]

§ 1.404(a)–9 Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).

(a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under the first, second, or third sentence of section 404(a)(3)(A), the contributions must be paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. Excess contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 404(a)(3)(A), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). This section is also applicable to contributions to a foreign situs profit-sharing or stock bonus trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States.

(b) The amount of deductions under section 404(a)(3)(A) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued by the employer during such taxable year to employees who are beneficiaries under the plan. For purposes of computing this limitation, the following rules are applicable:

(1) In the case of a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, in such taxable year of the employer, are beneficiaries of the trust funds accumulated under the plan.

(2) In the case of a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated, the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), were beneficiaries of the trust funds accumulated under the plan.

For purposes of this paragraph, ''compensation otherwise paid or accrued'' means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). The limitations under section 404(a)(3)(A) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 404(a)(3)(A), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued by the employer during such taxable year to the employees who are beneficiaries under the plan. See paragraph (b) of this section for rules for determining who are the beneficiaries under the plan.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years, where contributions in some taxable year are less than the primary

limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 404(a)(3)(A) for all prior years. Since contributions paid into a profit-sharing or stock bonus trust are deductible under section 404(a)(3)(A) only if they are paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the secondary limitation described in this paragraph is not applicable with respect to determining amounts deductible for a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated. See paragraph (e) of this section for rules relating to amounts which are deductible in such a taxable year.

(e) In any case when the contributions in a taxable year exceed the amount allowable as a deduction for the year under section 404(a)(3)(A), the excess is deductible in succeeding taxable years, in order of time, in accordance with the following limitations:

(1) If the succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a), such excess is deductible in any such succeeding taxable year in which the contributions are less than the primary limitation for that year; but the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such year, or (ii) the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

(2) If the succeeding taxable year ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or if such succeeding taxable year ends after the trust has terminated, the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such succeeding taxable year, or (ii) the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

In no case, however, are excess contributions deductible in a succeeding taxable year if such contributions were not paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a).

(f) In case deductions are allowable under section 404(a) (1) or (2), as well as under section 404(a)(3)(A), the limitations under section 404(a) (1) and (3)(A) are determined and applied without giving effect to the provisions of section 404(a)(7), but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

(g) The provisions of section 404(a)(3)(A) before giving effect to section 404(a)(7), may be illustrated as follows:

ILLUSTRATION OF PROVISIONS OF SECTION 404(A)(3)(A) FOR A PLAN PUT INTO EFFECT IN THE TAXABLE (CALENDAR) YEAR 1954, BEFORE GIVING EFFECT TO SECTION 404(A)(7) (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(A))

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
1. Amount of contributions:							
(i) In taxable year	$65	$10	$15	$100	$70	$40	$30
(ii) Carried over from prior taxable years	0	8	0	0	4	5	3

ILLUSTRATION OF PROVISIONS OF SECTION 404(A)(3)(A) FOR A PLAN PUT INTO EFFECT IN THE TAXABLE (CALENDAR) YEAR 1954, BEFORE GIVING EFFECT TO SECTION 404(A)(7) (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(A))—Continued

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
2. Primary limitation applicable to year:							
15 percent of covered compensation in year [1]	57	54	51	48	45	42	39
3. Secondary limitation applicable to year:							
(i) Twice primary limitation	.....	.....	.....	96	90	84	.....
(ii) (a) Aggregate primary limitations (see item 2)	.....	.....	.....	210	255	297	.....
(b) Aggregate prior deductions (see item 4 (iii))	.....	.....	.....	90	186	255	
(c) Excess of (a) over (b)	.....	.....	.....	120	69	42	.....
(iii) Lesser of (i) or (ii)	.....	.....	.....	96	69	42	.....
4. Amount deductible for year on account of:							
(i) Contributions in year	57	10	15	96	69	40	30
(ii) Contributions carried over	0	8	0	0	0	2	3
(iii) Total	57	18	15	96	69	42	33
5. Excess contributions carried over to succeeding years.	8	0	0	4	5	3	0

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

[T.D. 6500, 25 FR 11687, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 516, Jan. 20, 1961]

§ 1.404(a)–10 Profit-sharing plan of an affiliated group; application of section 404(a)(3)(B).

(a) Section 404(a)(3)(B) allows a corporation a deduction to the extent provided in paragraphs (b) and (c) of this section for a contribution which it makes for another corporation to a profit-sharing plan or a stock bonus plan under which contributions are determined by reference to profits, provided the following tests are met:

(1) The corporation for which the contribution is made and the contributing corporation are members of an affiliated group of corporations as defined in section 1504, relating to the filing of consolidated returns, and both such corporations participate in the plan. However, it is immaterial whether all the members of such group participate in the plan.

(2) The corporation for which the contribution is made is required under the plan to make the contribution, but such corporation is prevented from making such contribution because it has neither current nor accumulated earnings or profits, or because its current and accumulated earnings or profits are insufficient to make the required contribution. To the extent that such a corporation has any current or accumulated earnings or profits, it is not considered to be prevented from making its required contribution to the plan.

(3) The contribution is made out of the current or accumulated earnings or profits of the contributing corporation.

(b) The amount that is deductible under section 404(a)(3)(B) is determined by applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 as if the contribution were made by the corporation for which it is made. For example, the primary limitation described in paragraph (e) of § 1.404(a)–9 is determined by reference to the compensation otherwise paid or accrued to the employees of the corporation for which the contribution is made, and the secondary limitation described in paragraph (d) of § 1.404(a)–9 and the contribution carryover described in paragraph (c) of § 1.404(a)–9 are determined by reference to the prior contributions and deductions of such corporation. The contributing corporation may deduct the amount so determined subject to the limitations contained in paragraph (c) of this section. The contributing corporation shall not treat such amount as a contribution made by it in applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 either for the taxable year

for which the contribution is made or for succeeding taxable years. The corporation for which the contribution is made shall treat the contribution as having been made by it in applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 for succeeding taxable years.

(c) The allowance of the deduction under section 404(a)(3)(B) does not depend upon whether the affiliated group does or does not file a consolidated return. If a consolidated return is filed, it is immaterial which of the participating corporations makes the contribution and takes the deduction or how the contribution or the deduction is allocated among them. However, if a consolidated return is not filed, the contribution which is deductible under section 404(a)(3)(B) by each contributing corporation shall be limited to that portion of its total current and accumulated earnings or profits (adjusted for its contribution deductible without regard to section 404(a)(3)(B)) which the prevented contribution bears to the total current and accumulated earnings or profits of all the participating members of the group having such earnings or profits (adjusted for all contributions deductible without regard to section 404(a)(3)(B)). For the purpose of this section, current earnings or profits shall be computed as of the close of the taxable year without diminution by reason of any dividends during the taxable year, and accumulated earnings or profits shall be computed as of the beginning of the taxable year.

(d) The application of section 404(a)(3)(B) may be illustrated by the following example in which the affiliated group does not file a consolidated return:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A	($10,000)	($140,000)	($150,000)	$200,000	1/5	$6,000	.....	.....	.....	.....
B	(5,000)	105,000	100,000	300,000	3/10	9,000	$9,000	$91,000	6/326× 91,000	$1,674.85
C	75,000	175,000	250,000	500,000	1/2	15,000	15,000	235,000	6/326× 235,000	4,325.15
Total	60,000	140,000	200,000	1,000,000	.....	30,000	24,000	326,000	.....	6,000.00

Column:
(1) Member.
(2) Earnings and profits of the taxable year.
(3) Accumulated earnings and profits at beginning of taxable year.
(4) Total current and accumulated earnings and profits (column 2 plus column 3).
(5) Compensation of participating employees.
(6) Contribution formula: 50 percent of consolidated earnings and profits, allocated among participating member in proportion of covered payroll of each to covered payroll of consolidated group.
(7) Individual contribution had it not been prevented.
(8) Individual contribution made by each employer for its own employees.
(9) Balance of accumulated earnings and profits (column 4 minus column 8).
(10) Proportion of make-up contribution.
(11) Make-up contribution.

[T.D. 6500, 25 FR 11688, Nov. 26, 1960]

§ 1.404(a)–11 Trusts created or organized outside the United States; application of section 404(a)(4).

In order that a trust may constitute a qualified trust under section 401(a) and be exempt under section 501(a), it must be created or organized in the United States and maintained at all times as a domestic trust. See paragraph (a) of § 1.401–1. Paragraph (4) of section 404(a) provides, however, that an employer which is a resident, a corporation, or other entity of the United States, making contributions to a foreign stock bonus, pension, or profit-sharing trust, shall be allowed deductions for such contributions, under the applicable conditions and within the prescribed limits of section 404(a), if such foreign trust would qualify for exemption under section 501(a) except for the fact that it is a trust created, organized, or maintained outside the United States. Moreover, if a nonresident alien individual, foreign corporation, or other entity is engaged in trade or business within the United States and makes contributions to a foreign stock bonus, pension, or profit-sharing trust, which would qualify under section 401(a) and be exempt under section 501(a) except that it is

created, organized, or maintained outside the United States, such contributions are deductible subject to the conditions and limitations of section 404(a) and to the extent allowed by section 873 or 882(c).

[T.D. 6500, 25 FR 11689, Nov. 26, 1960]

§ 1.404(a)–12 Contributions of an employer under a plan that does not meet the requirements of section 401(a); application of section 404(a)(5).

(a) *In general.* Section 404(a)(5) covers all cases for which deductions are allowable under section 404(a) (for contributions paid by an employer under a stock bonus, pension, profit sharing, or annuity plan or for any compensation paid on account of any employee under a plan deferring the receipt of such compensation) but not allowable under paragraph (1), (2), (3), (4), or (7) of such section. For the rules with respect to the taxability of an employee when rights under a nonexempt trust become substantially vested, see section 402(b) and the regulations thereunder.

(b) *Contributions made after August 1, 1969*—(1) *In general.* A deduction is allowable for a contribution paid after August 1, 1969, under section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in his gross income as compensation, and then only to the extent allowable under section 404(a). See §1.404(a)-1. For example, if an employer A contributes $1,000 to the account of its employee E for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includible in E's gross income until his taxable (calendar) year 1980 (at which time the includible amount is $1,150), A's deduction for that contribution is $1,000 in 1980 (if allowable under section 404(a)). For purposes of this (1), a contribution is considered to be so includible where the employee or his beneficiary excludes it from his gross income under section 101(b) or subchapter N. To the extent that property of the employer is transferred in connection with such a contribution, such transfer will constitute a disposition of such property by the employer upon which gain or loss is recognized, except as provided in section 1032 and the regulations thereunder. The amount of gain or loss recognized from such disposition shall be the difference between the value of such property used to measure the deduction allowable under this section and the employer's adjusted basis in such property.

(2) *Special rule for unfunded pensions and certain death benefits.* If unfunded pensions are paid directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case when they are not includible under the other paragraphs of section 404(a).

(3) *Separate accounts for funded plans with more than one employee.* In the case of a funded plan under which more than one employee participates, no deduction is allowable under section 404(a)(5) for any contribution unless separate accounts are maintained for each employee. The requirement of separate accounts does not require that a separate trust be maintained for each employee. However, a separate account must be maintained for each employee to which employer contributions under the plan are allocated, along with any income earned thereon. In addition, such accounts must be sufficiently separate and independent to qualify as separate shares under section 663(c). Nothing shall preclude a trust which loses its exemption under section 501(a) from setting up such acounts and meeting the separate account requirement of section 404(a)(5) with respect to the taxable years in which such accounts are set up and maintained.

(c) *Contributions paid on or before August 1, 1969.* No deduction is allowable under section 404(a)(5) for any contribution paid on or before August 1, 1969, by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid

on account of any employee under plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under section 404(a). See §1.404(a)–1. If payments are made under such a plan and the amounts are not deductible under the other paragraphs of section 404(a), they are deductible under section 404(a)(5) to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. If unfunded pensions are paid directly to former employees, their rights to such payments are nonforfeitable, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case where they are not deductible under the other paragraphs of section 404(a). As to what constitutes nonforfeitable rights of an employee in other cases, see §1.402(b)–1(d)(2). If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amount are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 7554, 43 FR 31926, July 24, 1978]

§1.404(a)–13 Contributions of an employer where deductions are allowable under section 404(a) (1) or (2) and also under section 404(a)(3); application of section 404(a)(7).

(a) Where deductions are allowable under section 404(a) (1) or (2) on account of contributions under a pension or annuity plan and deductions are also allowable under section 404(a)(3) for the same taxable year on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 404(a)(7) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 404(a) (1) or (2) is also a beneficiary under the trusts for which deductions are allowable under section 404(a)(3). The provisions of section 404(a)(7) apply only to deductions for overlapping trusts or plans, *i.e.*, for all trusts or plans for which deductions are allowable under section 404(a) (1), (2), or (3) except (1) any trust or plan for which deductions are allowable under section 404(a) (1) or (2) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 404(a) (3), and (2) any trust for which deductions are allowable under section 404(a)(3) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 404(a) (1) or (2). The limitations under section 404(a)(7) for any taxable year of the employer are based on the compensation otherwise paid or accrued during the year by the employer to all employees who, in such year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans. For purposes of the preceding sentence, if the taxable year of the employer with respect to which the limitation is being computed ends with or within a taxable year of any of the overlapping trusts or plans during which any such trust is not exempt under section 501(a) or, in the case of a plan, during which it does not meet the requirements of section 404(a)(2), or if such taxable year of the employer ends after any such trust or plan has terminated, then, with respect to such trust or plan, those employees, and only those employees, who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), or the plan met the requirements of section 404(a)(2), were beneficiaries of the funds accumulated under such trust or plan shall be considered the beneficiaries of such trust or plan in the taxable year of the employer with respect to which the limitation is being computed. For purposes of this paragraph, ''compensation

otherwise paid or accrued'' means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2).

(b) Under section 404(a)(7), any excess of the total amount otherwise deductible for the taxable year under section 404(a) (1), (2), or (3) as contributions to overlapping trusts or plans over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans, is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deduction for contributions to such trusts or plans for a succeeding taxable year is equal to the lesser of—

(1) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(2) The sum of (i) the smaller of (*a*) 25 percent of the compensation otherwise paid or accrued during the taxable year to all employees who are beneficiaries under such trusts or plans in the year, or (*b*) the total of the amounts otherwise deductible under section 404(a) (1), (2), or (3) for the year for such trusts or plans and (ii) any carryover to the year from prior years under section 404(a)(7), i.e., any excess otherwise deductible under section 404(a) (1), (2), or (3), but not deducted for a prior taxable year because of the limitations under section 404(a)(7).

(c) The limitations under section 404(a)(7) are determined and applied after all the limitations, deductions otherwise allowable, and carryovers under section 404(a) (1), (2), and (3) have been determined and applied, and, in particular, after effect has been given to the carryover provision in section 404(a)(1)(D) and in the second and third sentences of section 404(a)(3)(A). Where the limitations under section 404(a)(7) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carryover which is distinct from, and additional to, any excess contributions carried over and deductible in succeeding years under the provisions in section 404(a)(1)(D) or in the third sentence of section 404(a)(3)(A). The application of the provisions of section 404(a)(7) and the treatment of carryovers for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1954 and covering the same employees may be illustrated as follows:

ILLUSTRATION OF APPLICATION OF PROVISIONS OF SECTION 404(A)(7) AND OF TREATMENT OF CARRYOVERS FOR OVERLAPPING PENSION AND PROFIT-SHARING TRUSTS PUT INTO EFFECT IN 1954 AND COVERING THE SAME EMPLOYEES (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS OF THE EMPLOYER ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(A))

	Taxable calendar years			
	1954	1955	1956	1957
BEFORE GIVING EFFECT TO SECTION 404(a)(7)				
Pension trust contributions and limitations, deductions, and carryovers under section 404(a)(1):				
1. Contributions paid in year	$215	$85	$140	$60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	215	90	140	80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	5	0	20	0
Profit-sharing trust contributions and limitations, deductions, and carryovers under section 404(a)(3):				
7. Contributions paid in year	200	125	105	65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for year subject to limitation	200	160	115	65
10. Limitation applicable to year	165	150	135	[1] 110

ILLUSTRATION OF APPLICATION OF PROVISIONS OF SECTION 404(A)(7) AND OF TREATMENT OF CARRYOVERS FOR OVERLAPPING PENSION AND PROFIT-SHARING TRUSTS PUT INTO EFFECT IN 1954 AND COVERING THE SAME EMPLOYEES (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS OF THE EMPLOYER ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(A))—Continued

	Taxable calendar years			
	1954	1955	1956	1957
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	35	10	0	0
APPLICATION OF SECTION 404(a)(7)				
Totals for pension and profit-sharing trust:				
13. Amount deductible for year under section 404(a)(7):				
(1) 30 percent of compensation covered in year [2]	([3])	300	270	180
(2) (i) (a) 25 percent of compensation covered in year [2]	275	250	225	150
(b) Total amount otherwise deductible for year: item 5 plus item 11	375	240	235	145
(c) Smaller of (a) or (b)	275	240	225	145
(ii) Carryover from prior years under section 404(a)(7)	0	100	40	10
(iii) Sum of (i)(c) and (ii)	275	340	265	155
(3) Amount deductible: Lesser of (1) or (2)(iii)	275	300	265	155
14. Carryover to succeeding years under section 404(a)(7): item 13(2)(ii) plus item 3(2)(i)(b) minus item 13(3)	100	40	10	0

[1] Includes carryover of 20 from 1956.
[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.
[3] 30 percent limitation not applicable to first year of plan.

[T.D. 6500, 25 FR 11689, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 517, Jan. 20, 1961]

§ 1.404(a)–14 Special rules in connection with the Employee Retirement Income Security Act of 1974.

(a) *Purpose of this section*. This section provides rules for determining the deductible limit under section 404(a)(1)(A) of the Internal Revenue Code of 1954 for defined benefit plans.

(b) *Definitions*. For purposes of this section—

(1) *Section 404(a)*. The term ''old section 404(a)'' means section 404(a) as in effect on September 1, 1974. Any reference to section 404 without the designation ''old'' is a reference to section 404 as amended by the Employee Retirement Income Security Act of 1974.

(2) *Ten-year amortization base*. The term ''10-year amortization base'' means either the past service and other supplementary pension and annuity credits described in section 404(a)(1)(A)(iii) or any base established in accordance with paragraph (g) of this section. A plan may have several 10-year amortization bases to reflect different plan amendments, changes in actuarial assumptions, changes in funding method, and experience gains and losses of previous years.

(3) *Limit adjustment*. The term ''limit adjustment'' with respect to any 10-year amortization base is the lesser of—

(i) The level annual amount necessary to amortize the base over 10 years using the valuation rate, or

(ii) The unamortized balance of the base,

in each case using absolute values (solely for the purpose of determining which is the lesser). To compute the level amortization amount, the base may be divided by the present value of an annuity of one dollar, obtained from standard annuity tables on the basis of a given interest rate (the valuation rate) and a known period (the amortization period).

(4) *Absolute value*. The term ''absolute value'' for any number is the value of that number, treating negative numbers as if they were positive numbers. For example, the absolute value of 5 is 5 and the absolute value of minus 3 is 3. On the other hand, the true value of

minus 3 is minus 3. This term is relevant to the computation of the limit adjustment described in paragraph (b)(3) and the remaining amortization period of combined bases described in paragraph (i)(3) of this section.

(5) *Valuation rate.* The term ''valuation rate'' means the assumed interest rate used to value plan liabilities.

(c) *Use of plan in determining deductible limit for employer's taxable year.* Although the deductible limit applies for an employer's taxable year, the deductible limit is determined on the basis of a plan year. If the employer's taxable year coincides with the plan year, the deductible limit for the taxable year is the deductible limit for the plan year that coincides with that year. If the employer's taxable year does not coincide with the plan year, the deductible limit under section 404(a)(1)(A) (i), (ii), or (iii) for a given taxable year of the employer is one of the following alternatives:

(1) The deductible limit determined for the plan year commencing within the taxable year.

(2) The deductible limit determined for the plan year ending within the taxable year, or

(3) A weighted average of alternatives (1) and (2). Such an average may be based, for example, upon the number of months of each plan year falling within the taxable year.

The employer must use the same alternative for each taxable year unless consent to change is obtained from the Commissioner under section 446 (e).

(d) *Computation of deductible limit for a plan year*—(1) *General rules.* The computation of the deductible limit for a plan year is based on the funding methods, actuarial assumptions, and benefit structure used for purposes of section 412, determined without regard to section 412(g) (relating to the alternative minimum funding standard), for the plan year. The method of valuing assets for purposes of section 404 must be the same method of valuing assets used for purposes of section 412.

(2) *Special adjustments of computations under section 412.* To apply the rules of this section (*i.e.*, rules regarding the computation of normal cost with aggregate type funding methods, unfunded liabilities, and the full funding limitation described in paragraph (k) of the section, where applicable) with respect to a given plan year in computing deductible limits under section 404 (a)(1)(A), the following adjustments must be made:

(i) There must be excluded from the total assets of the plan the amount of any plan contribution for a plan year for which the plan was qualified under section 401(a), 403(a) or 405(a) that has not been previously deducted, even though that amount may have been credited to the funding standard account under section 412(b)(3). In the case of a plan using a spread gain funding method which maintains an unfunded liability (e.g., the frozen initial liability method, but not the aggregate method), the amount described in the preceding sentence must be included in the unfunded liability of the plan.

(ii) There must be included in the total assets of the plan for a plan year the amount of any plan contribution that has been deducted with respect to a prior plan year, even though that amount is considered under section 412 to be contributed in a plan year subsequent to that prior plan year. In the case of a plan using a spread gain funding method which does not maintain an unfunded liability, the amount described in the preceding sentence must be excluded from the unfunded liability of the plan.

The special adjustments described in paragraph (d)(2) (i) and (ii) of this section apply on a year-by-year basis for purposes of section 404(a)(1)(A) only. Thus, the adjustments have no effect on the computation of the minimum funding requirement under section 412.

(e) *Special computation rules under section 404(a)(1)(A)(i)*—(1) *In general.* For purposes of determining the deductible limit under section 404(a)(1)(A)(i), the deductible limit with respect to a plan year is the sum of—

(i) The amount required to satisfy the minimum funding standard of section 412(a) (determined without regard to section 412(g)) for the plan year and

(ii) An amount equal to the includible employer contributions. The term ''includible employer contributions'' means employer contributions which were required by section 412 for the plan year immediately preceding such

plan year, and which were not deductible under section 404(a) for the prior taxable year of the employer solely because they were not contributed during the prior taxable year (determine with regard to section 404(a)(6)).

(2) *Rule for an employer using alternative minimum funding standard account and computing its deduction under section 404(a)(1)(A)(i).* This paragraph (e)(2) applies if the minimum funding requirements for the plan are determined under the alternative minimum funding standard described in section 412(g) for both the current plan year and the immediately preceding plan year. In that case, the deductible limit under section 404(a)(1)(A)(i) (regarding the minimum funding requirement of section 412) for the current year is the sum of the amount determined under the rules of paragraph (e)(1) of this section.

(i) Plus the charge under section 412(b)(2)(D), and

(ii) Less the credit under section 412(b)(3)(D),

that would be required if in the current plan year the use of the alternative method were discontinued.

(f) *Special computation rules under section* 404(a)(1)(A) (ii) and (iii)—(1) *In general.* Subject to the full funding limitation described in paragraph (k) of this section, the deductible limit under section 404(a)(1)(A)(ii) and (iii) is the normal cost of the plan (determined in accordance with paragraph (d) of this section).

(2) *Adjustments in calculating limit under section 404 (a)(1)(A)(iii).* In calculating the deductible limit under section 404(a)(1)(A)(iii), the normal cost of the plan is—

(i) Decreased by the limit adjustments to any unamortized bases required by paragraph (g) of this section, for example, bases that are due to a net experience gain, a change in actuarial assumptions, a change in funding method, or a plan provision or amendment which decreases the accrued liability of the plan, and

(ii) Increased by the limit adjustments of any unamortized 10-year amortization bases required by paragraph (g) or (j) of this section, for example, bases that are due to a net experience loss, a change in actuarial assumptions, a change in funding method, or a plan provision or amendment which increases the accrued liability.

(3) *Timing for computations and interest adjustments under section 404(a)(1)(A) (ii) and (iii).* Regardless of the actual time when contributions are made to a plan, in computing the deductible limit under section 404(a)(1)(A) (ii) and (iii) the normal cost and limit adjustments shall be computed as of the date when contributions are assumed to be made (''the computation date'') and adjusted for interest at the valuation rate from the computation date to the earlier of—

(i) The last day of the plan year used to compute the deductible limit for the taxable year, or

(ii) The last day of that taxable year. For additional provisions relating to the timing of computations and interest adjustments, see paragraph (h)(6) of this section (relating to the timing of computations and interest adjustments in the maintenance of 10-year amortization bases). For taxable years beginning before April 22, 1981, computations under the preceding sentence may, as an alternative, be based on prior published positions of the Internal Revenue Service under section 404(a).

(4) *Special limit under section 404(a)(1)(A)(ii).* If the deduction for the plan year is determined solely on the basis of section 404(a)(1)(A)(ii) (that is, without regard to clauses (i) or (iii)), the special limitation contained in section 404(a)(1)(A)(ii), regarding the unfunded cost with respect to any three individuals, applies, notwithstanding the rules contained in paragraphs (d)(2) and (f)(1) of this section.

(g) *Establishment of a 10-year amortization base*—(1) *Experience gains and losses.* In the case of a plan valued by the use of a funding method which is an immediate gain type of funding method (and therefore separately amortizes rather than includes experience gains and losses as a part of the normal cost of the plan), a 10-year amortization base must be established in any plan year equal to the net experience gain or loss required under section 412 to be determined with respect to that plan year. The base is to be maintained in accordance with paragraph (h) of this section. Such a base must not be established if

the deductible limit is determined by use of a funding method which is a spread gain type of funding method (under which experience gains and losses are spread over future periods as a part of the plan's normal cost). Examples of the immediate gain type of funding method are the unit credit method, entry age normal cost method, and the individual level premium cost method. Examples of the spread gain type of funding method are the aggregate cost method, frozen initial liability cost method, and the attained age normal cost method.

(2) *Change in actuarial assumptions.* (i) If the creation of an amortization base is required under the rules of section 412(b) (2)(B)(v) or (3)(B)(iii) (as applied to the funding method used by the plan), a 10-year amortization base must be established at the time of a change in actuarial assumptions used to value plan liabilities. The amount of the base is the difference between the accrued liability calculated on the basis of the new assumptions and the accrued liability calculated on the basis of the old assumptions. Both computations of accrued liability are made as of the date of the change in assumptions.

(ii) A plan using a funding method of the spread gain type does not directly determine an accrued liability. If a plan using such a method is required under section 412(b) (2)(B)(v) or (3)(B)(iii) to create an amortization base, it must establish a base as described in paragraph (g)(2)(i) of this section for a change in actuarial assumptions by determining an accrued liability on the basis of another funding method (of the immediate gain type) that does determine an accrued liability. (The aggregate method is an example of a funding method that is not required under section 412(b) (2)(B)(v) or (3)(B)(iii) to create an amortization base.) The funding method chosen to determine the accrued liability of the plan in these cases must be the same method used to establish all other 10-year amortization bases maintained by the plan, if any. These bases must be maintained in accordance with paragraph (h) of this section.

(3) *Past service or supplemental credits.* A 10-year base must be established when a plan is established or amended, if the creation of an amortizable base is required under the rules of section 412(b)(2)(B) (ii) or (iii), or (b)(3)(B)(i) (as applied to the funding method used by the plan). The amount of the base is the accrued liability arising from, or the decrease in accrued liability resulting from, the establishment or amendment of the plan. The base must be maintained in accordance with paragraph (h) of this section.

(4) *Change in funding method.* If a change in funding method results in an increase or decrease in an unfunded liability required to be amortized under section 412, a 10-year base must be established equal to the increase or decrease in unfunded liability resulting from the change in funding method. The base must be maintained in accordance with paragraph (h) of this section.

(h) *Maintenance of 10-year amortization base*—(1) *In general.* Each time a 10-year amortization base is established, whether by a change in funding method, by plan amendment, by change in actuarial assumptions, or by experience gains and losses, the base must, except as provided in paragraph (i) of this section, be separately maintained in order to determine when the unamortized amount of the base is zero. The sum of the unamortized balances of all of the 10-year bases must equal the plan's unfunded liability with the adjustments described in paragraph (d) of this section, if applicable. When the unamortized amount of a base is zero, the deductible limit is no longer adjusted to reflect the amortization of the base.

(2) *First year's base.* See either paragraph (g) or paragraph (i) of this section for rules applicable with respect to the first year of a base.

(3) *Succeeding year's base.* For any plan year after the first year of a base, the unamortized amount of the base is equal to—

(i) The unamortized amount of the base as of the valuation date in the prior plan year, plus

(ii) Interest at the valuation rate from the valuation date in the prior plan year to the valuation date in the current plan year on the amount described in subdivision (i), minus

(iii) The contribution described in paragraph (h)(4) of this section with respect to the base for the prior plan year.

The valuation date is the date as of which plan liabilities are valued under section 412(c)(9). If such a valuation is performed less often than annually for purposes of section 412, bases must be adjusted for purposes of section 404 each year as of the date on which a section 412 valuation would be performed were it required on an annual basis. See paragraph (b)(3) of this section for the definition of valuation rate.

(4) *Contribution allocation with respect to each base.* A portion of the total contribution for the prior plan year is allocated to each base. Generally, this portion equals the product of—

(i) The total contribution described in paragraph (h)(6) of this section with respect to all bases, and

(ii) The ratio of the amount described in paragraph (b)(3)(i) of this section with respect to the base to the sum (using true rather than absolute values) of such amounts with respect to all remaining bases.

However, if the result of this computation with respect to a particular base exceeds the amount necessary to amortize such base fully, the smaller amount shall be deemed the contribution made with respect to such base. The unallocated excess with respect to a now fully amortized base shall be allocated among the other bases as indicated above.

(5) *Other allocation methods.* The Commissioner may authorize the use of methods other than the method described in paragraph (h)(4) of this section for allocating contributions to bases.

(6) *Total contribution for all bases.* The contribution with respect to all bases for the prior plan year (see paragraph (h)(3)(iii) of this section) is the difference between—

(i) The sum of (A) the total deduction (including a carryover deduction) for the prior year, (B) interest on the actual contributions for the prior year (whether or not deductible) at the valuation rate for the period between the dates as of which the contributions are credited under section 412 and the valuation date in the current plan year, and (C) interest on the carryover described in section 404(a)(1)(D) that is available at the beginning of the prior taxable year at the valuation rate for the period between the current and prior valuation dates, and

(ii) The normal cost for the prior plan year and interest on it at the valuation rate from the date as of which the normal cost is calculated to the current valuation date.

(7) *Effect of failure to contribute normal cost plus interest on unamortized amounts.* The failure to make a contribution at least equal to the sum of the normal cost plus interest on the unamortized amounts has the following effects under the preceding rules of this section—

(i) It does not create a new base.

(ii) It results in an increase in the unamortized amount of each base and consequently extends the time before the base is fully amortized.

(iii) The limit adjustment for any base is not increased (in absolute terms) even if the unamortized amount computed under paragraph (h) of this section exceeds the initial 10-year amortization base. Thus, if the total unamortized amount of the plan's bases at the beginning of the plan year is $100,000 (which is also the unfunded liability of the plan), and a required $50,000 normal cost contribution is not made for the plan year, the following effects occur. The total unamortized balance of the plan's bases increases by the $50,000 normal cost for the year (adjusted for interest), plus interest on the $100,000 balance of the bases; and, because of that increase, it will take a longer period to amortize the remaining balance of the bases. (The annual amortization amount does not change.)

(8) *Required adjustment to a 10-year base limit adjustment if valuation rate changed.* If there is a change in the valuation rate, the limit adjustment for all unamortized 10-year amortization bases must be changed, in addition to establishing a new base as provided in paragraph (g)(2) of this section. The new limit adjustment for any base is the level amount necessary to amortize the unamortized amount of the base over the remaining amortization period using the new valuation rate. The remaining amortization period of the

base is the number of years at the end of which the unamortized amount of the base would be zero if the contribution made with respect to that base equaled the limit adjustment each year. This calculation of the remaining period is made on the basis of the valuation rate used before the change. Both the remaining amortization period and the revised limit adjustment may be determined through the use of standard annuity tables. The remaining period may be computed in terms of fractional years, or it may be rounded off to a full year. The unamortized amount of the base as of the valuation date and the remaining amortization period of that base shall not be changed by any change in the valuation rate.

(i) *Combining bases*—(1) *General method*. For purposes of section 404 only, and not for purposes of section 412, different 10-year amortization bases may be combined into a single 10-year amortization base if such single base satisfies all of the requirements of paragraph (i) (2), (3), and (4) of this section at the time of the combining of the different bases.

(2) *Unamortized amount*. The unamortized amount of the single base equals the sum, as of the date the combination is made, of the unamortized amount of the bases being combined (treating negative bases as having negative unamortized amounts).

(3) *Remaining amortization period*. The remaining amortization period of the single base is equal to (i) the sum of the separate products of (A) the unamortized amount of each of these bases (using absolute values) and (B) its remaining amortization period, divided by (ii) the sum of the unamortized amounts of each of the bases (using absolute values). For purposes of this paragraph (i)(3), the remaining amortization period of each base being combined is that number of years at the end of which the unamortized amount of the base would be zero if the contribution made with respect to that base equaled the limit adjustment of that base in each year. This number may be determined through the use of standard annuity tables. The remaining amortization period described in this paragraph may be computed in terms of fractional years, or it may be rounded off to a whole year.

(4) *Limit adjustment*. The limit adjustment for the single base is the level amount necessary to amortize the unamortized amount of the combined base over the remaining amortization period described in paragraph (i)(3) of this section, using the valuation rate. This amount may be determined through the use of standard annuity tables.

(5) *Fresh start alternative*. In lieu of combining different 10-year amortization bases, a plan may replace all existing bases with one new 10-year amortization base equal to the unfunded liability of the plan as of the time the new base is being established. This unfunded liability must be determined in accordance with the general rules of paragraphs (d) and (f) of this section. The unamortized amount of the base and the limit adjustment for the base will be determined as though the base were newly established.

(j) *Initial 10-year amortization base for existing plan*—(1) *In general*. In the case of a plan in existence before the effective date of section 404(a), the 10-year amortization base on the effective date of section 404(a) is the sum of all 10 percent bases existing immediately before section 404(a) became effective for the plan, determined under the rules of old section 404(a).

(2) *Limit adjustment*. The limit adjustment for the initial base is the lesser of the unamortized amount of such base or the sum of the amounts determined under paragraph (b)(3) of this section using the original balances of the remaining bases (under old section 404(a) rules) as the amount to be amortized.

(3) *Unamortized amount*. The employer may choose either to establish a single initial base reflecting both all prior 10-percent bases and the experience gain or loss for the immediately preceding actuarial period, or to establish a separate base for the prior 10-percent bases and another for the experience gain or loss for the immediately preceding period. If the initial 10-year amortization base reflects the net experience gain or loss from the immediately preceding actuarial period, the unamortized amount of the initial base shall equal

the total unfunded liability on the effective date of section 404(a) determined in accordance with the general rules of paragraphs (d) and (f) of this section. If, however, a separate base will be used to reflect that gain or loss, the unamortized amount of the initial base shall equal such unfunded liability on the effective date of section 404(a), reduced by the net experience loss or increased by the net experience gain for the immediately preceding actuarial period. In this case, a separate 10-year amortization base must be established on the effective date equal to the net experience gain or loss. Thus, if the effective date unfunded liability is $100,000 and an experience loss of $15,000 is recognized on that date, and if the loss is to be treated as a separate base, the unamortized balances of the two bases would be $85,000 and $15,000. If the unfunded liability were the same $100,000, but a gain of $15,000 instead of a loss were recognized on that date, the unamortized balances of the two bases would be $115,000 and a credit base of $15,000. In both cases, if only one 10-year base is to be established on the effective date, its unamortized balance would be $100,000 (the unfunded liability of the plan). See paragraphs (d) and (f) for rules for determining the unfunded liability of the plan.

(k) *Effect of full funding limit on 10-year-amortization bases.* The amount deductible under section 404(a)(1)(A) (i), (ii), or (iii) for a plan year may not exceed the full funding limitation for that year. See section 412 and paragraphs (d), (e), and (f) of this section for rules to be used in the computation of the full funding limitation. If the total deductible contribution (including carryover) for a plan year equals or exceeds the full funding limitation for the year, all 10-year amortization bases maintained by the plan will be considered fully amortized, and the deductible limit for subsequent plan years will not be adjusted to reflect the amortization of these bases.

(l) *Transitional rules*—(1) *Plan years beginning before April 22, 1981.* In determining the deductible limit for plan years beginning before April 22, 1981, a contribution will be deductible under section 404(a)(1)(A) if the computation of the deductible limit is based on an interpretation of section 404(a)(1)(A) that is reasonable when considered with prior published positions of the Internal Revenue Service. A computation of the deductible limit may satisfy the preceding sentence even if it does not satisfy the rules contained in paragraphs (c) through (i) of this section.

(2) *Transitional approaches.* The deductible limit determined for the first plan year with respect to which a plan applies the rules contained in paragraphs (c) through (i) of this section must be computed using one of the following approaches—

(i) The plan (whether or not in existence before the effective date of section 404(a)) may apply the rules of paragraph (j) for establishing the initial base for an existing plan, treating 10-year bases (if any) as 10 percent bases in adding bases.

(ii) The plan may apply the fresh start alternative for combining bases under paragraph (i)(5).

(iii) The plan may retroactively establish 10-year amortization bases for years with respect to which section 404(a)(1)(A) and the rules of this section would have applied but for the transition rule contained in paragraph (l)(1) of this section. Contributions actually deducted are used in retroactively establishing and maintaining these bases under paragraph (h). However, a deduction already taken shall not be recomputed because of the retroactive establishment of a base.

(m) *Effective date of section 404(a).* In the case of a plan which was in existence on January 1, 1974, section 404(a) generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after December 31, 1974. In the case of a plan not in existence on January 1, 1974, section 404(a) generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after September 4, 1974. See §1.410(a)–2(c) for rules concerning the time of plan existence. See also §1.410(a)–2(d), which provides that a plan in existence on January 1, 1974, may elect to have certain provisions, including the amendments to section 404(a) contained in section 1013 of the Employee Retirement Income Security Act of

1974, apply to a plan year beginning after September 2, 1974, and before the otherwise applicable effective date contained in that section.

[T.D. 7760, 46 FR 6914, Jan. 22, 1981; 46 FR 15685, Mar. 9, 1981]

§ 1.404(b)–1 Method of contribution, etc., having the effect of a plan; effect of section 404(b).

Section 404(a) is not confined to formal stock bonus, pension, profit- sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to a retired employee or employees or to their beneficiaries in such amounts as may be determined from time to time by the board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee or his beneficiaries, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 404(a). If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

[T.D. 6500, 25 FR 11690, Nov. 26, 1960]

§ 1.404(b)–1T Method or arrangement of contributions, etc., deferring the receipt of compensation or providing for deferred benefits. (Temporary)

Q–1: As amended by the Tax Reform Act of 1984, what does section 404(b) of the Internal Revenue Code provide?

A–1: As amended, section 404(b) clarifies that any plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits (other than compensation) is to be treated as a plan deferring the receipt of compensation for purposes of section 404 (a) and (d). Accordingly, section 404 (a) and (d) (in the case of employees and nonemployees; respectively) shall govern the deduction of contributions paid or compensation paid or incurred with respect to such a plan, or method or arrangement. Section 404 (a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. Thus, for example, under section 404 (a)(5) and (b), if otherwise deductible under section 162 or 212, a contribution paid or incurred with respect to a nonqualified plan, or method or arragement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusion under Chapter 1, Subtitle A, of the Internal Revenue Code). Section 404 (a) and (d) applies to all compensation and benefit plans, or methods or arrangements, however denominated, which defer the receipt of any amount of compensation or benefit, including fees or other payments. Thus, a limited partnership (using the accrual method of accounting) may not accrue deductions for a fee owed to an unrelated person (using the cash method of accounting) who performs services for the partnership until the partnership taxable year in which or with which ends the taxable year of the service provider in which the fee is included in income. However, notwithstanding the above,

section 404 does not apply to contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, §1.419–1T and §1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see §301.9100–16T of this chapter and §1.463–1T.

Q–2: When does a plan, or method or arrangement, defer the receipt of compensation or benefits for purposes of section 404 (a), (b), and (d)?

A–2: (a) For purposes of section 404 (a), (b), and (d), a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. The determination of whether a plan, or method or arrangement, defers the receipts of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit. Compensation or benefits received by an employee's spouse or dependent or any other person, but taxable to the employee, are treated as received by the employee for purposes of section 404. An employee is determined to receive compensation or benefits within or beyond a brief period of time after the end of the employer's taxable year under the rules provided in this Q&A. For the treatment of expenses with respect to transactions between related taxpayers, see section 267.

(b)(1) A plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered (''the 2½ month period''). Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation, to the extent that the salary or bonus is received beyond the applicable 2½ month period. Further, salary or a year-end bonus received beyond the applicable 2½ month period by one employee shall be presumed to constitute payment under a plan, or method or arrangement, deferring the receipt of compensation for such employee even though salary or bonus payments to all other employees are not similarly treated because they are received within the 2½ month period. Benefits are ''deferred benefits'' if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation. Thus, a plan, or method or arrangement, shall be presumed to be one providing for deferred benefits to the extent benefits for services are received by an employee after the 2½ month period following the end of the employer's taxable year in which the related services are rendered.

(2) The taxpayer may rebut the presumption established under the previous subparagraph with respect to an amount of compensation or benefits only by setting forth facts and circumstances the preponderance of which demonstrates that it was impracticable, either administratively or economically, to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2½ month period and that, as of the end of the employer's taxable year such impracticability was unforeseeable. For example, the presumption may be rebutted with respect to an amount of compensation to the extent that receipt of such amount is deferred beyond the applicable 2½ month period (i) either because the funds of the employer were not sufficient to make the payment within the 2½ month period without jeopardizing the solvency of the employer or because it was not reasonably possible to determine within the 2½ month period whether payment of such amount was to be made, and (ii) the circumstance causing the deferral

described in (i) was unforeseeable as of the close of the employer's taxable year. Thus, the presumption with respect to the receipt of an amount of compensation or benefit is not rebutted to the extent it was foreseeable, as of the end of the employer's taxable year, that the amount would be received after the applicable 2½ month period. For example, if, as of the end of the employer's taxable year, it is foreseeable that calculation of a year-end bonus to be paid to an employee under a given formula will not be completed and thus the bonus will not be received (and is in fact not received) by the end of the applicable 2½ month period, the presumption that the bonus is deferred compensation is not rebutted.

(c) A plan, or method or arrangement, shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2½ month period. Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is not considered paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that such salary or bonus is received by the employee on or before the end of the applicable 2½ month period.

(d) Solely for purposes of applying the rules of paragraphs (b) and (c) of this Q&A, in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986, compensation or benefits that relate to services rendered in such taxable year shall be deemed to have been received within the applicable 2½ month period if such receipt actually occurs after such 2½ month period but on or before March 21, 1986.

Q–3: When does section 404(b), as amended by the Tax Reform Act of 1984, become effective?

A–3: With the exceptions discussed below, section 404(b), as amended, and the rules under Q&A–2 are effective with respect to amounts paid or incurred after July 18, 1984, in taxable years of employers (and payors) ending after that date. In the case of an extended vacation pay plan maintained pursuant to a collective bargaining agreement (a) between employee representatives and one or more employers, and (b) in effect on June 22, 1984, section 404(b) is not effective before the date on which such collective bargaining agreement terminates (determined without regard to any extension thereof agreed to after June 22, 1984). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 512 of the Tax Reform Act of 1984 shall not be treated as a termination of such collective bargaining agreement. For purposes of this section, an ''extended vacation pay plan'' is one under which covered employees gradually over a specified period of years earn the right to additional vacation benefits, no part of which, under the terms of the plan, can be taken until the end of the specified period.

[T.D. 8073, 51 FR 4321, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986; 51 FR 11303, Apr. 2, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.404(c)–1 Certain negotiated plans; effect of section 404(c).

(a) Section 404(a) does not apply to deductions for contributions paid by an employer under a negotiated plan which meets the following conditions:

(1) The contributions under the plan are held in trust for the purpose of paying, either from principal or income or both, for the benefit of employees and their families, at least medical or hospital care, and pensions on retirement or death of employees; and

(2) Such plan was established before January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged.

If these conditions are met, such contributions shall be deductible under section 162, to the extent that they constitute ordinary and necessary business expenses.

(b) The term ''as a result of an agreement'' is intended primarily to cover a trust established under the terms of an agreement referred to in paragraph (a)(2) of this section. It will also include a trust established under a plan of an employer, or group of employers, who are in competition with the employers whose facilities were seized by reason of producing the same commodity, and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. Thus, for example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established about the same time in the anthracite coal industry would be covered by this provision.

(c) If any such trust becomes qualified for exemption under section 501(a), the deductibility of contributions by an employer to such trust on or after the date of such qualification would no longer be governed by section 404(c), even though the trust may later lose its exemption under section 501(a).

[T.D. 6500, 25 FR 11690, Nov. 26, 1960]

§ 1.404(d)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for independent contractors. (Temporary)

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of contributions or compensation under section 404(d)?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(d) shall govern the deduction of contributions paid and compensation paid or incurred by a payor under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits for service providers with respect to which there is no employer-employee relationship. In such a case, section 404 (a) and (b) and the regulations thereunder apply as if the person providing the services were the employee and the person to whom the services are provided were the employer. Section 404(a) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in section 419(e)) after June 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected under such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, § 1.419–1T and § 1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 301.9100–16T of this chapter and § 1.463–1T.

[T.D. 8073, 51 FR 4322, Feb. 4, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.404(e)–1 Contributions on behalf of a self-employed individual to or under a pension, annuity, or profit-sharing plan meeting the requirements of section 401; application of section 404(a) (8), (9), and (10) and section 404 (e) and (f).

(a) *In general.* (1) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits certain self-employed individuals to be treated as employees for purposes of pension, annuity, and profit-sharing plans included in paragraph (1), (2), or (3) of section 404(a). Therefore, for taxable years of an employer beginning after December 31, 1962, employer contributions to qualified plans on behalf of self-employed individuals are deductible under section 404 subject to the limitations of paragraphs (b) and (c) of this section.

(2) In the case of contributions to qualified plans on behalf of self-employed individuals, the amount deductible differs from the amount allowed as a deduction. In general, the amount deductible is 10 percent of the earned income derived by the self-employed individual from the trade or business with respect to which the plan is established, or $2,500, whichever is the lesser. This is the amount referred to in section 401 when reference is made to the amounts which may be deducted

under section 404 or the amount of contributions deductible under section 404. Thus, this is the amount taken into consideration in determining whether contributions under the plan are discriminatory. The amount allowed as a deduction with respect to contributions on behalf of a self-employed individual is one-half of the amount deductible. The amount allowed as a deduction is relevant only for purposes of determining the amount an employer may deduct from gross income.

(b) *Determination of the amount deductible*. (1) If a plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See paragraph (f) of this section. For the additional rules applicable where contributions are made by more than one employer on behalf of a self-employed individual, see paragraph (d) of this section.

(2) If contributions are made to a plan included in section 404(a) (1), (2), or (3) on behalf of employees, some of whom are self-employed individuals, the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of section 404(a) (1), (3), and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer to the common-law employees. Similarly, the costs referred to in section 404(a)(1) (B) and (C) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed, or to the amounts deductible, on behalf of such employees.

(3) If contributions are made to a plan included in section 404(a) (1), (2), or (3) on behalf of individuals some or all of whom are self-employed individuals, the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(i) The provisions of section 404(a) (1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under subdivision (iii) of this subparagraph, the maximum amount deductible with respect to such individuals shall be the costs of their benefits.

(ii) The provisions of section 404(a)(1)(D), the second and third sentences of section 404(a)(3)(A), and the second sentence of section 404(a)(7), relating to certain carryover deductions, are not applicable to contributions on behalf of self-employed individuals. Contributions on behalf of self-employed individuals are deductible, if at all, only in the taxable year in which the contribution is paid or deemed paid under section 404(a)(6).

(iii) The amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $2,500 or 10 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(iv) If a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. See paragraph (d) of this section.

(c) *Special limitation on the amount allowed as a deduction for self-employed individuals.* The amount allowed as a deduction under section 404(a) (1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of a self-employed individual shall be an amount equal to one-half of the amount deductible with respect to such contributions under paragraph (b)(3) of this section. However, for purposes of section 401, the amount which may be deducted, or the amount deductible, under section 404 with respect to contributions made on behalf of self-employed individuals shall be determined without regard to the special limitation of this paragraph.

(d) *Rules applicable where contributions are made by more than one employer on behalf of a self-employed individual.* (1) Under paragraph (b)(3)(iv) of this section, if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. This limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established, even though such employee may be covered as a self-employed individual under a plan or plans established by other trades or businesses.

(2) In any case in which the application of subparagraph (1) of this paragraph reduces the amount otherwise deductible, the amount deductible by each employer shall be that amount which bears the same ratio to the aggregate amount deductible with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as the earned income derived from that employer bears to the aggregate of the earned income derived from all of the trades or businesses with respect to which plans are established. The amount allowed as a deduction to each employer is one-half of the amount determined (in accordance with the preceding sentence) to be deductible by such employer.

(e) *Partner's distributive share of contributions and deductions.* For purposes of sections 702(a)(8) and 704, a partner's distributive share of contributions on behalf of self-employed individuals under a qualified pension, annuity, or profit-sharing plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of self-employed individuals is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(f) *Contributions allocable to insurance protection.* For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of § 1.72–16.

(g) *Rules applicable to loans.* For purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(h) *Definitions.* For purposes of section 404 and the regulations thereunder—

(1) The term ''employee'' includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4);

(2) The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term ''earned income'' means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term ''compensation'' when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

(i) *Years to which this section applies.* This section applies to taxable years of employers beginning before January 1, 1974. For taxable years beginning after December 31, 1973, see § 1.404(e)–1A.

[T.D. 6673, 28 FR 10145, Sept. 17, 1963; as amended by T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.404(e)–1A Contributions on behalf of a self-employed individual to or under a qualified pension, annuity, or profit-sharing plan.

(a) *In general.* This section provides rules relating to employer contributions to qualified plans on behalf of self-employed individuals described in subsections (a) (8) and (9), (e), and (f) of section 404. Unless otherwise specifically provided, this section applies to taxable years of an employer beginning after December 31, 1973. See section 1.404(e)–1 for rules relating to plans for self-employed individuals for taxable years beginning before January 1, 1974. Paragraph (b) of this section provides general rules of deductibility, paragraph (c) provides rules relating to defined contribution plans, paragraph (d) provides rules relating to defined benefit plans, paragraph (e) provides rules relating to combinations of plans, paragraph (f) provides rules for partnerships, paragraph (g) provides rules for insurance, paragraph (h) provides rules for loans, and paragraph (i) provides definitions.

(b) *Determination of the amount deductible.* (1) If a defined contribution plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See paragraph (g) of this section.

(2)(i) If contributions are made on behalf of employees, some of whom are self-employed individuals, to a defined contribution plan described in section 414(i) and included in section 404(a) (1), (2), or (3), the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of section 404(a) (3) and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer with respect to the common-law employees. Similarly, the costs referred to in section 404(a)(1) (A) and (B) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed

or to the amounts deductible on behalf of such employees.

(ii) The amount deductible, by reason of contributions on behalf of employees to a defined benefit plan, shall be determined without regard to the self-employed or common law status of each employee.

(3)(i) If contributions are made on behalf of individuals, some or all of whom are self-employed individuals, to a defined contribution plan described in section 414(i) and included in section 404(a) (1), (2), or (3), the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(A) The provisions of section 404(a) (1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under paragraph (c) of this section, the maximum amount deductible with respect to such individuals shall be the cost of their benefits.

(B) The provisions of section 404(a) (1), (D), the third sentence of section 404(a) (3), (A), and the second sentence of section 404(a)(7), relating to certain carryover deductions are applicable to contributions on behalf of self-employed individuals made in taxable years of an employer beginning after December 31, 1975.

(C) For any employer taxable year in applying the 15 percent limit on deductible contributions set forth section in 404(a)(3) and the 25 percent limit in section 404(a)(7) for any taxable year of the employer, the amount deductible under section 404(e)(4) and paragraph (c)(4) of this section (relating to the minimum deduction of $750 or 100 percent of earned income) shall be substituted for such limits with respect to the self-employed individuals on whose behalf contributions are deductible under section 404(e)(4) for the taxable year of the employer. In addition, although the limitations of section 415 are applicable to the plan for plan years beginning after December 31, 1975, the defined contribution compensation limitation described in section 415(c)(1)(B) shall not be less than the amount deductible under section 404(e)(4) and paragraph (c)(4) of this section with respect to any self-employed individual for the taxable year of the employer wnding with or within the limitation year. The special rule in the second sentence of paragraph (3)(A) of section 404(a) is not applicable in determining the amounts deductible on behalf of self-employed individuals.

(ii) The limitations of this subparagraph are not applicable to a defined benefit plan for self-employed individuals.

(c) *Defined contribution plans.* (1) Under section 404(e)(1) in the case of a defined contribution plan, as defined in section 414(i), the amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $7,500 or 15 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(2) Under section 404(e)(2)(A) if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers under two or more defined contribution plans the aggregate amounts deductible shall not exceed the lesser of $7,500 or 15 percent of such earned income. This limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established.

(3) Under section 404(e)(2)(B) in any case in which the applicable limitation of subparagraph (2) of this paragraph reduces the amount otherwise deductible with respect to contributions on behalf of any employee within the meaning of section 401(c)(1), the amount deductible by each employer for such employee shall be that amount which bears the same ratio to the aggregate amount deductible for such employee with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as his earned income derived from the employer bears to the aggregate of his earned income derived from all of the

trades or businesses with respect to which plans are established.

Under section 404(e)(4), notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, the limitations on the amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not be less than the lesser of $750 or 100 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established. If such individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, 100 percent of such earned income shall be taken into account for purposes of the limitations determined under this subparagraph. This subparagraph does not apply to any taxable year beginning after December 31, 1975, to any employee whose adjusted gross income for that taxable year is greater than $15,000. In applying the preceding sentence, the adjusted gross income of an employee for a taxable year is determined separately for each individual, without regard to any community property laws, and without regard to the deduction allowable under section 404(a).

(d) *Defined benefit plans.* In the case of a defined benefit plan, as defined in section 401(j), the special limitations provided by section 404(e) and paragraph (c) of this section do not apply. See section 401(j) for requirements applicable to defined benefit plans.

(e) *Combination of plans.* For special rules applied if a self-employed individual in any taxable year is a paraticipant in both a defined benefit plan and a defined contribution plan, see section 401(j) and the regulations thereunder.

(f) *Partner's distributive share of contributions and deductions.* (1) For purposes of sections 702(a)(8) and 704 in the case of a defined contribution plan, a partner's distributive share of contributions on behalf of self-employed individuals under such a plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of a self-employed individual is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(2) In the case of a defined benefit plan, a partner's distributive share of contributions on behalf of self-employed individuals and his distributive share of deductions allowed the partnership under section 404 for such contributions is determined in the same manner as his distributive share of partnership taxable income. See section 704, relating to the determination of the distributive share and the regulations thereunder.

(g) *Contributions allocable to insurance protection.* Under Section 404(e)(3), for purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of § 1.72–16.

(h) *Rules applicable to loans.* Under section 404(f), for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount recieved from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(i) *Definitions.* Under section 404(a)(8), for purposes of section 404 and the regulations thereunder—

(1) The term ''employee'' includes an employee as defined in section 401(c)(1) and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4);

(2) The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3);

(3) The term ''earned income'' means earned income as defined in section 401(c)(2); and

(4) The term ''compensation'' when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

[T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.404(g)–1 Deduction of employer liability payments.

(a) *General rule.* Employer liability payments shall be treated as contributions to a stock bonus, pension, profit-sharing, or annuity plan to which section 404 applies. Such payments that satisfy the limitations of this section shall be deductible under section 404 when paid without regard to any other limitations in section 404.

(b) *Employer liability payments.* For purposes of this section, employer liability payments mean:

(1) Any payment to the Pension Benefit Guaranty Corporation (PBGC) for termination or withdrawal liability imposed under section 4062 (without regard to section 4062(b)(2)), 4063, or 4064 of the Employee Retirement Insurance Security Act of 1974 (ERISA). Any bond or escrow payment furnished under section 4063 of ERISA shall not be considered as a payment of liability until applied against the liability of the employer.

(2) Any payment to a non-multiemployer plan pursuant to a commitment to the PBGC made in accordance with PBGC Determination of Plan Sufficiency and Termination of Sufficient Plans. See PBGC regulations, 29 CFR 2617.13(b) for rules concerning these commitments. Such payments shall not exceed an amount necessary to provide for, and used to fund, the benefits guaranteed under section 4022 of ERISA.

(3) Any payment to a multiemployer plan for withdrawal liability imposed under part 1 of subtitle E of title IV of ERISA. Any bond or escrow payment furnished under such part shall not be considered as a payment of liability until applied against the liability of the employer.

(c) *Limitations, etc.*—(1) *Permissible expenses.* A payment shall be deductible under section 404(g) and this section only if the payment satisfies the conditions of section 162 or section 212. Payments made by an entity which is liable for such payments because it is a member of a commonly controlled group of corporations, or trades or businesses, within the meaning of section 414 (b) or (c), shall not fail to satisfy such conditions merely because the entity did not directly employ participants in the plan with respect to which the liability payments were made.

(2) *Qualified plan.* A payment shall be deductible under section 404(g) and this section only if the payment is made in a taxable year of the employer ending within or with a taxable year of the trust for which the trust is exempt under section 501(a). For purposes of this paragraph, the payment timing rules of section 404(a)(6) shall apply.

(3) *Full funding limitation.* (i) If the employer liability payment is to a plan, the total amount deductible for such payment and for other plan contributions may not exceed an amount equal to the full funding limitation as defined in section 412(c)(7) for the taxable year with respect to which the contributions are deemed made under section 404.

(ii) If the total contributions to the plan for the taxable year including the employer liability payment exceed the amount equal to this full funding limitation, the employer liability payment shall be deductible first.

(iii) Any amount paid in a taxable year in excess of the amount deductible in such year under the full funding limitation shall be treated as a liability payment and be deductible in the succeeding taxable years in order of time to the extent of the difference between the employer liability payments made in each succeeding year and the maximum amount deductible for such year under the full funding limitation.

(4) *Maximum deduction allowable under section 404.* The amount deductible

under section 404 is limited to the higher of the maximum amount deductible by the employer under section 404(a) or the amount otherwise deductible under section 404(g). If the contributions are to a plan to which more than one employer contributes, this limit shall apply to each employer separately rather than all employers in the aggregate. Thus, each employer may deduct the greater of its allocable share of the deduction determined under sections 404(a) and 413(b)(7) or 413(c)(6) or its allocable share of the amount deductible under section 404(g). However, pursuant to the rule in subdivision (ii) of subparagraph (3), in determining each employer's allocable share under section 404(a), the total amount deductible under section 404(a) by all employers shall not exceed the difference between the full funding limitation and the total amount deductible by all employers under section 404(g).

(5) *Example*. The provisions of this paragraph may be illustrated by the following example:

Example. In the 1983 taxable year, Employer *A* makes a withdrawal liability payment of $700,000 to multiemployer Plan *X* to which Employer *A* and Employer *B* are required to contribute. Employer *A*'s allocable share of the deduction allowable under sections 404(a) and 413(b)(7) in the 1983 taxable year is $600,000. Employer *B*'s allocable share of the deduction allowable under section 404(a) and 413(b)(7) in the 1983 taxable year is $400,000.

The full funding limitation for the 1983 taxable year is $1,000,000. Based on paragraph (c)(4) of this section, Employer *A* may deduct $700,000, the amount of the withdrawal liability payment. However, the deduction of Employer *B* is limited to $300,000, the difference between the full funding limitation and the amount deductible under section 404(g).

(d) *Effective date etc.*—(1) *General rule*. This section is effective for employer payments made after September 25, 1980.

(2) *Transitional rule*. For employer payments made before September 26, 1980, for purposes of section 404, any amount paid by an employer under section 4062, 4063, or 4064 of the Employee Retirement Income Security Act of 1974 shall be treated as a contribution to which section 404 applies by such employer to or under a stock bonus, pension, profit-sharing, or annuity plan.

[T.D. 8085, 51 FR 16297, May 2, 1986]

§ 1.404(k)–1T Questions and answers relating to the deductibility of certain dividend distributions. (Temporary)

Q–1: What does section 404(k) provide?

A–1: Section 404(k) allows a corporation a deduction for dividends actually paid in accordance with section 404(k)(2) with respect to stock of such corporation held by an employee stock ownership plan (as defined in section 4975(e)(7)) maintained by the corporation (or by any other corporation that is a member of a ''controlled group of corporations'' within the meaning of section 409(l)(4) that includes the corporation), but only if such dividends may be immediately distributed under the terms of the plan and all of the applicable qualification and distribution rules. The deduction is allowed under section 404(k) for the taxable year of the corporation during which the dividends are received by the participants.

Q–2: Is the deductibility of dividends paid to plan participants under section 404(k) affected by a plan provision which permits participants to elect to receive or not receive payment of dividends?

A–2: No. Dividends actually paid in cash to plan participants in accordance with section 404(k) are deductible under section 404(k) despite such an election provision.

Q–3: Are dividends paid in cash directly to plan participants by the corporation and dividends paid to the plan and then distributed in cash to plan participants under section 404(k) treated as distributions under the plan holding stock to which the dividends relate for purposes of sections 72, 401 and 402?

A–3: Generally, yes. However, a deductible dividend under section 404(k) is treated for purposes of section 72 as paid under a contract separate from any other contract that is part of the plan. Thus, a deductible dividend is treated as a plan distribution and as paid under a separate contract providing only for payment of deductible dividends. Therefore, a deductible dividend under section 404(k) is a taxable

plan distribution even though an employee has unrecovered employee contributions or basis in the plan.

[T.D. 8073, 51 FR 4322, Feb. 4, 1986]

§ 1.405–1 Qualified bond purchase plans.

(a) *Introduction.* Section 405 relates to the requirements for qualification of, and the tax treatment of funds contributed to, retirement plans of an employer for the benefit of his employees which are funded through the purchase of United States retirement plan bonds. Such bonds may be purchased under a qualified bond purchase plan described in section 405(a) and paragraph (b) of this section. The qualified bond purchase plan is an alternative method of providing some of the deferred compensation benefits provided by plans described in section 401. In addition, retirement bonds may be purchased under a qualified pension or profit-sharing plan described in section 401. A qualified bond purchase plan or a qualified pension or profit-sharing plan under which retirement bonds are purchased may cover only common-law employees, self-employed individuals, or both. A qualified bond purchase plan may be established after December 31, 1962, and retirement bonds may be purchased by a qualified pension or profit-sharing plan after December 31, 1962. For the terms and conditions of the retirement bonds, see section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

(b) *Qualified bond purchase plans.* (1) A qualified bond purchase plan is a definite written program and arrangement which is communicated to the employees and established and maintained by an employer solely to purchase for and distribute to his employees or their beneficiaries retirement bonds. These bonds must be purchased in the name of the employee on whose behalf the contributions are made. The plan must be a permanent plan which meets the requirements of section 401(a) (3), (4), (5), (6), (7), (8), (16), and (19), and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), (8), (16), and (19)). The rules set forth in the regulations relating to those provisions shall be applicable to qualified bond purchase plans.

(2) A qualified bond purchase plan must provide that an employee's right to the proceeds of a bond purchased in his name are nonforfeitable and will in no event inure to the benefit of the employer or be reallocated in any manner.

(c) *Benefits under a qualified bond purchase plan.* (1) Except as provided in subparagraph (2) of this paragraph, a qualified bond purchase plan must conform to the definition of a pension plan in paragraph (b)(1)(i) of § 1.401–1, or the definition of a profit-sharing plan in paragraph (b)(1)(ii) of § 1.401–1. For example, if the qualified bond purchase plan is a profit-sharing plan, the plan must include the definite allocation formula described in paragraph (b)(1)(ii) of § 1.401–1. In addition, if such a profit-sharing plan covers any owner-employee, the plan must also include the definite contribution formula described in section 401(d)(2)(B).

(2)(i) Under a qualified bond purchase plan, the bonds may be distributed to the employees at any time, and the plan need not prohibit the distribution or redemption of the bonds until the retirement of the employee. Accordingly, even though a qualified bond purchase plan is designed as a pension plan, it need not provide systematically for the payment of definitely determinable benefits. However, provisions for distribution must apply in a nondiscriminatory manner.

(ii) A qualified bond purchase plan which is designed as a pension plan may not contain a formula for contributions or benefits which might require the reallocation of amounts to an employee's credit or which might provide for the reversion of any amounts to the employer.

(d) *Contributions under a qualified bond purchase plan.* (1) The retirement bonds will be issued in the denominations of $50, $100, $500, and $1,000. Therefore, the contribution otherwise called for under the plan may not coincide with an amount that can be invested in retirement bonds. Accordingly, the plan must provide that the contributions on behalf of an individual employee for any year shall be rounded to the nearest multiple of $50.

(2) Since the employee's rights to any bonds purchased for him under a qualified bond purchase plan must be nonforfeitable, a qualified bond purchase plan must, in order to conform to the requirements of section 401(a)(4) with respect to the early termination of the plan, restrict the contributions on behalf of any employee to the amount which could be allocated to him under paragraph (c) of § 1.401–4.

(e) *Definitions.* For purposes of this section and §§ 1.405–2 and 1.405–3—

(1) The term ''employee'' includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4);

(2) The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term ''earned income'' means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term ''retirement bond'' means a United States Retirement Plan Bond, as described in section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

[T.D. 6675, 28 FR 10131, Sept. 17, 1963, as amended by T.D. 7748, 46 FR 1697, Jan. 7, 1981]

§ 1.405–2 Deduction of contributions to qualified bond purchase plans.

(a) *In general.* An employer shall be allowed a deduction for contributions paid to or under a qualified bond purchase plan in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a). A deduction will be allowed only for the taxable year in which the contributions are paid, or treated as paid, except as provided by section 404(a) (1), (3), and (7). For purposes of the deduction, a contribution is paid at the time the application for the bond is made and the full purchase price paid.

(b) *Rules for applying section 404.* If a qualified bond purchase plan is designed as a pension plan as defined in paragraph (b)(1)(i) of § 1.401–1, the limitations of section 404 applicable to qualified pension trusts shall apply. See §§ 1.404(a)–3 through 1.404(a)–7. Similarly, if a qualified bond purchase plan is designed as a profit-sharing plan as defined in paragraph (b)(1)(ii) of § 1.401–1, the limitations of section 404 applicable to qualified profit-sharing trusts shall apply. See §§ 1.404(a)–9 and 1.404(a)–10. In addition, if a qualified bond purchase plan designed as a pension plan covers some or all of the employees who are covered by a qualified profit-sharing plan established and maintained by the same employer, or if a qualified bond purchase plan which is designed as a profit-sharing plan covers some or all the employees who are also covered by a qualified pension or annuity plan established and maintained by the same employer, section 404(a)(7) is applicable. See § 1.404(a)–(13). Furthermore, if a qualified bond purchase plan covers employees some or all of whom are employees within the meaning of section 401(c)(1), the provisions of section 404(a) (8), (9), and (10) and 404(e) shall also apply.

(c) *Accrual method taxpayers.* In the case of a taxpayer using the accrual method of accounting, a contribution to a qualified bond purchase plan will be deemed paid on the last day of the year of accrual if—

(1) During the taxable year of accrual the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year, and

(2) Payment is in fact made no later than the time prescribed by the law for filing the return for the taxable year of accrual (including extensions thereof).

[T.D. 6675, 28 FR 10131, Sept. 17, 1963]

§ 1.405–3 Taxation of retirement bonds.

(a) *In general.* (1) As in the case of employer contributions under a qualified pension, annuity, profit-sharing, or stock bonus plan, employer contributions on behalf of his common-law employees under a qualified bond purchase plan are not includible in the gross income of the employees when made, and employer contributions on behalf of self-employed individuals are deductible as provided in section 405(c) and § 1.405–2. Further, an employee or his beneficiary does not realize gross income upon the receipt of a retirement bond pursuant to a qualified bond

purchase plan or from a trust described in section 401(a) which is exempt from tax under section 501(a). Upon redemption of such a bond, ordinary income will be realized to the extent the proceeds thereof exceed the basis (determined in accordance with paragraph (b) of this section) of the bond. The proceeds of a retirement bond are not entitled to the special tax treatment of section 72(n) and § 1.72–18.

(2) In the event a retirement bond is surrendered for partial redemption and reissuance of the remainder, the person surrendering the bond shall be taxable on the proceeds received to the extent such proceeds exceed the basis in the portion redeemed. In such case, the basis shall be determined (in accordance with paragraph (b) of this section) as if the portion redeemed and the portion reissued had been issued as separate bonds.

(3) In the event a retirement bond is redeemed after the death of the registered owner, the amount taxable (as determined in accordance with subparagraph (1) of this paragraph) is income in respect of a decedent under section 691.

(4) The provisions of section 402(a)(2) are not applicable to a retirement bond. In general, section 402(a)(2) provides for capital gains treatment of certain distributions from a qualified trust which constitute the total distributions payable with respect to any employee. The proceeds of a retirement bond received upon redemption will not be entitled to such capital gain treatment even though the bond is received as a part of, or as the whole of, such a total distribution. Nor will such a bond be taken into consideration in determining whether the distribution represents the total amount payable by the trust with respect to an employee. Thus, a distribution by a qualified trust may constitute a total distribution payable with respect to an employee for purposes of section 402(a)(2) even though the trust retains retirement bonds registered in the name of such employee.

(b) *Basis*. (1) This paragraph is applicable in determining the basis of any retirement bond distributed pursuant to a qualified bond purchase plan or distributed by a trust qualifying under section 401. In the case of such a bond purchased for an individual at the time he is a common-law employee, the basis is that portion of the purchase price attributable to employee contributions. In the case of such a bond purchased for an individual at the time he is a self-employed individual, the basis shall be determined under subparagraph (3) of this paragraph.

(2) At the time a retirement bond is purchased, there shall be indicated on the application for the retirement bond whether the individual for whom the retirement bond is purchased is a common-law employee or a self-employed individual, and in the case of common-law employees the amount of the purchase price, if any, attributable to the employee's contribution. The answers to these questions will appear on the retirement bond, and when the retirement bond is purchased for a common-law employee, the basis for the retirement bond is presumed to be the amount of the purchase price which the retirement bond indicates was contributed by the employee.

(3)(i) Except as provided in subdivision (ii) of this subparagraph, for purposes of determining the basis of retirement bonds purchased for an individual while he was a self-employed individual, all such bonds redeemed during a taxable year shall be considered in the aggregate as a single retirement bond. The basis of such retirement bonds shall be the difference between the aggregate of their face amounts and the lesser of:

(A)1 One-half the aggregate of their face amounts, or

(B) The aggregate of the unused amounts allowed as a deduction at the end of the taxable year (as determined in subparagraph (4) of this paragraph).

(ii) The basis of a retirement bond purchased for a self-employed individual which is redeemed after his death is the amount determined by multiplying the face amount of such retirement bond by a fraction—

(A) The numerator of which is the aggregate of the face amounts of all the bonds registered in the individual's name at his death which were purchased while he was a self-employed individual reduced by the aggregate of

the unused amounts allowed as a deduction at his death (as determined in subparagraph (4) of this paragraph), and

(B) The denominator of which is the aggregate of the face amounts of all such bonds.

(4)(i) In the case of retirement bonds purchased under a qualified bond purchase plan, the aggregate of the unused amounts allowed as a deduction at the end of any taxable year shall be an amount equal to the total of the amounts allowable for such taxable year, and the amounts allowed in all prior taxable years, as a deduction under section 405(c) for contributions used to purchase retirement bonds for the registered owner while he was a self-employed individual, reduced by an amount equal to the portion of the face amounts of such retirement bonds redeemed in prior taxable years which were included in the registered owner's gross income.

(ii) In the case of retirement bonds purchased by a trust described in section 401(a) and exempt under section 501(a), there shall be allocated to the retirement bond the deduction under section 404 attributable to the contributions used to purchase the retirement bond. The amount so allocated shall be treated in the same manner as the deduction allowed under section 405(c) for purposes of computing the unused amounts allowed as a deduction under subdivision (i) of this subparagraph. Further, the amount so allocated shall not be included in the investment in the contract for purposes of section 72 in determining the portion of the other assets distributed by the trust included in gross income.

(5) The application of the rule of subparagraphs (3) and (4) of this paragraph may be illustrated by the following examples:

Example (1). B, a self-employed individual, adopts a qualified bond purchase plan in 1963. During 1963 the plan purchased $2,000 worth of retirement bonds in his name. As a result of overestimating his income for 1963, only $400 was allowed B as a deduction pursuant to section 405(c). In 1964, prior to B's retirement in June of that year, the plan purchased a $500 retirement bond in B's name for which a deduction was allowable pursuant to section 405(c) in the amount of $250. B redeemed a retirement bond with a face amount of $500 in September of 1964 and another with a face amount of $500 in October of 1964. Of the proceeds received in 1964 from the redemption of the bonds, $1,000 plus interest, B shall exclude from his gross income $500 (face amount of the retirement bonds, $1,000, less $500, one-half of the face amount, the latter being less than the aggregate of the unused amounts allowed as a deduction, $250 allowable for the taxable year in which the bonds were redeemed plus $400, the unused amounts allowed in prior taxable years, or $650). The aggregate of the unused amounts allowed as a deduction shall be reduced by the amount so excluded ($650 − $500=$150). During the following year, B redeems another retirement bond with a face amount of $500. Of the proceeds received from the redemption of such retirement bond, $500 plus interest, B shall exclude from his gross income $350 (face amount of the retirement bonds, $500, less $150, the aggregate of the unused amounts allowed as a deduction, the latter being less than one-half of the face amount of the bond, $250). The aggregate of the unused amounts allowed as a deduction is reduced to zero ($150 − $150=0). Upon redemption of the remaining retirement bonds registered in B's name, B shall exclude from his gross income with respect to such proceeds an amount equal to the face amounts of the bonds redeemed.

Example (2). C, a self-employed individual, participated in a qualified bond purchase plan during the years 1963 through 1966. The plan purchased in his name retirement bonds in the aggregate of $10,000. C deducted $4,000 from his gross income for the four years ($1,000 for each year) with respect to the purchase of such retirement bonds. C retired in December of 1966 and during the following year redeemed one retirement bond with a face amount of $1,000. C excluded from his gross income $500 of the proceeds of the bond. C died without redeeming any of the remaining retirement bonds registered in his name. The basis of each remaining retirement bond shall be determined by multiplying the face amount of each retirement bond by $5,500÷$9,000. The numerator is the aggregate of the face amounts registered in C's name (as a self-employed individual) at his death, $9,000, reduced by the aggregate of the unused amounts allowed as a deduction at his death, $3,500 (amounts allowed as a deduction under section 405(c), $4,000, reduced by the portion of the face amount of the retirement bond redeemed by C which was included in C's gross income, $500), or $5,500. The denominator is the face amount of the retirement bonds registered in his name as a self-employed individual at his death, $9,000.

[T.D. 6675, 28 FR 10131, Sept. 17, 1963]

§ 1.406–1 Treatment of certain employees of foreign subsidiaries as employees of the domestic corporation.

(a) *Scope*—(1) *General rule*. For purposes of applying the rules in part 1 of subchapter D of chapter 1 of subtitle A of the Code and the regulations thereunder with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic corporation, an individual who is a citizen of the United States and who is an employee of a foreign subsidiary (as defined in section 3121(1)(8) and the regulations thereunder) of such domestic corporation shall be treated as an employee of such domestic corporation if the requirements of paragraph (b) of this section are satisfied.

(2) *Cross-references*. For rules relating to nondiscrimination requirements and the determination of compensation, see paragraph (c) of this section. For rules under which termination of the status of an individual as an employe of the domestic corporation in certain instances will not be considered as separation from service for certain purposes, see paragraph (d) of this section. For rules regarding deductibility of contribution, see paragraph (e) of this section. For rules regarding treatment of such individual as an employee of the domestic corporation under related provisions, see paragraph (f) of this section.

(b) *Application of this section*—(1) *Requirements*. This section shall apply and the employee of the foreign subsidiary shall be treated as an employee of domestic corporation for the purposes set forth in paragraph (a)(1) of this section only if each of the following requirements is satisfied:

(i) The domestic corporation must have entered into an agreement under section 3121(l) to provide social security coverage which applies to the foreign subsidiary of which such individual is an employee and which has not been terminated under section 3121(l)(3) or (4).

(ii) The plan, referred to in paragraph (a)(1) of this section, must expressly provide for contributions or benefits for individuals who are citizens of the United States and who are employees of one or more of its foreign subsidiaries to which an agreement entered into by such domestic corporation under section 3121(l) applies. The plan must apply to all of the foreign subsidiaries to which such agreement applies.

(iii) Contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) must not be provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary.

(2) *Supplementary rules*. Subparagraph (l)(ii) of this paragraph does not modify the requirements for qualification of a plan described in section 401(a), 403(a), or 405(a) and the regulations thereunder. It is not necessary that the plan provide benefits or contributions for all United States citizens who are employees of such foreign subsidiaries. If the plan is amended to cover individuals who are employees by reason of paragraph (a)(1) of this section, the plan will not qualify unless it meets the coverage requirements of section 410(b)(1) (section 401(a)(3), as in effect on September 1, 1974, for plan years to which section 410 does not apply; see § 1.410(a)–2 for the effective dates of section 401) and the nondiscrimination requirements of section 401(a)(4). In addition, the administrative rules contained in § 1.401(a)–3(e) (relating to the determination of the contributions or benefits provided by the employer under the Social Security Act) will also apply for purposes of determining whether the plan meets the requirements of section 401. For purposes of subparagraph (1)(iii) of this paragraph, contributions will not be considered as provided under a funded plan merely because the foreign subsidiary is required under the laws of the foreign jurisdiction to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.

(c) *Special rules*—(1) *Nondiscrimination requirements*. For purposes of applying sections 401(a)(4) and 410(b)(1)(B) (section 401(a)(3)(B), as in effect on September 1, 1974, for plan years to which

section 410 does not apply) and the regulations thereunder (relating to nondiscrimination concerning benefits and contributions and coverage of employees) with respect to an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) If the employee is an officer, shareholder, or (with respect to plan years to which section 410 does not apply) person whose principal duties consist in supervising the work of other employees of the foreign subsidiary of the domestic corporation, he shall be treated as having such capacity with respect to the domestic corporation; and

(ii) The determination as to whether the employee is a highly compensated employee shall be made by comparing his total compensation (determined under subparagraph (2) of this paragraph) with the compensation of all the employees of the domestic corporation (including individuals treated as employees of the domestic corporation pursuant to section 406 and this section).

(2) *Determination of compensation.* For purposes of applying section 401(a)(5) and the regulations thereunder, relating to classifications that will not be considered discriminatory, with respect to an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) The total compensation of the employee shall be the remuneration of the employee from the foreign subsidiary (including any allowances that are paid to the employee because of his employment in a foreign country) which would constitute his total compensation if his services had been performed for the domestic corporation;

(ii) The basic or regular rate of compensation of the employee shall be determined for the employee in the same manner as it is determined under section 401 for other employees of the domestic corporation; and

(iii) The amount paid by the domestic corporation which is equivalent to the tax imposed with respect to the employee by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act) shall be treated as having been paid by the employee and shall be included in his compensation.

(d) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gain provisions and limitation of tax.* For purposes of applying the rules, relating to the treatment of certain distributions which are made after an employee's separation from service, set forth in section 72(n) as in effect on September 1, 1974 (with respect to taxable years ending after December 31, 1969, and to which section 402(e) does not apply), and in sections 402(a)(2) and (e) and 403(a)(2) with respect to distributions or payments made after December 31, 1973, and in taxable years beginning after December 31, 1973) with respect to an employee of a foreign subsidiary who is treated as an employee of a domestic corporation under paragraph (a)(1) of this section, the employee shall not be considered as separated from the service of the domestic corporation solely by reason of the occurrence of any one or more of the following events:

(1) The termination, under the provisions of section 3121(l), of the agreement entered into by the domestic corporation under that section which covers the employment of the employee;

(2) The employee's becoming an employee of another foreign subsidiary of the domestic corporation with respect to which such agreement does not apply,

(3) The employee's ceasing to be an employee of the foreign subsidiary by reason of which employment he was treated as an employee of such domestic corporation, if he becomes an employee of another corporation controlled by such domestic corporation; or

(4) The termination of the provision of the plan described in paragraph (b)(1)(ii) of this section, for coverage of United States citizens who are employees of foreign subsidiaries covered by an agreement under section 3121(l).

For purposes of subparagraph (3) of this paragraph, a corporation is considered to be controlled by a domestic corporation if such domestic corporation owns

directly or indirectly more than 50 percent of the voting stock of the corporation.

(e) *Deductibility of contributions*—(1) *In general.* For purposes of applying sections 404 and 405(c) with respect to the deduction for contributions made to or under a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), by a domestic corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an employee of a foreign subsidiary treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, no deduction shall be allowed to such domestic corporation or to any other corporation which would otherwise be entitled to deduct its contributions on behalf of such employee under one of such sections;

(ii) There shall be allowed as a deduction from the gross income of the foreign subsidiary which is effectively connected with the conduct of a trade or business within the United States (within the meaning of section 882 and the regulations thereunder) an amount which is allocable and apportionable to such gross income under the rules of §1.861–8 and which in no event may exceed the amount which (but for subdivision (i) of this subparagraph) would be deductible under section 404 or section 405(c) by the domestic corporation if the individual were an employee of the domestic corporation and if his compensation were paid by the domestic corporation; and

(iii) Any reference to compensation shall be considered to be a reference to the total compensation of such individual (determined by applying paragraph (c)(2) of this section).

(2) *Year of deduction.* Any amount deductible by the foreign subsidiary under section 406(d) and this paragraph shall be deductible for its taxable year with or within which ends the taxable year of the domestic corporation for which the contribution was made.

(3) *Special rules.* Whether contributions to a plan on behalf of an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section, or whether forfeitures with regard to such employee, will require an inclusion in the income of the domestic corporation or an adjustment in the basis of its stock in the foreign subsidiary, shall be determined in accordance with the rules of general application of subtitle A of chapter 1 of the Code (relating to income taxes). For example, an unreimbursed contribution by the domestic corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.

(f) *Treatment as an employee of the domestic corporation under related provisions.* An individual who is treated as an employee of a domestic corporation under paragraph (a)(1) of this section shall also be treated as an employee of such domestic corporation, with respect to the plan having the provision described in paragraph (b)(1)(ii) of this section, for purposes of applying section 72(d) (relating to employees' annuities), section 72(f) (relating to special rules for computing employees' contributions), section 101(b) (relating to employees' death benefits), section 2039 (relating to annuities), and section 2517 (relating to certain annuities under qualified plans) and the regulations thereunder.

(g) *Nonexempt trust.* If the plan of the domestic corporation is a qualified plan described under section 401(a), the fact that a trust which forms a part of such plan is not exempt from tax under section 501(a) shall not affect the treatment of an employee of a foreign subsidiary as an employee of a domestic corporation under section 406(a) and paragraph (a)(1) of this section.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42321, Aug. 23, 1978]

§ 1.407–1 Treatment of certain employees of domestic subsidiaries engaged in business outside the United States as employees of the domestic parent corporation.

(a) *Scope*—(1) *General rule.* For purposes of applying the rules in part 1 of subchapter D of chapter 1 of subtitle A of the Code and the regulations thereunder with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic parent corporation (as defined in paragraph (b)(3)(ii) of this section), an individual who is a citizen of the United States and who is an employee of a domestic subsidiary (as defined in paragraph (b)(3)(i) of this section) of such domestic parent corporation shall be treated as an employee of such domestic parent corporation if the requirements of paragraph (b) of this section are satisfied.

(2) *Cross-references.* For rules relating to nondiscrimination requirements and the determination of compensation, see paragraph (c) of this section. For rules under which termination of the status of an individual as an employee of the domestic parent corporation in certain instances will not be considered as separation from service for certain purposes, see paragraph (d) of this section. For rules regarding deductibility of contributions, see paragraph (e) of this section. For rules regarding treatment of such individual as an employee of the domestic parent corporation under related provisions, see paragraph (f) of this section.

(b) *Application of this section*—(1) *Requirements.* This section shall apply and the employee of the domestic subsidiary shall be treated as an employee of the domestic parent corporation for the purposes set forth in paragraph (a)(1) of this section only if each of the following requirements is satisfied:

(i) The plan, referred to in paragraph (a)(1) of this section, must expressly provide for contributions of benefits for individuals who are citizens of the United States and who are employees of one or more of the domestic subsidiaries of the domestic parent corporation. The plan must apply to every domestic subsidiary.

(ii) Contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) must not be provided by any other person with respect to the remuneration paid to such individual by the domestic subsidiary.

(2) *Supplementary rules.* Subparagraph (1)(i) of this paragraph does not modify the requirements for qualification of a plan described in section 401(a), 403(a), or 405(a) and the regulations thereunder. It is not necessary that the plan provide benefits or contributions for all United States citizens who are employees of such domestic subsidiaries. It the plan is amended to cover individuals who are employees by reason of paragraph (a)(1) of this section, the plan will not qualify unless it meets the coverage requirements of section 410(b)(1) (section 401(a)(3), as in effect on September 1, 1974, for plan years to which section 410 does not apply; see § 1.410 (a)-2 for the effective dates of section 401) and the nondiscrimination requirements of section 410(a)(4). The administrative rules contained in § 1.401 (a)–3(e) (relating to the determination of the contributions or benefits provided by the employer under the Social Security Act) will also apply for purposes of determining whether the plan meets the requirements of section 401. For purposes of subparagraph (1)(ii) of this paragraph, contributions will not be considered as provided under a funded plan merely because the domestic subsidiary employer pays the tax imposed by section 3111 (relating to tax on employers under the Federal Insurance Contributions Act) with respect to such employee or is required under the laws of a foreign jurisdiction to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.

(3) *Definitions*—(i) *Domestic subsidiary.* For purposes of this section, a corporation shall be treated as a domestic subsidiary for any taxable year only if each of the following requirements is satisfied:

(A) It is a domestic corporation 80 percent or more of the outstanding voting stock of which is owned by another domestic corporation;

(B) 95 percent of more of its gross income for the three-year period immediately preceding the close of its taxable year which ends on or before the close of the taxable year of such other domestic corporation (or for such part of such period during which it was in existence) was derived from sources without the United States, determined pursuant to sections 861 through 864 and the regulations thereunder; and

(C) 90 percent or more of its gross income for such period (or such part) was derived from the active conduct of a trade or business.

If for the period (or part thereof) referred to in (B) and (C) of this subdivision such corporation has no gross income, the provisions of (B) and (C) shall be treated as satisfied if it is reasonable to anticipate that, with respect to the first taxable year thereafter for which such corporation has gross income, such provisions will be satisfied.

(ii) *Domestic parent corporation.* The domestic parent corporation of any domestic subsidiary is the domestic corporation which owns 80 percent or more of the outstanding voting stock of such domestic subsidiary.

(c) *Special rules*—(1) *Nondiscrimination requirements.* For purposes of applying sections 401(a)(4) and 410(b)(1)(B) (section 401(a)(3)(B), as in effect on Septemeber 1, 1974, for plan years to which section 410 does not apply) and the regulation thereunder (relating to nondiscrimination concerning benefits and contributions and coverage of employees) with respect to an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) If the employee is an officer, shareholder, or (with respect to plan years to which section 410 does not apply) a person whose principal duties consist in supervising the work of other employees of the domestic subsidiary of the domestic parent corporation, he shall be treated as having such capacity with respect to the domestic parent corporation; and

(ii) The determination as to whether the employee is a highly compensated employee shall be made by comparing his total compensation determined under subparagraph (2) of this paragraph with the compensation of all the employees of the domestic parent corporation (including individuals treated as employees of the domestic parent corporation pursuant to section 407 and this section).

(2) *Determination of compensation.* For purposes of applying section 401(a) (5) and the regulations thereunder, relating to classifications that will not be considered discriminatory, with respect to an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) The total compensation of the employee shall be the remuneration of the employee from the domestic subsidiary (including any allowances that are paid to the employee because of his employment in a foreign country) which would constitute his total compensation if his services had been performed for such domestic parent corporation; and

(ii) The basic or regular rate of compensation of the employee shall be determined for the employee in the same manner as it is determined under section 401 for other employees of the domestic parent corporation.

(d) *Termination of status as deemed employee not to be treated as separation from service for purposes of captial gain provisions and limitation of tax.* For purposes of applying the rules, relating to treatment of certain distributions which are made after an employee's separation from service, set forth in section 72(n) as in effect on September 1, 1974 (with respect to taxable years ending after December 31, 1969, and to which section 402(e) does not apply), and in sections 402 (a)(2) and (e) and 403(a)(2) (with respect to distributions or payments made after December 31, 1973, and in taxable years beginning after December 31, 1973) with respect to an employee of a domestic subsidiary who is treated as an employee of a domestic parent corporation under paragraph (a)(1) of this section, the employee shall not be considered as separated from the service of the domestic parent corporation solely by reason of the occurrence of any one or more of the following events:

(1) The fact that the corporation of which such individual is an employee

ceases, for any taxable year, to be a domestic subsidiary within the mean of paragraph (b)(3)(i) of this section;

(2) The employee' ceasing to be an employee of the domestic subsidiary of such domestic parent corporation, if he becomes an employee of another corporation controlled by such domestic parent corporation; or

(3) The termination of the provision of the plan described in paragraph (b)(1)(i) of this section, requiring coverage of the United States citizens who are employees of domestic subsidiaries of the domestic parent corporation.

For purposes of subparagraph (2) of this paragraph, a corporation is considered to be controlled by a domestic parent corporation if the domestic parent corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(e) *Deductibility of contributions*—(1) *In general*. For purposes of applying sections 404 and 405(c) with respect to the deduction for contributions made to or under a pension, profit-sharing, or stock bonus plan described in section 401(a), and annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), by a domestic parent corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an employee of a domestic subsidiary treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, no deduction shall be allowed to the domestic parent corporation which would otherwise be entitled to deduct its contributions on behalf of such employee under one of such sections;

(ii) There shall be allowed as a deduction to the domestic subsidiary of which such individual is an employee an amount equal to the amount which (but for subdivision (i) of this subparagraph) would be deductible under section 404 or section 405(c) by the domestic parent corporation if the individual were an employee of the domestic parent corporation and if his compensation were paid by the domestic corporation; and

(iii) Any reference to compensation shall be considered to be a reference to the total compensation of such individual determined by applying paragraph (c)(2) of this section).

(2) *Year of deduction*. Any amount deductible by the domestic subsidiary under section 407(d) and this paragraph shall be deductible for its taxable year with or within which ends the taxable year of the domestic parent corporation for which the contribution was made.

(3) *Special rules*. Whether contributions to a plan on behalf of an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section, or whether forfeitures with regard to such employee, will require an inclusion in the income of the domestic parent corporation or an adjustment in the basis of its stock in the domestic subsidiary, shall be determined in accordance with the rules of general application of subtitle A of chapter 1 of the Code (relating to income taxes). For an example, and unreimbursed contribution by the domestic parent corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the domestic subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.

(f) *Treatment as an employee of the domestic parent corporation under related provisions*. An individual who is treated as an employee of a domestic parent corporation under paragraph (a)(1) of this section shall also be treated as an employee of such domestic corporation, with respect to the plan having the provision described in paragraph (b)(1)(i) of this section, for purposes of applying section 72(d) (relating to special rules for computing employees' contributions), section 72(f) (relating to special rules for computing employees' contributions), section 101(b) (relating to employees' section 101(b) (relating to employees' death benefits), section 2039 (relating to annuities), and section 2517 (relating to certain annuities under qualified plans) and the regulations thereunder.

(g) *Nonexempt trust*. If the plan of the domestic parent corporation is a qualified plan described under section 401(a), the fact that a trust which forms a part of such plan is not exempt from tax under section 501(a) shall not affect the treatment of an employee of a domestic subsidiary as an employee of a domestic parent corporation under section 407(a) and paragraph (a)(1) of this section.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42323, Aug. 23, 1977]

§ 1.408–1 General rules.

(a) *In general*. Section 408 prescribes rules relating to individual retirement accounts and individual retirement annuities. In addition to the rules set forth in §§ 1.408–2 and 1.408–3, relating respectively to individual retirement accounts and individual retirement annuities, the rules set forth in this section shall also apply.

(b) *Exemption from tax*. The individual retirement account or individual retirement annuity is exempt from all taxes under subtitle A of the Code other than the taxes imposed under section 511, relating to tax on unrelated business income of charitable, etc., organizations.

(c) *Sanctions*—(1) *Excess contributions*. If an individual retirement account or individual retirement annuity accepts and retains excess contributions, the individual on whose behalf the account is established or who is the owner of the annuity will be subject to the excise tax imposed by section 4973.

(2) *Prohibited transactions by owner or beneficiary of individual retirement account*—(i) Under section 408(e)(2), if, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year. In any case in which any individual retirement account ceases to be an individual retirement account by reason of the preceding sentence as of the first day of any taxable year, section 408(d)(1) applies as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day). The preceding sentence applies even though part of the fair market value of the individual retirement account as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(ii) If the trust with which the individual engages in any transaction described in subdivision (i) of this subparagraph is established by an employer or employee association under section 408(c), only the employee who engages in the prohibited transaction is subject to disqualification of his separate account.

(3) *Prohibited transaction by person other than owner or beneficiary of account*. If any person other than the individual on whose behalf an individual retirement account is established or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such person shall be subject to the taxes imposed by section 4975.

(4) *Pledging account as security*. Under section 408(e)(4), if, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual.

(5) *Borrowing on annuity contract*. Under section 408(e)(3), if during any taxable year the owner of an individual retirement annuity borrows any money under or by use of such contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year. See § 1.408–3(c).

(6) *Premature distributions*. If a distribution (whether a deemed distribution or an actual distribution) is made from an individual retirement account, or individual retirement annuity, to the individual for whose benefit the account was established, or who is the owner of the annuity, before the individual attains age 59½ (unless the individual has become disabled within the meaning of section 72(m)(7)), the tax

under Chapter 1 of the Code for the taxable year in which such distribution is received is increased under section 408(f)(1) or (f)(2). The increase equals 10 percent of the amount of the distribution which is includible in gross income for the taxable year. Except in the case of the credits allowable under section 31, 39, or 42, no credit can be used to offset the increased tax described in this subparagraph. See, however, § 1.408–4(c)(3).

(d) *Limitation on contributions and benefits.* An individual retirement account or individual retirement annuity is subject to the limitation on contributions and benefits imposed by section 415 for years beginning after December 31, 1975.

(e) *Community property laws.* Section 408 shall be applied without regard to any community property laws.

[T.D. 7714, 45 FR 52790, Aug. 8, 1980]

§ 1.408–2 Individual retirement accounts.

(a) *In general.* An individual retirement account must be a trust or a custodial account (see paragraph (d) of this section). It must satisfy the requirements of paragraph (b) of this section in order to qualify as an individual retirement account. It may be established and maintained by an individual, by an employer for the benefit of his employees (see paragraph (c) of this section), or by an employee association for the benefit of its members (see paragraph (c) of this section).

(b) *Requirements.* An individual retirement account must be a trust created or organized in the United States (as defined in section 7701(a)(9)) for the exclusive benefit of an individual or his beneficiaries. Such trust must be maintained at all times as a domestic trust in the United States. The instrument creating the trust must be in writing and the following requirements must be satisfied.

(1) *Amount of acceptable contributions.* Except in the case of a contribution to a simplified employee pension described in section 408(k) and a rollover contribution described in section 408(d)(3), 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8) or 409(b)(3)(C), the trust instrument must provide that contributions may not be accepted by the trustee for the taxable year in excess of $1,500 on behalf of any individual for whom the trust is maintained. An individual retirement account maintained as a simplified employee pension may provide for the receipt of up to $7,500 for a calendar year.

(2) *Trustee.* (i) The trustee must be a bank (as defined in section 408(n) and the regulations thereunder) or another person who demonstrates, in the manner described in paragraph (e) of this section, to the satisfaction of the Commissioner, that the manner in which the trust will be administered will be consistent with the requirements of section 408 and this section.

(ii) Section 11.408(a)(2)–1 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this subparagraph (2).

(3) *Life insurance contracts.* No part of the trust funds may be invested in life insurance contracts. An individual retirement account may invest in annuity contracts which provide, in the case of death prior to the time distributions commence, for a payment equal to the sum of the premiums paid or, if greater, the cash value of the contract.

(4) *Nonforfeitability.* The interest of any individual on whose behalf the trust is maintained in the balance of his account must be nonforfeitable.

(5) *Prohibition against commingling.* (i) The assets of the trust must not be commingled with other property except in a common trust fund or common investment fund.

(ii) For purposes of this subparagraph, the term ''common investment fund'' means a group trust created for the purpose of providing a satisfactory diversification or investments or a reduction of administrative expenses for the individual participating trusts, and which group trust satisfies the requirements of section 408(c) (except that it need not be established by an employer or an association of employees) and the requirements of section 401(a) in the case of a group trust in which one of the individual participating trusts is an employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(iii) For purposes of this subparagraph, the term ''individual participating trust'' means an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or a trust which satisfies the requirements of section 408(a) provided that in the case of such an employees' trust, such trust would be permitted to participate in such a group trust if all the other individual participating trusts were employees' trusts described in section 401(a) which are exempt from tax under section 501(a).

(6) *Distribution of interest.* (i) The trust instrument must provide that the entire interest of the individual for whose benefit the trust is maintained must be distributed to him in accordance with paragraph (b)(6)(ii) or (iii) of this section.

(ii) Unless the provisions of paragraph (b)(6)(iii) of this section apply, the entire interest of the individual must be actually distributed to him not later than the close of his taxable year in which he attains age 70½.

(iii) In lieu of distributing the individual's entire interest as provided in paragraph (b)(6)(ii) of this section, the interest may be distributed commencing not later than the taxable year described in such paragraph (b)(6)(ii). In such case, the trust must expressly provide that the entire interest of the individual will be distributed to the individual and the individual's beneficiaries, in a manner which satisfies the requirements of paragraph (b)(6)(v) of this section, over any of the following periods (or any combination thereof)—

(A) The life of the individual,

(B) The lives of the individual and spouse,

(C) A period certain not extending beyond the life expectancy of the individual, or

(D) A period certain not extending beyond the joint life and last survivor expectancy of the individual and spouse.

(iv) The life expectancy of the individual or the joint life and last survivor expectancy of the individual and spouse cannot exceed the period computed by use of the expected return multiples in §1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the mortality tables of such company.

(v) If an individual's entire interest is to be distributed over a period described in paragraph (b)(6)(iii) of this section, beginning in the year the individual attains 70½ the amount to be distributed each year must be not less than the lesser of the balance of the individual's entire interest or an amount equal to the quotient obtained by dividing the entire interest of the individual in the trust at the beginning of such year (including amounts not in the individual retirement account at the beginning of the year because they have been withdrawn for the purpose of making a rollover contribution to another individual retirement plan) by the life expectancy of the individual (or the joint life and last survivor expectancy of the individual and spouse (whichever is applicable)), determined in either case as of the date the individual attains age 70 in accordance with paragraph (b)(6)(iv) of this section, reduced by one for each taxable year commencing after the individual's attainment of age 70½. An annuity or endowment contract issued by an insurance company which provides for non-increasing payments over one of the periods described in paragraph (b)(6)(iii) of this section beginning not later than the close of the taxable year in which the individual attains age 70½ satisfies this provision. However, no distribution need be made in any year, or a lesser amount may be distributed, if beginning with the year the individual attains age 70½ the aggregate amounts distributed by the end of any year are at least equal to the aggregate of the minimum amounts required by this subdivision to have been distributed by the end of such year.

(vi) If an individual's entire interest is distributed in the form of an annuity contract, then the requirements of section 408(a)(6) are satisfied if the distribution of such contract takes place before the close of the taxable year described in subdivision (ii) of this subparagraph, and if the individual's interest will be paid over a period described in subdivision (iii) of this subparagraph

and at a rate which satisfies the requirements of subdivision (v) of this subparagraph.

(vii) In determining whether paragraph (b)(6)(v) of this section is satisfied, all individual retirement plans maintained for an individual's benefit (except those under which he is a beneficiary described in section 408(a)(7)) at the close of the taxable year in which he reaches age 70½ must be aggregated. Thus, the total payments which such individual receives in any taxable year must be at least equal to the amount he would have been required to receive had all the plans been one plan at the close of the taxable year in which he attained age 70½.

(7) *Distribution upon death.* (i) The trust instrument must provide that if the individual for whose benefit the trust is maintained dies before the entire interest in the trust has been distributed to him, or if distribution has been commenced as provided in paragraph (b)(6) of this section to the surviving spouse and such spouse dies before the entire interest has been distributed to such spouse, the entire interest (or the remaining part of such interest if distribution thereof has commenced) must, within 5 years after the individual's death (or the death of the surviving spouse) be distributed or applied to the purchase of an immediate annuity for this beneficiary or beneficiaries (or the beneficiary or beneficiaries of the surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaries) and which annuity contract will be immediately distributed to such beneficiary or beneficiaries. A contract described in the preceding sentence is not includible in gross income upon distribution. Section 1.408–4(e) provides rules applicable to the taxation of such contracts. The first sentence of this paragraph (b)(7) shall have no application if distributions over a term certain commenced before the death of the individual for whose benefit the trust was maintained and the term certain is for a period permitted under paragraph (b)(6)(iii) (C) or (D) of this section.

(ii) Each such beneficiary (or beneficiary of a surviving spouse) may elect to treat the entire interest in the trust (or the remaining part of such interest if distribution thereof has commenced) as an account subject to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section instead of those of section 408(a)(7) and paragraph (b)(7) of this section. Such an election will be deemed to have been made if such beneficiary treats the account in accordance with the requirements of section 408(a)(6) and paragraph (b)(6) of this section. An election will be considered to have been made by such beneficiary if either of the following occurs: (A) any amounts in the account (including any amounts that have been rolled over, in accordance with the requirements of section 408(d)(3)(A)(i), into an individual retirement account, individual retirement annuity, or retirement bond for the benefit of such individual) have not been distributed within the appropriate time period required by section 408(a)(7) and paragraph (b)(7) of this section; or (B) any additional amounts are contributed to the account (or to the account, annuity, or bond to which the beneficiary has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section.

(8) *Definition of beneficiaries.* The term ''beneficiaries'' on whose behalf an individual retirement account is established includes (except where the context indicates otherwise) the estate of the individual, dependents of the individual, and any person designated by the individual to share in the benefits of the account after the death of the individual.

(c) *Accounts established by employers and certain association of employees*—(1) *In general.* A trust created or organized in the United States (as defined in section 7701(a)(9)) by an employer for the exclusive benefit of his employees or their beneficiaries, or by an association of employees for the exclusive benefit of its members or their beneficiaries, is treated as an individual retirement account if the requirements of paragraphs (c)(2) and (c)(3) of this section

are satisfied under the written governing instrument creating the trust. A trust described in the preceding sentence is for the exclusive benefit of employees or members even though it may maintain an account for former employees or members and employees who are temporarily on leave.

(2) *General requirements.* The trust must satisfy the requirements of paragraphs (b) (1) through (7) of this section.

(3) *Special requirement.* There must be a separate accounting for the interest of each employee or member.

(4) *Definitions*—(i) *Separate accounting.* For purposes of paragraph (c)(3) of this section, the term ''separate accounting'' means that separate records must be maintained with respect to the interest of each individual for whose benefit the trust is maintained. The assets of the trust may be held in a common trust fund, common investment fund, or common fund for the account of all individuals who have an interest in the trust.

(ii) *Employee association.* For purposes of this paragraph and section 408(c), the term ''employee association'' means any organization composed of two or more employees, including but not limited to, an employee association described in section 501(c)(4). Such association may include employees within the meaning of section 401(c)(1). There must be, however, some nexus between the employees (e.g., employees of same employer, employees in the same industry, etc.) in order to qualify as an employee association described in this subdivision (ii).

(d) *Custodial accounts.* For purposes of this section and section 408(a), a custodial account is treated as a trust described in section 408(a) if such account satisfies the requirements of section 408(a) except that it is not a trust and if the assets of such account are held by a bank (as defined in section 401(d)(1) and the regulations thereunder) or such other person who satisfies the requirements of paragraph (b)(2)(ii) of this section. For purposes of this chapter, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account will be treated as the trustee thereof.

(e)(1) *In general.* The trustee of a trust described in paragraph (b) of this section may be a person other than a bank if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer trusts will be consistent with the requirements of section 408. The person must demonstrate by written application that the requirements of paragraph (e)(2) to (e)(6) of this section will be met. The written application must be sent to address prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter). For procedural and administrative rules, see paragraph (e)(7) of this section.

(2) *Fiduciary ability.* The applicant must demonstrate in detail its ability to act within the accepted rules of fiduciary conduct. Such demonstration must include the following elements of proof:

(i) *Continuity.* (A) The applicant must assure the uninterrupted performance of its fiduciary duties nonwithstanding the death or change of its owners. Thus, for example, there must be sufficient diversity in the ownership of the applicant to ensure that the death or change of its owners will not interrupt the conduct of its business. Therefore, the applicant cannot be an individual.

(B) Sufficient diversity in the ownership of an incorporated applicant is demonstrated in the following circumstances:

(*1*) Individuals each of whom owns more than 20 percent of the voting stock in the applicant own, in the aggregate, no more than 50 percent of such stock;

(*2*) The applicant has issued securities registered under section 12 (b) of the Securities Exchange Act of 1934 (15 U.S.C. 78l (b)) or required to be registered under section 12(g) (1) of that Act (15 U.S.C. 78l (g)(1)); or

(*3*) The applicant has a parent corporation within the meaning of section 1563 (a) (1) that has issued securities registered under section 12 (b) of the Securities Exchange Act of 1934 (15 U.S.C. 78l (b)) or required to be registered under Section 12 (g) (1) of that Act (15 U.S.C. 78l (g)(1)).

(C) Sufficient diversity in the ownership of an applicant that is a partnership means that—

(*1*) Individuals each of whom owns more than 20 percent of the profits interest in the partnership own, in the aggregate, no more than 50 percent of such profits interest, and

(*2*) Individuals each of whom owns more than 20 percent of the capital interest in the partnership own, in the aggregate, no more than 50 percent of such capital interest.

(D) For purposes of this subdivision, the ownership of stock and of capital and profits interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 1563 (e) and (f) (2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f) (2) shall apply to a capital or profits interest in a partnership as if it were a stock interest.

(ii) *Established location*. The applicant must have an established place of business in the United States where it is accessible during every business day.

(iii) *Fiduciary experience*. The applicant must have fiduciary experience or expertise sufficient to ensure that it will be able to perform its fiduciary duties. Evidence of fiduciary experience must include proof that a significant part of the business of the applicant consists of exercising fiduciary powers similar to those it will exercise if its application is approved. Evidence of fiduciary expertise must include proof that the applicant employs personnel experienced in the administration of fiduciary powers similar to those the applicant will exercise if its application is approved.

(iv) *Fiduciary responsibility*. The applicant must assure compliance with the rules of fiduciary conduct set out in paragraph (e)(5) of this section.

(v) *Financial responsibility*. The applicant must exhibit a high degree of solvency commensurate with the obligations imposed by this paragraph. Among the factors to be taken into account are the applicant's net worth, its liquidity, and its ability to pay its debts as they come due.

(3) *Capacity to account*. The applicant must demonstrate in detail its experience and competence with respect to accounting for the interests of a large number of individuals (including calculating and allocating income earned and paying out distributions to payees). Examples of accounting for the interests of a large number of individuals include accounting for the interests of a large number of shareholders in a regulated investment company and accounting for the interests of a large number of variable annuity contract holders.

(4) *Fitness to handle funds*—(i) *In general*. The applicant must demonstrate in detail its experience and competence with respect to other activities normally associated with the handling of retirement funds.

(ii) *Examples*. Examples of activities normally associated with the handling of retirement funds include:

(A) To Receive, issue receipts for, and safely keep securities;

(B) To collect income;

(C) To execute such ownership certificates, to keep such records, make such returns, and render such statements as are required for Federal tax purposes;

(D) To give proper notification regarding all collections;

(E) To collect matured or called principal and properly report all such collections;

(F) To exchange temporary for definitive securities;

(G) To give proper notification of calls, subscription rights, defaults in principal or interest, and the formation of protective committees;

(H) To buy, sell, receive, or deliver securities on specific directions.

(5) *Rules of fiduciary conduct*. The applicant must demonstrate that under applicable regulatory requirements, corporate or other governing instruments, or its established operating procedures:

(i) *Administration of fiduciary powers*. (A)(*1*) The owners or directors of the applicant will be responsible for the proper exercise of fiduciary powers by the applicant. Thus, all matters pertinent thereto, including the determination of policies, the investment and disposition of property held in a fiduciary capacity, and the direction and review of the actions of all employees

utilized by the applicant in the exercise of its fiduciary powers, will be the responsibility of the owners or directors. In discharging this responsibility, the owners or directors may assign to designated employees, by action duly recorded, the administration of such of the applicant's fiduciary powers as may be proper to assign.

(*2*) A written record will be made of the acceptance and of the relinquishment or closing out of all fiduciary accounts, and of the assets held for each account.

(*3*) If the applicant has the authority or the responsibility to render any investment advice with regard to the assets held in or for each fiduciary account, the advisability of retaining or disposing of the assets will be determined at least once during each period of 12 months.

(B) All employees taking part in the performance of the applicant's fiduciary duties will be adequately bonded. Nothing in this subdivision (i)(B) shall require any person to be bonded in contravention of section 412(d) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1112(d)).

(C) The applicant will employ or retain legal counsel who will be readily available to pass upon fiduciary matters and to advise the applicant.

(D) In order to segregate the performance of its fiduciary duties from other business activities, the applicant will maintain a separate trust division under the immediate supervision of an individual designated for that purpose. The trust division may utilize the personnel and facilities of other divisions of the applicant, and other divisions of the applicant may utilize the personnel and facilities of the trust division, as long as the separate identity of the trust division is preserved.

(ii) *Adequacy of net worth*—(A) *Initial net worth requirement*. In the case of applications received after January 5, 1995, no initial application will be accepted by the Commissioner unless the applicant has a net worth of not less than $250,000 (determined as of the end of the most recent taxable year). Thereafter, the applicant must satisfy the adequacy of net worth requirements of paragraph (e)(5)(ii)(B) and (C) of this section.

(B) No fiduciary account will be accepted by the applicant unless the applicant's net worth (determined as of the end of the most recent taxable year) exceeds the greater of—

(*1*) $100,000, or

(*2*) Four percent (or, in the case of a passive trustee described in paragraph (e)(6)(i)(A) of this section, two percent) of the value of all of the assets held by the applicant in fiduciary accounts (determined as of the most recent valuation date).

(C) The applicant will take whatever lawful steps are necessary (including the relinquishment of fiduciary accounts) to ensure that its net worth (determined as of the close of each taxable year) exceeds the greater of—

(*1*) $50,000, or

(*2*) Two percent (or, in the case of a passive trustee described in paragraph (e)(6)(i)(A) of this section, one percent) of the value of all of the assets held by the applicant in fiduciary accounts (determined as of the most recent valuation date).

(D) *Assets held by members of SIPC*—(*1*) For purposes of satisfying the adequacy-of-net-worth requirement of this paragraph, a special rule is provided for nonbank trustees that are members of the Securities Investor Protection Corporation (SIPC) created under the Securities Investor Protection Act of 1970 (SIPA)(15 U.S.C. 78aaa *et seq.*, as amended). The amount that the net worth of a nonbank trustee that is a member of SIPC must exceed is reduced by two percent for purposes of paragraph (e)(5)(ii)(B)(*2*), and one percent for purposes of paragraph (e)(5)(ii)(C)(*2*), of the value of assets (determined on an account-by-account basis) held for the benefit of customers (as defined in 15 U.S.C. 78fff–2(e)(4)) in fiduciary accounts by the nonbank trustee to the extent of the portion of each account that does not exceed the dollar limit on advances described in 15 U.S.C. 78fff–3(a), as amended, that would apply to the assets in that account in the event of a liquidation proceeding under the SIPA.

(*2*) The provisions of this special rule for assets held in fiduciary accounts by members of SIPC are illustrated in the following example.

Example: (a) Trustee X is a broker-dealer and is a member of the Securities Investment Protection Corporation. Trustee X also has been approved as a nonbank trustee for individual retirement accounts (IRAs) by the Commissioner but not as a passive nonbank trustee. Trustee X is the trustee for four IRAs. The total assets of each IRA (for which Trustee X is the trustee) as of the most recent valuation date before the last day of Trustee X's taxable year ending in 1995 are as follows: the total assets for IRA–1 is $3,000,000 (all of which is invested in securities); the value of the total assets for IRA–2 is $500,000 ($200,000 of which is cash and $300,000 of which is invested in securities), the value of the total assets for IRA–3 is $400,000 (all of which is invested in securities); and the value of the total assets of IRA–4 is $200,000 (all of which is cash). The value of all assets held in fiduciary accounts, as defined in §1.408–2(e)(6)(viii)(A), is $4,100,000.

(b) The dollar limit on advances described in 15 U.S.C. §78fff–3(a) that would apply to the assets in each account in the event of a liquidation proceeding under the Securities Investor Protection Act of 1970 in effect as of the last day of Trustee X's taxable year ending in 1995 is $500,000 per account (no more than $100,000 of which is permitted to be cash). Thus, the dollar limit that would apply to IRA–1 is $500,000; the dollar limit for IRA–2 is $400,000 ($100,000 of the cash and the $300,000 of the value of the securities); the dollar limit for IRA–3 is $400,000 (the full value of the account because the value of the account is less than $500,000 and no portion of the account is cash); and the dollar limit for IRA–4 is $100,000 (the entire account is cash and the dollar limit per account for cash is $100,000). The aggregate dollar limits of the four IRAs is $1,400,000.

(c) For 1996, the amount determined under §1.408–2(e)(5)(ii)(B) is determined as follows for Trustee X: (1) four percent of $4,100,000 equals $164,000; (2) two percent of $1,400,000 equals $28,000; and (3) $164,000 minus $28,000 equals $136,000. Thus, because $136,000 exceeds $100,000, the minimum net worth necessary for Trustee X to accept new accounts for 1996 is $136,000.

(d) For 1996, the amount determined under §1.408–2(e)(5)(ii)(C) for Trustee X is determined as follows: (1) two percent of $4,100,000 equals $82,000; (2) one percent of $1,400,000 equals $14,000; and (3) $82,000 minus $14,000 equals $68,000. Thus, because $68,000 exceeds $50,000, the minimum net worth necessary for Trustee X to avoid a mandatory relinquishment of accounts for 1996 is $68,000.

(E) The applicant will determine the value of the assets held by it in trust at least once in each calendar year and no more than 18 months after the preceding valuation. The assets will be valued at their fair market value, except that the assets of an employee pension benefit plan to which section 103(b)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1023(b)(3)(A)) applies will be considered to have the value stated in the most recent annual report of the plan.

(iii) *Audits.* (A) At least once during each period of 12 months, the applicant will cause detailed audits of the fiduciary books and records to be made by a qualified public accountant. At that time, the applicant will ascertain whether the fiduciary accounts have been administered in accordance with law, this paragraph, and sound fiduciary principles. The audits shall be conducted in accordance with generally accepted auditing standards, and shall involve whatever tests of the fiduciary books and records of the applicant are considered necessary by the qualified public accountant.

(B) In the case of an applicant which is regulated, supervised, and subject to periodic examination by a State or Federal agency, such applicant may adopt an adequate continuous audit system in lieu of the periodic audits required by paragraph (e)(5)(iii)(A) of this section.

(C) A report of the audits and examinations required under this subdivision, together with the action taken thereon, will be noted in the fiduciary records of the applicant.

(iv) *Funds awaiting investment or distribution.* Funds held in a fiduciary capacity by the applicant awaiting investment or distribution will not be held uninvested or undistributed any longer than is reasonable for the proper management of the account.

(v) *Custody of investments.* (A) Except for investments pooled in a common investment fund in accordance with the provisions of paragraph (e)(5)(vi) of this section, the investments of each account will not be commingled with any other property.

(B) Assets of accounts requiring safekeeping will be deposited in an adequate vault. A permanent record will be kept of assets deposited in or withdrawn from the vault.

(vi) *Common investment funds.* The assets of an account may be pooled in a common investment fund (as defined in

paragraph (e)(5)(viii)(C) of this section) if the applicant is authorized under applicable law to administer a common investment fund and if pooling the assets in a common investment fund is not in contravention of the plan documents or applicable law. The common investment fund must be administered as follows:

(A) Each common investment fund must be established and maintained in accordance with a written agreement, containing appropriate provisions as to the manner in which the fund is to be operated, including provisions relating to the investment powers and a general statement of the investment policy of the applicant with respect to the fund; the allocation of income, profits and losses; the terms and conditions governing the admission or withdrawal of participations in the funds; the auditing of accounts of the applicant with respect to the fund; the basis and method of valuing assets held by the fund, setting forth specific criteria for each type of asset; the minimum frequency for valuation of assets of the fund; the period following each such valuation date during which the valuation may be made (which period in usual circumstances may not exceed 10 business days); the basis upon which the fund may be terminated; and such other matters as may be necessary to define clearly the rights of participants in the fund. A copy of the agreement must be available at the principal office of the applicant for inspection during all business hours, and upon request a copy of the agreement must be furnished to the employer, the plan administrator, any participant or beneficiary of an account, or the individual for whose benefit the account is established or that individual's beneficiary.

(B) All participations in the common investment fund must be on the basis of a proportionate interest in all of the investments.

(C) Not less frequently than once during each period of 3 months the applicant must determine the value of the assets in the fund as of the date set for the valuation of assets. No participation may be admitted to or withdrawn from the fund except (*1*) on the basis of such valuation and (*2*) as of such valuation date. No participation may be admitted to or withdrawn from the fund unless a written request for or notice of intention of taking such action has been entered on or before the valuation date in the fiduciary records of the applicant. No request or notice may be canceled or countermanded after the valuation date.

(D)(*1*) The applicant must at least once during each period of 12 months cause an adequate audit to be made of the common investment fund by a qualified public accountant.

(*2*) The applicant must at least once during each period of 12 months prepare a financial report of the fund which, based upon the above audit, must contain a list of investments in the fund showing the cost and current value of each investment; a statement for the period since the previous report showing purchases, with cost; sales, with profit or loss; any other investment changes; income and disbursements; and an appropriate notation as to any investments in default.

(*3*) The applicant must transmit and certify the accuracy of the financial report to the administrator of each plan participating in the common investment fund within 120 days after the end of the plan year.

(E) When participations are withdrawn from a common investment fund, distributions may be made in cash or ratably in kind, or partly in cash and partly in kind: *Provided*, That all distributions as of any one valuation date must be made on the same basis.

(F) If for any reason an investment is withdrawn in kind from a common investment fund for the benefit of all participants in the fund at the time of such withdrawal and such investment is not distributed ratably in kind, it must be segregated and administered or realized upon for the benefit ratably of all participants in the common investment fund at the time of withdrawal.

(vii) *Books and records*. (A) The applicant must keep its fiduciary records separate and distinct from other records. All fiduciary records must be so kept and retained for as long as the contents thereof may become material in the administration of any internal revenue law. The fiduciary records

must contain full information relative to each account.

(B) The applicant must keep an adequate record of all pending litigation to which it is a party in connection with the exercise of fiduciary powers.

(viii) *Definitions*. For purposes of this paragraph (e)(5), and paragraph (e)(2)(v), and paragraph (e)(7) of this section—

(A) The term ''account'' or ''fiduciary account'' means a trust described in section 401(a) (including a custodial account described in section 401(f)), a custodial account described in section 403(b)(7), or an individual retirement account described in section 408(a) (including a custodial account described in section 408(h)).

(B) The term ''plan administrator'' means an administrator as defined in §1.414(g)–1.

(C) The term ''common investment fund'' means a trust that satisfies the following requirements:

(*1*) The trust consists of all or part of the assets of several accounts that have been established with the applicant, and

(*2*) The trust is described in section 401(a) and is exempt from tax under section 501(a), or is a trust that is created for the purpose of providing a satisfactory diversification of investments or a reduction of administrative expenses for the participating accounts and that satisfies the requirements of section 408(c).

(D) The term ''fiduciary records'' means all matters which are written, transcribed, recorded, received or otherwise come into the possession of the applicant and are necessary to preserve information concerning the acts and events relevant to the fiduciary activities of the applicant.

(E) The term ''qualified public accountant'' means a qualified public accountant, as defined in section 103(a)(3)(D) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1023(a)(3)(D), who is independent of the applicant.

(F) The term ''net worth'' means the amount of the applicant's assets less the amount of its liabilities, as determined in accordance with generally accepted accounting principles.

(6) *Special rules*—(i) *Passive trustee*. (A) An applicant that undertakes to act only as a passive trustee may be relieved of one or more of the requirements of this paragraph upon clear and convincing proof that such requirements are not germane, under all the facts and circumstances, to the manner in which the applicant will administer any trust. A trustee is a passive trustee only if under the written trust instrument the trustee has no discretion to direct the investment of the trust funds or any other aspect of the business administration of the trust, but is merely authorized to acquire and hold particular investments specified by the trust instrument. Thus, for example, in the case of an applicant that undertakes merely to acquire and hold the stock of regulated investment companies, the requirements of paragraph (e)(5)(i)(A)(*3*) in its place, and (i)(D), and (vi) of this section shall not apply and no negative inference shall be drawn from the applicant's failure to demonstrate its experience of competence with respect to the activities described in paragraph (e)(4)(ii)(E) to (H) of this section.

(B) The notice of approval issued to an applicant that is approved by reason of this subdivision shall state that the applicant is authorized to act only as a passive trustee.

(ii) *Federal or State regulation*. Evidence that an applicant is subject to Federal or State regulation with respect to one or more relevant factors shall be given weight in proportion to the extent that such regulatory standards are consonant with the requirements of section 401. Such evidence may be submitted in addition to, or in lieu of, the specific proofs required by this paragraph.

(iii) *Savings account*. (A) An applicant will be approved to act as trustee under this subdivision if the following requirements are satisfied:

(*1*) The applicant is a credit union, industrial loan company, or other financial institution designated by the Commissioner;

(*2*) The investment of the trust assets will be solely in deposits in the applicant;

(*3*) Deposits in the applicant are insured (up to the dollar limit prescribed

by applicable law) by an agency or instrumentality of the United States, or by an organization established under a special statute the business of which is limited to insuring deposits in financial institutions and providing related services.

(B) Any applicant that satisfies the requirements of this subdivision is hereby approved, and (notwithstanding subparagraph (2) of this paragraph) is not required to submit a written application. This approval takes effect on the first day after December 22, 1976, on which the applicant satisfies the requirements of this subdivision, and continues in effect for so long as the applicant continues to satisfy those requirements.

(C) If deposits are insured, but not in the manner provided in paragraph (e)(6)(iii)(A)(*3*) of this section, the applicant must submit an application. The application, notwithstanding subparagraph (2) of this paragraph, will be limited to a complete description of the insurance of applicant's deposits. The applicant will be approved if the Commissioner approves of the applicant's insurance.

(iv) *Notification of Commissioner*. The applicant must notify the Commissioner in writing of any change that affects the continuing accuracy of any representation made in the application required by this paragraph, whether the change occurs before or after the applicant receives a notice of approval. The notification must be addressed to address prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter.

(v) *Substitution of trustee*. No applicant will be approved unless the applicant undertakes to act as trustee only under trust instruments which contain a provision to the effect that the grantor is to substitute another trustee upon notification by the Commissioner that such substitution is required because the applicant has failed to comply with the requirements of this paragraph or is not keeping such records, or making such returns, or rendering such statements as are required by forms or regulations.

(7) *Procedure and administration*—(i) *Notice of approval*. If the applicant is approved, a written notice of approval will be issued to the applicant. The notice of approval will state the day on which it becomes effective, and (except as otherwise provided therein) will remain effective until revoked. This paragraph does not authorize the applicant to accept any fiduciary account before such notice of approval becomes effective.

(ii) *Notice of disapproval*. If the applicant is not approved, a written notice will be furnished to the applicant containing a statement of the reasons why the applicant has not been approved.

(iii) *Copy to be furnished*. The applicant must not accept a fiduciary account until after the plan administrator or the person for whose benefit the account is to be established is furnished with a copy of the written notice of approval issued to the applicant. This provision is effective six months after April 20, 1979 for new accounts accepted thereafter. For accounts accepted before that date, the administrator must be notified before the later of the effective date of this provision or six months after acceptance of the account.

(iv) *Grounds for revocation*. The notice of approval issued to an applicant will be revoked if the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of this paragraph. Generally, the notice will not be revoked unless the Commissioner determines that the applicant has knowingly, willfully, or repeatedly failed to administer fiduciary accounts in a manner consistent with the requirements of this paragraph, or has administered a fiduciary account in a grossly negligent manner.

(v) *Procedures for revocation*. The notice of approval issued to an applicant may be revoked in accordance with the following procedures:

(A) If the Commissioner proposes to revoke the notice of approval issued to an applicant, the Commissioner will advise the applicant in writing of the proposed revocation and of the reasons therefor.

(B) Within 60 days after the receipt of such written advice, the applicant may protest the proposed revocation by submitting a written statement of facts, law, and arguments opposing such revocation to address prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter. In addition, the applicant may request a conference in the National Office.

(C) If the applicant consents to the proposed revocation, either before or after a National Office conference, or if the applicant fails to file a timely protest, the Commissioner will revoke the notice of approval that was issued to the applicant.

(D) If, after considering the applicant's protest and any information developed in conference, the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of this paragraph, the Commissioner will revoke the notice of approval that was issued to the applicant and will furnish the applicant with a written statement of findings on which the revocation is based.

(E) If at any time the Commissioner determines that immediate action is necessary to protect the interest of the Internal Revenue Service or of any fiduciary account, the notice of approval issued to the applicant will be suspended at once, pending a final decision to be based on the applicant's protest and any information developed in conference.

[T.D. 7714, 45 FR 52791, Aug. 8, 1980, as amended by T.D. 8635, 60 FR 65549, Dec. 20, 1995; 61 FR 11307, Mar. 20, 1996]

§ 1.408–3 Individual retirement annuities.

(a) *In general.* An individual retirement annuity is an annuity contract or endowment contract (described in paragraph (e)(1) of this section) issued by an insurance company which is qualified to do business under the law of the jurisdiction in which the contract is sold and which satisfies the requirements of paragraph (b) of this section. A participation certificate in a group contract issued by an insurance company described in this paragraph will be treated as an individual retirement annuity if the contract satisfies the requirements of paragraph (b) of this section; the certificate of participation sets forth the requirements of paragraphs (1) through (5) of section 408 (b); the contract provides for a separate accounting of the benefit allocable to each participant-owner; and the group contract is for the exclusive benefit of the participant owners and their beneficiaries. For purposes of this title, a participant-owner of a group contract described in this paragraph shall be treated as the owner of an individual retirement annuity. A contract will not be treated as other than an individual retirement annuity merely because it provides for waiver of premium on disability. An individual retirement annuity contract which satisfies the requirements of section 408 (b) need not be purchased under a trust if the requirements of paragraph (b) of this section are satisfied. An individual retirement endowment contract may not be held under a trust which satisfies the requirements of section 408 (a). Distribution of the contract is not a taxable event. Distributions under the contract are includible in gross income in accordance with the provisions of § 1.408–4 (e).

(b) *Requirements*—(1) *Transferability.* The annuity or the endowment contract must not be transferable by the owner. An annuity or endowment contract is transferable if the owner can transfer any portion of his interest in the contract to any person other than the issuer thereof. Accordingly, such a contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the contract to any person other than the issuer thereof. On the other hand, a contract is not to be considered transferable merely because the contract contains: a provision permitting the individual to designate a beneficiary to receive the proceeds in the event of his death, a provision permitting the individual to elect a joint and survivor annuity, or other similar provisions.

(2) *Annual premium.* Except in the case of a contribution to a simplified

employee pension described in section 408 (k), the annual premium on behalf of any individual for the annuity or the endowment contract cannot exceed $1,500. Any refund of premiums must be applied before the close of the calendar year following the year of the refund toward the payment of future premiums or the purchase of additional benefits.

(3) *Distribution*. The entire interest of the owner must be distributed to him in the same manner and over the same period as described in § 1.408–2 (b) (6).

(4) *Distribution upon death*. If the owner dies before the entire interest has been distributed to him, or if distribution has commenced to the surviving spouse, the remaining interest must be distributed in the same manner, over the same period, and to the same beneficiaries as described in § 1.408–2 (b) (7).

(5) *Nonforfeitability*. The entire interest of the owner in the annuity or endowment contract must be nonforfeitable.

(6) *Flexible premium*. [Reserved]

(c) *Disqualification*. If during any taxable year the owner of an annuity borrows any money under the annuity or endowment contract or by use of such contract (including, but not limited to, pledging the contract as security for any loan), such contract will cease to be an individual retirement annuity as of the first day of such taxable year, and will not be an individual retirement annuity at any time thereafter. If an annuity or endowment contract which constitutes an individual retirement annuity is disqualified as a result of the preceding sentence, an amount equal to the fair market value of the contract as of the first day of the taxable year of the owner in which such contract is disqualified is deemed to be distributed to the owner. Such owner shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day. The preceding sentence applies even though part of the fair market value of the individual retirement annuity as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(d) *Premature distribution tax on deemed distribution*. If the individual has not attained age 59½ before the beginning of the year in which the disqualification described in paragraph (c) of this section occurs, see section 408(f)(2) for additional tax on premature distributions.

(e) *Endowment contracts*—(1) *Additional requirement for endowment contracts*. No contract providing life insurance protection issued by a company described in paragraph (a) of this section shall be treated as an endowment contract for purposes of this section if—

(i) Such contract matures later than the taxable year in which the individual in whose name the contract is purchased attains the age of 70½;

(ii) Such contract is not for the exclusive benefit of such individual or his beneficiaries;

(iii) Premiums under the contract may increase over the term of the contract;

(iv) When all premiums are paid when due, the case value of such contract at maturity is less than the death benefit payable under the contract at any time before maturity;

(v) The death benefit does not, at some time before maturity, exceed the greater of the cash value or the sum of premiums paid under the contract;

(vi) Such contract does not provide for a cash value;

(vii) Such contract provides that the life insurance element of such contract may increase over the term of such contract, unless such increase is merely because such contract provides for the purchase of additional benefits;

(viii) Such contract provides insurance other than life insurance and waiver of premiums upon disability; or

(ix) Such contract is issued after November 6, 1978.

(2) *Treatment of proceeds under endowment contract upon death of individual*. In the case of the payment of a death benefit under an endowment contract upon the death of the individual in whose name the contract is purchased, the portion of such payment which is equal to the cash value immediately before the death of such individual is not excludable from gross income under section 101(a) and is treated as a

distribution from an individual retirement annuity. The remaining portion, if any, of such payment constitutes current life insurance protection and is excludable under section 101(a). If a death benefit is paid under an endowment contract at a date or dates later than the death of the individual, section 101(d) is applicable only to the portion of the benefit which is attributable to the amount excludable under section 101(a).

[T.D. 7714, 45 FR 52792, Aug. 8, 1980]

§ 1.408–4 Treatment of distributions from individual retirement arrangements.

(a) *General rule*—(1) *Inclusion in income.* Except as otherwise provided in this section, any amount actually paid or distributed or deemed paid or distributed from an individual retirement account or individual retirement annuity shall be included in the gross income of the payee or distributee for the taxable year in which the payment or distribution is received.

(2) *Zero basis.* Notwithstanding section 1015(d) or any other provision of the Code, the basis (or investment in the contract) of any person in such an account or annuity is zero. For purposes of this section, an assignment of an individual's rights under an individual retirement account or an individual retirement annuity shall, except as provided in §1.408–4(g) (relating to transfer incident to divorce), be deemed a distribution to such individual from such account or annuity of the amount assigned.

(b) *Rollover contribution*—(1) *To individual retirement arrangement.* Paragraph (a)(1) of this section shall not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if the entire amount received (including the same amount of money and any other property) is paid into an individual retirement account, annuity (other than an endowment contract), or bond created for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution.

(2) *To qualified plan.* Paragraph (a)(1) of this section does not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if—

(i) No amount in the account or no part of the value of the annuity is attributable to any source other than a rollover contribution from an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or a rollover contribution from an annuity plan described in section 403(a) and the earnings on such sums, and

(ii) The entire amount received (including the same amount of money and any other property) represents the entire amount in the account and is paid into another such trust or plan (for the benefit of such individual) not later than the 60th day after the day on which the payment or distribution is received.

This subparagraph does not apply if any portion of the rollover contribution described in paragraph (b)(2)(i) of this section is attributable to an employees' trust forming part of a plan or an annuity under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan.

(3) *To section 403(b) contract.* [Reserved]

(4) *Frequency limitation.* (i) For taxable years beginning on or before December 31, 1977, paragraph (b)(1) of this section does not apply to any amount received by an individual from an individual retirement account, annuity or bond if at any time during the 3-year period ending on the day of receipt, the individual received any other amount from an individual retirement account, annuity or bond which was not includible in his gross income because of the application of paragraph (b)(1) of this section.

(ii) [Reserved]

(c) *Excess contributions returned before due date of return*—(1) *Excess contribution.* For purposes of this paragraph, excess contributions are the excess of

the amounts contributed to an individual retirement account or paid for an individual retirement annuity during the taxable year over the amount allowable as a deduction under section 219 or 220 for the taxable year.

(2) *General rule*. (i) Paragraph (a)(1) of this section does not apply to the distribution of any excess contribution paid during a taxable year to an account or annuity if: the distribution is received on or before the date prescribed by law (including extensions) for filing the individual's return for such taxable year; no deduction is allowed under section 219 or section 220 with respect to the excess contribution; and the distribution is accompanied by the amount of net income attributable to the excess contribution as of the date of the distribution as determined under subdivision (ii).

(ii) The amount of net income attributable to the excess contributions is an amount which bears the same ratio to the net income earned by the account during the computation period as the excess contribution bears to the sum of the balance of the account as of the first day of the taxable year in which the excess contribution is made and the total contribution made for such taxable year. For purposes of this paragraph, the term ''computation period'' means the period beginning on the first day of the taxable year in which the excess contribution is made and ending on the date of the distribution from the account.

(iii) For purposes of paragraph (c)(2)(ii), the net income earned by the account during the computation period is the fair market value of the balance of the account immediately after the distribution increased by the amount of distributions from the account during the computation period, and reduced (but not below zero) by the sum of: (A) the fair market value of the balance of the account as of the first day of the taxable year in which the excess contribution is made and (B) the contributions to the account made during the computation period.

(3) *Time of inclusion*. (i) For taxable years beginning before January 1, 1977, the amount of net income determined under subparagraph (2) is includible in the gross income of the individual for the taxable year in which it is received. The amount of net income thus distributed is subject to the tax imposed by section 408(f)(1) for the year includible in gross income.

(ii) [Reserved]

(4) *Example*. The provisions of this paragraph may be illustrated by the following example:

Example. On January 1, 1975, A, age 55, who is a calendar-year taxpayer, contributes $1,500 to an individual retirement account established for his benefit. For 1975, A is entitled to a deduction of $1,400 under section 219. For 1975, A does not claim as deductions any other items listed in section 62. A's gross income for 1975 is $9,334. On April 1, 1976, $107 is distributed to A from his individual retirement account. As of such date, the balance of the account is $1,498 [$1,605 − $107]. There were no other distributions from the account as of such date. The net amount of income earned by the account is $105 [$1,498 + $107 − (0 + $1,500)]. The net income attributable to the excess contribution is $7. [$105 × ($100/$1,500)]. A's adjusted gross income for 1975 is his gross income for 1975 ($9,334) reduced by the amount allowable to A as a deduction under section 219 ($1,400), or $7,934. A will include the $7 of the $107 distributed on April 1, 1976, in his gross income for 1976. Further, A will pay an additional income tax of $.70 for 1976 under section 408(f)(1).

(d) *Deemed distribution*—(1) *General rule*. In any case in which an individual retirement account ceases to be an individual retirement account by reason of the application of section 408(e)(2), paragraph (a)(1) of this section shall apply as if there were a distribution on the first day of the taxable year in which such account ceases to be an individual retirement account of an amount equal to the fair market value on such day of all of the assets in the account on such day. In the case of a deemed distribution from an individual retirement annuity, see §1.408–3(d).

(2) *Using account as security*. In any case in which an individual for whose benefit an individual retirement account is established uses, directly or indirectly, all or any portion of the account as security for a loan, paragraph (a)(1) of this section shall apply as if there were distributed on the first day of the taxable year in which the loan was made an amount equal to that portion of the account used as security for such loan.

(e) *Distribution of annuity contracts.* Paragraph (a)(1) of this section does not apply to any annuity contract which is distributed from an individual retirement account and which satisfies the requirements of paragraphs (b) (1), (3), (4) and (5) of section 408. Amounts distributed under such contracts will be taxable to the distributee under section 72. For purposes of applying section 72 to a distribution from such a contract, the investment in such contract is zero.

(f) *Treatment of assets distributed from an individual retirement account for the purchase of an endowment contract.* Under section 408(e)(5), if all, or any portion, of the assets of an individual retirement account are used to purchase an endowment contract described in § 1.408–3(e) for the benefit of the individual for whose benefit the account is established—

(1) The excess, if any, of the total amount of assets used to purchase such contract over the portion of the assets attributable to life insurance protection shall be treated as a rollover contribution described in section 408(d)(3), and

(2) The portion of the assets attributable to life insurance protection shall be treated as a distribution described in paragraph (a)(91) of this section, except that the provisions of section 408(f) shall not apply to such amount.

(g) *Transfer incident to divorce*—(1) *General rule.* The transfer of an individual's interest, in whole or in part, in an individual retirement account, individual retirement annuity, or a retirement bond, to his former spouse under a valid divorce decree or a written instrument incident to such divorce shall not be considered to be a distribution from such an account or annuity to such individual or his former spouse; nor shall it be considered a taxable transfer by such individual to his former spouse notwithstanding any other provision of Subtitle A of the Code.

(2) *Spousal account.* The interest described in this paragraph (g) which is transferred to the former spouse shall be treated as an individual retirement account of such spouse if the interest is an individual retirement account; an individual retirement annuity of such spouse if such interest is an individual retirement annuity; and a retirement bond of such spouse if such interest is a retirement bond.

[T.D. 7714, 45 FR 52793, Aug. 8, 1980]

§ 1.408–5 Annual reports by trustees or issuers.

(a) *In general.* The trustee of an individual retirement account or the issuer of an individual retirement annuity shall make annual calendar year reports concerning the status of the account or annuity. The report shall contain the information required in paragraph (b) and be furnished or filed in the manner and time specified in paragraph (c).

(b) *Information required to be included in the annual reports.* The annual calendar year report shall contain the following information for transactions occurring during the calendar year—

(1) The amount of contributions;

(2) The amount of distributions;

(3) In the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance;

(4) The name and address of the trustee or issuer; and

(5) Such other information as the Commissioner may require.

(c) *Manner and time for filing.* (1) The annual report shall be furnished to the individual on whose behalf the account is established or in whose name the annuity is purchased (or the beneficiary of the individual or owner). The report shall be furnished on or before the 30th day of June following the calendar year for which the report is required.

(2) The Commissioner may require the annual report to be filed with the Service at the time the Commissioner specifies.

(d) *Penalties.* Section 6693 prescribes penalties for failure to file the annual report.

(e) *Effective date.* This section shall apply to reports for calendar years after 1978.

(f) *Reports for years prior to 1979.* For years prior to 1979, a trustee or issuer shall make reports in the time and manner as the Commissioner requires.

[T.D. 7714, 45 FR 52795, Aug. 8, 1980]

§ 1.408–6 Disclosure statements for individual retirement arrangements.

(a) *In general*—(1) *General rule*. Trustees and issuers of individual retirement accounts and annuities are, under the authority of section 408(i), required to provide disclosure statements. This section sets forth these requirements.

(2) [Reserved]

(b)–(c) [Reserved]

(d) *Requirements*. (1)–(3) [Reserved]

(4) *Disclosure statements*—(i) Under the authority contained in section 408(i), a disclosure statement shall be furnished in accordance with the provisions of this subparagraph by the trustee of an individual retirement account described in section 408(a) or the issuer of an individual retirement annuity described in section 408(b) or of an endowment contract described in section 408(b) to the individual (hereinafter referred to as the ''benefited individual'') for whom such an account, annuity, or contract is, or is to be, established.

(ii)(A)*(1)* The trustee or issuer shall furnish, or cause to be furnished, to the benefited individual, a disclosure statement satisfying the requirements of subdivisions (iii) through (viii) of this subparagraph, as applicable, and a copy of the governing instrument to be used in establishing the account, annuity, or endowment contract. The copy of such governing instrument need not be filled in with financial and other data pertaining to the benefited individual; however, such copy must be complete in all other respects. The disclosure statement and copy of the governing instrument must be received by the benefited individual at least seven days preceding the earlier of the date of establishment or purchase of the account, annuity, or endowment contract. A disclosure statement or copy of the governing instrument required by this subparagraph may be received by the benefited individual less than seven days preceding, but no later than, the earlier of the date of establishment or purchase, if the benefited individual is permitted to revoke the account, annuity, or endowment contract pursuant to a procedure which satisfies the requirements of subdivision (ii)(A)(*2*) of this subparagraph.

(*2*) A procedure for revocation satisfies the requirements of this subdivision (ii)(A)(*2*) of this subparagraph if the benefited individual is permitted to revoke the account, or endowment contract by mailing or delivering, at his option, a notice of revocation on or before a day not less than seven days after the earlier of the date of establishment or purchase and, upon revocation, is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or endowment contract without adjustment for such items as sales commissions, administrative expenses or fluctuation in market value. The procedure may require that the notice be in writing or that it be oral, or it may require both a written and an oral notice. If an oral notice is required or permitted, the procedure must permit it to be delivered by telephone call during normal business hours. If a written notice is required or permitted, the procedure must provide that, if mailed, it shall be deemed mailed on the date of the postmark (or if sent by certified or registered mail, the date of certification or registration) if it is deposited in the mail in the United States in an envelope, or other appropriate wrapper, first class postage prepaid, properly addressed.

(B) If after a disclosure statement has been furnished, or caused to be furnished, to the benefited individual pursuant to paragraph (d)(4)(ii)(A) of this section and—

(*1*) On or before the earlier of the date of establishment or purchase, or

(*2*) On or before the last day on which the benefited individual is permitted to revoke the account, annuity, or endowment contract (if the benefited individual has a right to revoke the account, annuity, or endowment contract pursuant to the rules of subdivision (ii)(A) of this subparagraph).

there becomes effective a material adverse change in the information set forth in such disclosure statement or a material change in the governing instrument to be used in establishing the account, annuity, or contract, the trustee or issuer shall furnish, or cause to be furnished, to the benefited individual such amendments to any previously furnished disclosure statement or governing instrument as may be necessary to adequately inform the

benefited individual of such change. The trustee or issuer shall be treated as satisfying this subdivision (ii)(B) of this subparagraph only if material required to be furnished by this subdivision is received by the benefited individual at least seven days preceding the earlier of the date of establishment or purchase of the account, annuity, or endowment contract or if the benefited individual is permitted to revoke the account, annuity, or endowment contract on or before a date not less than seven days after the date on which such material is received, pursuant to a procedure for revocation otherwise satisfying the provisions of subdivision (ii)(A)(*2*) of this subparagraph.

(C) If the governing instrument is amended after the account, annuity, or endowment contract is no longer subject to revocation pursuant to subdivision (ii)(A) or (B) of this subparagraph, the trustee or issuer shall not later than the 30th day after the later of the date on which the amendment is adopted or becomes effective, deliver or mail to the last known address of the benefited individual a copy of such amendment and, if such amendment affects a matter described in subdivisions (iii) through (viii) of this subparagraph, a disclosure statement with respect to such matter meeting the requirements of subdivision (iv) of this subparagraph.

(D) For purposes of subdivision (ii)(A) and (B) of this subparagraph, if a disclosure statement, governing instrument, or an amendment to either, is mailed to the benefited individual, it shall be deemed (in the absence of evidence to the contrary) to be received by the benefited individual seven days after the date of mailing.

(E) In the case of a trust described in section 408(c) (relating to certain retirement savings arrangements for employees or members of associations of employees), the following special rules shall be applied:

(*1*) For purposes of this subparagraph, references to the benefited individual's account, annuity, or endowment contract shall refer to the benefited individual's interest in such trust, and

(*2*) The provisions of subdivision (ii) of this subparagraph shall be applied by substituting ''the date on which the benefited individual's interest in such trust commences'' for ''the earlier of the date of establishment or purchase'' wherever it appear therein.

Thus, for example, if an employer establishes a trust described in section 408(c) for the benefit of employees, and the trustee furnishes an employee with a disclosure statement and a copy of the governing instrument (as required by this subparagraph) on the date such employee's interest in the trust commences, such employee must be given a right to revoke such interest within a period of at least seven days. If any contribution has been made within such period (whether by the employee or by the employer), the full amount of such contribution must be paid to such employee pursuant to subdivision (ii)(A)(*2*) of this subparagraph.

(iii) The disclosure statement required by this subparagraph shall set forth in nontechnical language the following matters as such matters relate to the account, annuity, or endowment contract (as the case may be);

(A) Concise explanations of—

(*1*) The statutory requirements prescribed in section 408(a) (relating to an individual retirement account) or section 408(b) (relating to an individual retirement annuity and an endowment contract), and any additional requirements (whether or not required by law) that pertain to the particular retirement savings arrangement.

(*2*) The income tax consequences of establishing an account, annuity, or endowment contract (as the case may be) which meets the requirements of section 408(a) relating to an individual retirement account) or section 408(b) (relating to an individual retirement annuity and an endowment contract), including the deductibility of contributions to, the tax treatment of distributions (other than premature distributions) from, the availability of income tax free rollovers to and from, and the tax status of such account, annuity, or endowment contract.

(*3*) The limitations and restrictions on the deduction for retirement savings under section 219, including the ineligibility of certain individuals who are active participants in a plan described in section 219(b)(2)(A) or for whom amounts are contributed under a contract described in section

219(b)(2)(B) to make deductible contributions to an account or for an annuity or endowment contract.

(*4*) The circumstances under which the benefited individual may revoke the account, annuity, or endowment contract, and the procedure therefor (including the name, address, and telephone number of the person designated to receive notice of such revocation). Such explanation shall be prominently displayed at the beginning of the disclosure statement.

(B) Statements to the effect that—

(*1*) If the benefited individual or his beneficiary engages in a prohibited transaction, described in section 4975(c) with respect to an individual retirement account, the account will lose its exemption from tax by reason of section 408(e)(2)(A), and the benefited individual must include in gross income, for the taxable year during which the benefited individual or his beneficiary engages in the prohibited transaction the fair market value of the account.

(*2*) If the owner of an individual retirement annuity or endowment contract described in section 408(b) borrows any money under, or by use of, such annuity or endowment contract, then, under section 408(e)(3), such annuity or endowment contract loses its section 408(b) classification, and the owner must include in gross income, for the taxable year during which the owner borrows any money under, or by use of, such annuity or endowment contract, the fair market value of the annuity or endowment contract.

(*3*) If a benefited individual uses all or any portion of an individual retirement account as security for a loan, then, under section 408(e)(4), the portion so used is treated as distributed to such individual and the benefited individual must include such distribution in gross income for the taxable year during which he so uses such account.

(*4*) An additional tax of 10 percent is imposed by section 408(f) on distributions (including amounts deemed distributed as the result of a prohibited loan or use as security for a loan) made before the benefited individual has attained age 59½, unless such distribution is made on account of death or disability, or unless a rollover contribution is made with such distribution.

(*5*) Sections 2039(e) (relating to exemption from estate tax of annuities under certain trusts and plans) and 2517 (relating to exemption from gift tax of specified transfers of certain annuities under qualified plans) apply (including the manner in which such sections apply) to the account, annuity, or endowment contract.

(*6*) Section 402(a)(2) and (e) (relating to tax on lump sum distributions) is not applicable to distributions from an account, annuity, or endowment contract.

(*7*) A minimum distribution is required under section 408(a) (6) or (7) and 408(b) (3) or (4) (including a brief explanation of the amount of minimum distribution) and that if the amount distributed from an account, annuity, or endowment contract during the taxable year of the payee is less than the minimum required during such year, an excise tax, which shall be paid by the payee, is imposed under section 4974, in an amount equal to 50 percent of the excess of the minimum required to be distributed over the amount actually distributed during the year.

(*8*) An excise tax is imposed under section 4973 on excess contributions (including a brief explanation of an excess contribution).

(*9*) The benefited individual must file Form 5329 (Return for Individual Retirement Savings Arrangement) with the Internal Revenue for each taxable year during which the account, annuity, or endowment contract is maintained.

(*10*) The account or contract has or has not (as the case may be) been approved as to form for use as an account, annuity, or endowment contract by the Internal Revenue Service. For purposes of this subdivision, if a favorable opinion or determination letter with respect to the form of a prototype trust, custodial account, annuity, or endowment contract has been issued by the Internal Revenue Service, or the instrument which establishes an individual retirement trust account or an individual retirement custodial account utilizes the precise language of a form currently provided by the Internal Revenue Service (including any additional language permitted by such

form), such account or contract may be treated as approved as to form.

(*11*) The Internal Revenue Service approval is a determination only as to the form of the account, annuity, or endowment contract, and does not represent a determination of the merits of such account, annuity, or endowment contract.

(*12*) The proceeds from the account, annuity or endowment contract may be used by the benefited individual as a rollover contribution to another account or annuity or retirement bond in accordance with the provisions of section 408(d)(3).

(*13*) In the case of an endowment contract described in section 408(b), no deduction is allowed under section 219 for that portion of the amounts paid under the contract for the taxable year properly allocable to the cost of life insurance.

(*14*) If applicable, in the event that the benefited individual revokes the account, annuity, or endowment contract, pursuant to the procedure described in the disclosure statement (see subdivision (A)(*4*) of this subdivision (iii)), the benefited individual is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or endowment contract without adjustment for such items as sales commissions, administrative expenses or fluctuation in market value.

(*15*) Further information can be obtained from any district office of the Internal Revenue Service.

To the extent that information on the matters described in subdivisions (iii) (A) and (B) of this subparagraph is provided in a publication of the Internal Revenue Service relating to individual retirement savings arrangements, such publication may be furnished by the trustee or issuer in lieu of providing information relating to such matters in a disclosure statement.

(C) The financial disclosure required by paragraph (d)(4) (v), (vi), and (vii) of this section.

(iv) In the case of an amendment to the terms of an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section, the disclosure statement required by this subparagraph need not repeat material contained in the statement furnished pursuant to paragraph (d)(4)(iii) of this section, but it must set forth in nontechnical language those matters described in paragraph (d)(4)(iii) of this section which are affected by such amendment.

(v) With respect to an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section (other than an account or annuity which is to receive only a rollover contribution described in paragraph (d)(4)(vi) of this section and to which no deductible contributions will be made), the disclosure statement must set forth in cases where either an amount is guaranteed over period of time (such as in the case of a nonparticipating endowment or annuity contract), or a projection of growth of the value of the account, annuity, or endowment contract can reasonably be made (such as in the case of a participating endowment or annuity contract (other than a variable annuity) or passbook savings account), the following:

(A) To the extent that an amount is guaranteed,

(*1*) The amount, determined without regard to any portion of a contribution which is not deductible, that would be guaranteed to be available to the benefited individual if (*i*) level annual contributions in the amount of $1,000 were to be made on the first day of each year, and (*ii*) the benefited individual were to withdraw in a single sum the entire amount of such account, annuity, or endowment contract at the end of each of the first five years during which contributions are to be made, at the end of the year in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the guaranteed available amount is less than the increase of the guaranteed available amount during any preceding year for any reason other than decrease of cessation of contributions, and

(*2*) A statement that the amount described in subdivision (v)(A)(*1*) of this subparagraph is guaranteed, and the period for which guaranteed;

(B) To the extent a projection of growth of the value of the account, annuity, or endowment contract can reasonably be made but the amounts are not guaranteed.

(*1*) The amount, determined without regard to any portion of a contribution which is not deductible, and upon the basis of an earnings rate no greater than, and terms no different from, those currently in effect, that would be available to the benefited individual if (*i*) level annual contributions in the amount of $1,000 were to be made on the first day of each year, and (*ii*) the benefited individual were to withdraw in a single sum the entire amount of such account, annuity, or endowment contract at the end of each of the first five years during which contributions are to be made, at the end of each of the years in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year for any reason other than decrease or cessation of contributions, and

(*2*) A statement that the amount described in paragraph (d)(4)(v)(B)(*1*) of this section is a projection and is not guaranteed and a statement of the earnings rate and terms on the basis of which the projection is made;

(C) The portion of each $1,000 contribution attributable to the cost of life insurance, which would not be deductible, for each year during which contributions are to be made; and

(D) The sales commission (including any commission attributable to the sale of life insurance), if any, to be charged in each year, expressed as a percentage of gross annual contributions (including any portion attributable to the cost of life insurance) to be made for each year.

(vi) With respect to an account or annuity described in paragraph (d)(4)(i) of this section to which a rollover contribution described in section 402(a)(5)(A), 403(a)(4)(A), 408(d)(3)(A) or 409(b)(3)(C) will be made, the disclosure statement must set forth, in cases where an amount is guaranteed over a period of time (such as in the case of a non-participating annuity contract, or a projection of growth of the value of the account or annuity can reasonably be made (such as in the case of a participating annuity contract (other than a variable annuity) or a passbook savings account), the following:

(A) To the extent guaranteed,

(1) The amount that would be guaranteed to be available to the benefited individual if *(i)* Such a rollover contribution in the amount of $1,000 were to be made on the first day of the year, *(ii)* No other contribution were to be made, and *(iii)* The benefited individual were to withdraw in a single sum the entire amount of such account or annuity at the end of each of the first five years after the contribution is made, at the end of the year in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the guaranteed available amount is less than the increase of the guaranteed available amount during any preceding year, and

(2) A statement that the amount described in paragraph (d)(vi)(A)(*1*) of this section is guaranteed;

(B) To the extent that a projection of growth of the value of the account or annuity can reasonably be made but the amounts are not guaranteed,

(1) The amount, determined upon the basis of an earnings rate no greater than, and terms no different from, those currently in effect, that would be available to the benefited individual if *(i)* such a rollover contribution in the amount of $1,000 were to be made on the first day of the year, *(ii)* no other contribution were to be made, and *(iii)* the benefited individual were to withdraw in a single sum the entire amount of such account or annuity at the end of each of the first five years after the contribution is made, at the end of each of the years in which the benefited individual attains the ages 60, 65, 70, and at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year, and

(2) A statement that the amount described in paragraph (d)(4)(vi)(B) *(1)* of this section is a projection and is not guaranteed and a statement of the

earnings rate and terms on the basis of which the projection is made; and

(C) The sales commission, if any, to be charged in each year, expressed as a percentage of the assumed $1,000 contribution.

(vii) With respect to an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section, in all cases not subject to paragraph (d)(4) (v) or (vi) of this section (such as in the case of a mutual fund or variable annuity), the disclosure statement must set forth information described in subdivisions (A) through (C) of this subdivisions (vii) based (as applicable with respect to the type or types of contributions to be received by the account, annuity, or endowment contract) upon the assumption of (1) level annual contributions of $1,000 on the first day of each year, (2) a rollover contribution of $1,000 on the first day of the year and no other contributions, or (3) a rollover contribution of $1,000 on the first day of the year plus level annual contributions of $1,000 on the first day of each year.

(A) A description (in nontechnical language) with respect to the benefited individual's interest in the account, annuity, or endowment contract, of:

(1) Each type of charge, and the amount thereof, which may be made against a contribution,

(2) The method for computing and allocating annual earnings, and

(3) Each charge (other than those described in complying with paragraph (d)(4)(vii)(A)*(1)* of this section) which may be applied to such interest in determining the net amount of money available to the benefited individual and the method of computing each such charge;

(B) A statement that growth in value of the account, annuity, or endowment contract is neither guaranteed nor projected; and

(C) The portion of each $1,000 contribution attributable to the cost of life insurance, which would not be deductible, for every year during which contributions are to be made.

(viii) A disclosure statement, or an amendment thereto, furnished pursuant to the provisions of this subparagraph may contain information in addition to that required by paragraph (d)(4)(iii) through (vii) of this section. However, such disclosure statement will not be considered to comply with the provisions of this subparagraph if the substance of such additional material or the form in which it is presented causes such disclosure statement to be false or misleading with respect to the information required to be disclosed by this paragraph.

(ix) The provisions of section 6693, relating to failure to provide reports on individual retirement accounts or annuities, shall apply to any trustee or issuer who fails to furnish, or cause to be furnished, a disclosure statement, a copy of the governing instrument, or an amendment to either, as required by this paragraph.

(x) This section shall be effective for disclosure statements and copies of governing instruments mailed, or delivered without mailing, after February 14, 1977.

(xi) This section does not reflect the amendments made by section 1501 of the Tax Reform Act of 1976 (90 Stat. 1734) relating to retirement savings for certain married individuals.

[T.D. 7714, 45 FR 52795, Aug. 8, 1980; 45 FR 56802, Aug. 26, 1980]

§ 1.408–7 Reports on distributions from individual retirement plans.

(a) *Requirement of report.* The trustee of an individual retirement account or the issuer of an individual retirement annuity who makes a distribution during any calendar year to an individual from such account or under such annuity shall make a report on Form W–2P (in the case of distributions that are not total distributions) or Form 1099R (in the case of total distributions), and their related transmittal forms, for such year. The return must show the name and address of the person to whom the distribution was made, the aggregate amount of such distribution, and such other information as is required by the forms.

(b) *Amount subject to this section.* The amounts subject to reporting under paragraph (a) include all amounts distributed or made available to which section 408(d) applies.

(c) *Time and place for filing.* The report required under this section for any calendar year shall be filed after the

close of that year and on or before February 28 of the following year with the appropriate Internal Revenue Service Center.

(d) *Statement to recipients.* (1) Each trustee or issuer required to file Form 1099R or Form W–2P under this section shall furnish to the person whose identifying number is (or should be) shown on the forms a copy of the form.

(2) Each statement required by this paragraph to be furnished to recipients shall be furnished to such person after November 30 of the year of the distribution and on or before January 31 of the following year.

(e) *Effective date.* This section is effective for calendar years beginning after December 31, 1977.

[T.D. 7714, 45 FR 52798, Aug. 8, 1980]

§ 1.408A–0 Roth IRAs; table of contents.

This table of contents lists the regulations relating to Roth IRAs under section 408A of the Internal Revenue Code as follows:

§ 1.408A–1 Roth IRAs in general.
§ 1.408A–2 Establishing Roth IRAs.
§ 1.408A–3 Contributions to Roth IRAs.
§ 1.408A–4 Converting amounts to Roth IRAs.
§ 1.408A–5 Recharacterized contributions.
§ 1.408A–6 Distributions.
§ 1.408A–7 Reporting.
§ 1.408A–8 Definitions.
§ 1.408A–9 Effective date.

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–1 Roth IRAs in general.

This section sets forth the following questions and answers that discuss the background and general features of Roth IRAs:

Q–1. What is a Roth IRA?

A–1. (a) A Roth IRA is a new type of individual retirement plan that individuals can use, beginning in 1998. Roth IRAs are described in section 408A, which was added by the Taxpayer Relief Act of 1997 (TRA 97), Public Law 105–34 (111 Stat. 788).

(b) Roth IRAs are treated like traditional IRAs except where the Internal Revenue Code specifies different treatment. For example, aggregate contributions (other than by a conversion or other rollover) to all an individual's Roth IRAs are not permitted to exceed $2,000 for a taxable year. Further, income earned on funds held in a Roth IRA is generally not taxable. Similarly, the rules of section 408(e), such as the loss of exemption of the account where the owner engages in a prohibited transaction, apply to Roth IRAs in the same manner as to traditional IRAs.

Q–2. What are the significant differences between traditional IRAs and Roth IRAs?

A–2. There are several significant differences between traditional IRAs and Roth IRAs under the Internal Revenue Code. For example, eligibility to contribute to a Roth IRA is subject to special modified AGI (adjusted gross income) limits; contributions to a Roth IRA are never deductible; qualified distributions from a Roth IRA are not includible in gross income; the required minimum distribution rules under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) do not apply to a Roth IRA during the lifetime of the owner; and contributions to a Roth IRA can be made after the owner has attained age 70½.

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–2 Establishing Roth IRAs.

This section sets forth the following questions and answers that provide rules applicable to establishing Roth IRAs:

Q–1. Who can establish a Roth IRA?

A–1. Except as provided in A–3 of this section, only an individual can establish a Roth IRA. In addition, in order to be eligible to contribute to a Roth IRA for a particular year, an individual must satisfy certain compensation requirements and adjusted gross income limits (see § 1.408A–3 A–3).

Q–2. How is a Roth IRA established?

A–2. A Roth IRA can be established with any bank, insurance company, or other person authorized in accordance with § 1.408–2(e) to serve as a trustee with respect to IRAs. The document establishing the Roth IRA must clearly designate the IRA as a Roth IRA, and this designation cannot be changed at a later date. Thus, an IRA that is designated as a Roth IRA cannot later be treated as a traditional IRA. However, see § 1.408A–4 A–1(b)(3) for certain rules

for converting a traditional IRA to a Roth IRA with the same trustee by redesignating the traditional IRA as a Roth IRA, and see §1.408A–5 for rules for recharacterizing certain IRA contributions.

Q–3. Can an employer or an association of employees establish a Roth IRA to hold contributions of employees or members?

A–3. Yes. Pursuant to section 408(c), an employer or an association of employees can establish a trust to hold contributions of employees or members made under a Roth IRA. Each employee's or member's account in the trust is treated as a separate Roth IRA that is subject to the generally applicable Roth IRA rules. The employer or association of employees may do certain acts otherwise required by an individual, for example, establishing and designating a trust as a Roth IRA.

Q–4. What is the effect of a surviving spouse of a Roth IRA owner treating an IRA as his or her own?

A–4. If the surviving spouse of a Roth IRA owner treats a Roth IRA as his or her own as of a date, the Roth IRA is treated from that date forward as though it were established for the benefit of the surviving spouse and not the original Roth IRA owner. Thus, for example, the surviving spouse is treated as the Roth IRA owner for purposes of applying the minimum distribution requirements under section 408(a)(6) and (b)(3). Similarly, the surviving spouse is treated as the Roth IRA owner rather than a beneficiary for purposes of determining the amount of any distribution from the Roth IRA that is includible in gross income and whether the distribution is subject to the 10-percent additional tax under section 72(t).

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–3 Contributions to Roth IRAs.

This section sets forth the following questions and answers that provide rules regarding contributions to Roth IRAs:

Q–1. What types of contributions are permitted to be made to a Roth IRA?

A–1. There are two types of contributions that are permitted to be made to a Roth IRA: regular contributions and qualified rollover contributions (including conversion contributions). The term regular contributions means contributions other than qualified rollover contributions.

Q–2. When are contributions permitted to be made to a Roth IRA?

A–2. (a) The provisions of section 408A are effective for taxable years beginning on or after January 1, 1998. Thus, the first taxable year for which contributions are permitted to be made to a Roth IRA by an individual is the individual's taxable year beginning in 1998.

(b) Regular contributions for a particular taxable year must generally be contributed by the due date (not including extensions) for filing a Federal income tax return for that taxable year. (See §1.408A–5 regarding recharacterization of certain contributions.)

Q–3. What is the maximum aggregate amount of regular contributions an individual is eligible to contribute to a Roth IRA for a taxable year?

A–3. (a) The maximum aggregate amount that an individual is eligible to contribute to all his or her Roth IRAs as a regular contribution for a taxable year is the same as the maximum for traditional IRAs: $2,000 or, if less, that individual's compensation for the year.

(b) For Roth IRAs, the maximum amount described in paragraph (a) of this A–3 is phased out between certain levels of modified AGI. For an individual who is not married, the dollar amount is phased out ratably between modified AGI of $95,000 and $110,000; for a married individual filing a joint return, between modified AGI of $150,000 and $160,000; and for a married individual filing separately, between modified AGI of $0 and $10,000. For this purpose, a married individual who has lived apart from his or her spouse for the entire taxable year and who files separately is treated as not married. Under section 408A(c)(3)(A), in applying the phase-out, the maximum amount is rounded up to the next higher multiple of $10 and is not reduced below $200 until completely phased out.

(c) If an individual makes regular contributions to both traditional IRAs and Roth IRAs for a taxable year, the maximum limit for the Roth IRA is the lesser of—

(1) The amount described in paragraph (a) of this A–3 reduced by the amount contributed to traditional IRAs for the taxable year; and

(2) The amount described in paragraph (b) of this A–3. Employer contributions, including elective deferrals, made under a SEP or SIMPLE IRA Plan on behalf of an individual (including a self-employed individual) do not reduce the amount of the individual's maximum regular contribution.

(d) The rules in this A–3 are illustrated by the following examples:

Example 1. In 1998, unmarried, calendar-year taxpayer B, age 60, has modified AGI of $40,000 and compensation of $5,000. For 1998, B can contribute a maximum of $2,000 to a traditional IRA, a Roth IRA or a combination of traditional and Roth IRAs.

Example 2. The facts are the same as in *Example 1.* However, assume that B violates the maximum regular contribution limit by contributing $2,000 to a traditional IRA and $2,000 to a Roth IRA for 1998. The $2,000 to B's Roth IRA would be an excess contribution to B's Roth IRA for 1998 because an individual's contributions are applied first to a traditional IRA, then to a Roth IRA.

Example 3. The facts are the same as in *Example 1,* except that B's compensation is $900. The maximum amount B can contribute to either a traditional IRA or a Roth (or a combination of the two) for 1998 is $900.

Example 4. In 1998, unmarried, calendar-year taxpayer C, age 60, has modified AGI of $100,000 and compensation of $5,000. For 1998, C contributes $800 to a traditional IRA and $1,200 to a Roth IRA. Because C's $1,200 Roth IRA contribution does not exceed the phased-out maximum Roth IRA contribution of $1,340 and because C's total IRA contributions do not exceed $2,000, C's Roth IRA contribution does not exceed the maximum permissible contribution.

Q–4. How is compensation defined for purposes of the Roth IRA contribution limit?

A–4. For purposes of the contribution limit described in A–3 of this section, an individual's compensation is the same as that used to determine the maximum contribution an individual can make to a traditional IRA. This amount is defined in section 219(f)(1) to include wages, commissions, professional fees, tips, and other amounts received for personal services, as well as taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance. Compensation also includes earned income as defined in section 401(c)(2), but does not include any amount received as a pension or annuity or as deferred compensation. In addition, under section 219(c), a married individual filing a joint return is permitted to make an IRA contribution by treating his or her spouse's higher compensation as his or her own, but only to the extent that the spouse's compensation is not being used for purposes of the spouse making a contribution to a Roth IRA or a deductible contribution to a traditional IRA.

Q–5. What is the significance of modified AGI and how is it determined?

A–5. Modified AGI is used for purposes of the phase-out rules described in A–3 of this section and for purposes of the $100,000 modified AGI limitation described in §1.408A–4 A–2(a) (relating to eligibility for conversion). As defined in section 408A(c)(3)(C)(i), modified AGI is the same as adjusted gross income under section 219(g)(3)(A) (used to determine the amount of deductible contributions that can be made to a traditional IRA by an individual who is an active participant in an employer-sponsored retirement plan), except that any conversion is disregarded in determining modified AGI. For example, the deduction for contributions to an IRA is not taken into account for purposes of determining adjusted gross income under section 219 and thus does not apply in determining modified AGI for Roth IRA purposes.

Q–6. Is a required minimum distribution from an IRA for a year included in income for purposes of determining modified AGI?

A–6. (a) Yes. For taxable years beginning before January 1, 2005, any required minimum distribution from an IRA under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) is included in income for purposes of determining modified AGI.

(b) For taxable years beginning after December 31, 2004, and solely for purposes of the $100,000 limitation applicable to conversions, modified AGI does not include any required minimum distributions from an IRA under section 408(a)(6) and (b)(3).

Q–7. Does an excise tax apply if an individual exceeds the aggregate regular contribution limits for Roth IRAs?

A–7. Yes. Section 4973 imposes an annual 6-percent excise tax on aggregate amounts contributed to Roth IRAs that exceed the maximum contribution limits described in A–3 of this section. Any contribution that is distributed, together with net income, from a Roth IRA on or before the tax return due date (plus extensions) for the taxable year of the contribution is treated as not contributed. Net income described in the previous sentence is includible in gross income for the taxable year in which the contribution is made. Aggregate excess contributions that are not distributed from a Roth IRA on or before the tax return due date (with extensions) for the taxable year of the contributions are reduced as a deemed Roth IRA contribution for each subsequent taxable year to the extent that the Roth IRA owner does not actually make regular IRA contributions for such years. Section 4973 applies separately to an individual's Roth IRAs and other types of IRAs.

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–4 Converting amounts to Roth IRAs.

This section sets forth the following questions and answers that provide rules applicable to Roth IRA conversions:

Q–1. Can an individual convert an amount in his or her traditional IRA to a Roth IRA?

A–1. (a) Yes. An amount in a traditional IRA may be converted to an amount in a Roth IRA if two requirements are satisfied. First, the IRA owner must satisfy the modified AGI limitation described in A–2(a) of this section and, if married, the joint filing requirement described in A–2(b) of this section. Second, the amount contributed to the Roth IRA must satisfy the definition of a qualified rollover contribution in section 408A(e) (i.e., it must satisfy the requirements for a rollover contribution as defined in section 408(d)(3), except that the one-rollover-per-year limitation in section 408(d)(3)(B) does not apply).

(b) An amount can be converted by any of three methods—

(1) An amount distributed from a traditional IRA is contributed (rolled over) to a Roth IRA within the 60-day period described in section 408(d)(3)(A)(i);

(2) An amount in a traditional IRA is transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA; or

(3) An amount in a traditional IRA is transferred to a Roth IRA maintained by the same trustee. For purposes of sections 408 and 408A, redesignating a traditional IRA as a Roth IRA is treated as a transfer of the entire account balance from a traditional IRA to a Roth IRA.

(c) Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA for purposes of section 408 and section 408A, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs of the same trustee.

(d) A transaction that is treated as a failed conversion under §1.408A–5 A–9(a)(1) is not a conversion.

Q–2. What are the modified AGI limitation and joint filing requirements for conversions?

A–2. (a) An individual with modified AGI in excess of $100,000 for a taxable year is not permitted to convert an amount to a Roth IRA during that taxable year. This $100,000 limitation applies to the taxable year that the funds are paid from the traditional IRA, rather than the year they are contributed to the Roth IRA.

(b) If the individual is married, he or she is permitted to convert an amount to a Roth IRA during a taxable year only if the individual and the individual's spouse file a joint return for the taxable year that the funds are paid from the traditional IRA. In this case, the modified AGI subject to the $100,000 limit is the modified AGI derived from the joint return using the couple's combined income. The only exception to this joint filing requirement is for an individual who has lived apart from his or her spouse for the entire taxable year. If the 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 this paragraph, file a separate return and be subject to the $100,000 limit on his or her separate modified AGI. In all other cases, a married individual filing a separate return is not permitted to convert an amount to a Roth IRA, regardless of the individual's modified AGI.

Q–3. Is a remedy available to an individual who makes a failed conversion?

A–3. (a) Yes. See §1.408A–5 for rules permitting a failed conversion amount to be recharacterized as a contribution to a traditional IRA. If the requirements in §1.408A–5 are satisfied, the failed conversion amount will be treated as having been contributed to the traditional IRA and not to the Roth IRA.

(b) If the contribution is not recharacterized in accordance with §1.408A–5, the contribution will be treated as a regular contribution to the Roth IRA and, thus, an excess contribution subject to the excise tax under section 4973 to the extent that it exceeds the individual's regular contribution limit. This is the result regardless of which of the three methods described in A–1(b) of this section applies to this transaction. Additionally, the distribution from the traditional IRA will not be eligible for the 4-year spread and will be subject to the additional tax under section 72(t) (unless an exception under that section applies).

Q–4. Do any special rules apply to a conversion of an amount in an individual's SEP IRA or SIMPLE IRA to a Roth IRA?

A–4. (a) An amount in an individual's SEP IRA can be converted to a Roth IRA on the same terms as an amount in any other traditional IRA.

(b) An amount in an individual's SIMPLE IRA can be converted to a Roth IRA on the same terms as a conversion from a traditional IRA, except that an amount distributed from a SIMPLE IRA during the 2-year period described in section 72(t)(6), which begins on the date that the individual first participated in any SIMPLE IRA Plan maintained by the individual's employer, cannot be converted to a Roth IRA. Pursuant to section 408(d)(3)(G), a distribution of an amount from an individual's SIMPLE IRA during this 2-year period is not eligible to be rolled over into an IRA that is not a SIMPLE IRA and thus cannot be a qualified rollover contribution. This 2-year period of section 408(d)(3)(G) applies separately to the contributions of each of an individual's employers maintaining a SIMPLE IRA Plan.

(c) Once an amount in a SEP IRA or SIMPLE IRA has been converted to a Roth IRA, it is treated as a contribution to a Roth IRA for all purposes. Future contributions under the SEP or under the SIMPLE IRA Plan may not be made to the Roth IRA.

Q–5. Can amounts in other kinds of retirement plans be converted to a Roth IRA?

A–5. No. Only amounts in another IRA can be converted to a Roth IRA. For example, amounts in a qualified plan or annuity plan described in section 401(a) or 403(a) cannot be converted directly to a Roth IRA. Also, amounts held in an annuity contract or account described in section 403(b) cannot be converted directly to a Roth IRA.

Q–6. Can an individual who has attained at least age 70½ by the end of a calendar year convert an amount distributed from a traditional IRA during that year to a Roth IRA before receiving his or her required minimum distribution with respect to the traditional IRA for the year of the conversion?

A–6. (a) No. In order to be eligible for a conversion, an amount first must be eligible to be rolled over. Section 408(d)(3) prohibits the rollover of a required minimum distribution. If a minimum distribution is required for a year with respect to an IRA, the first dollars distributed during that year are treated as consisting of the required minimum distribution until an amount equal to the required minimum distribution for that year has been distributed.

(b) As provided in A–1(c) of this section, any amount converted is treated as a distribution from a traditional IRA and a rollover contribution to a Roth IRA and not as a trustee-to-trustee transfer for purposes of section 408 and section 408A. Thus, in a year for

which a minimum distribution is required (including the calendar year in which the individual attains age 70½), an individual may not convert the assets of an IRA (or any portion of those assets) to a Roth IRA to the extent that the required minimum distribution for the traditional IRA for the year has not been distributed.

(c) If a required minimum distribution is contributed to a Roth IRA, it is treated as having been distributed, subject to the normal rules under section 408(d)(1) and (2), and then contributed as a regular contribution to a Roth IRA. The amount of the required minimum distribution is not a conversion contribution.

Q–7. What are the tax consequences when an amount is converted to a Roth IRA?

A–7. (a) Any amount that is converted to a Roth IRA is includible in gross income as a distribution according to the rules of section 408(d)(1) and (2) for the taxable year in which the amount is distributed or transferred from the traditional IRA. Thus, any portion of the distribution or transfer that is treated as a return of basis under section 408(d)(1) and (2) is not includible in gross income as a result of the conversion.

(b) The 10-percent additional tax under section 72(t) generally does not apply to the taxable conversion amount. But see §1.408A–6 A–5 for circumstances under which the taxable conversion amount would be subject to the additional tax under section 72(t).

(c) Pursuant to section 408A(e), a conversion is not treated as a rollover for purposes of the one-rollover-per-year rule of section 408(d)(3)(B).

Q–8. Is there an exception to the income-inclusion rule described in A–7 of this section for 1998 conversions?

A–8. Yes. In the case of a distribution (including a trustee-to-trustee transfer) from a traditional IRA on or before December 31, 1998, that is converted to a Roth IRA, instead of having the entire taxable conversion amount includible in income in 1998, an individual includes in gross income for 1998 only one quarter of that amount and one quarter of that amount for each of the next 3 years. This 4-year spread also applies if the conversion amount was distributed in 1998 and contributed to the Roth IRA within the 60-day period described in section 408(d)(3)(A)(i), but after December 31, 1998. However, see §1.408A–6 A–6 for special rules requiring acceleration of inclusion if an amount subject to the 4-year spread is distributed from the Roth IRA before 2001.

Q–9. Is the taxable conversion amount included in income for all purposes?

A–9. Except as provided below, any taxable conversion amount includible in gross income for a year as a result of the conversion (regardless of whether the individual is using a 4-year spread) is included in income for all purposes. Thus, for example, it is counted for purposes of determining the taxable portion of social security payments under section 86 and for purposes of determining the phase-out of the $25,000 exemption under section 469(i) relating to the disallowance of passive activity losses from rental real estate activities. However, as provided in §1.408A–3 A–5, the taxable conversion amount (and any resulting change in other elements of adjusted gross income) is disregarded for purposes of determining modified AGI for section 408A.

Q–10. Can an individual who makes a 1998 conversion elect not to have the 4-year spread apply and instead have the full taxable conversion amount includible in gross income for 1998?

A–10. Yes. Instead of having the taxable conversion amount for a 1998 conversion included over 4 years as provided under A–8 of this section, an individual can elect to include the full taxable conversion amount in income for 1998. The election is made on Form 8606 and cannot be made or changed after the due date (including extensions) for filing the 1998 Federal income tax return.

Q–11. What happens when an individual who is using the 4-year spread dies, files separately, or divorces before the full taxable conversion amount has been included in gross income?

A–11. (a) If an individual who is using the 4-year spread described in A–8 of this section dies before the full taxable conversion amount has been included in gross income, then the remainder must be included in the individual's

gross income for the taxable year that includes the date of death.

(b) However, if the sole beneficiary of all the decedent's Roth IRAs is the decedent's spouse, then the spouse can elect to continue the 4-year spread. Thus, the spouse can elect to include in gross income the same amount that the decedent would have included in each of the remaining years of the 4-year period. Where the spouse makes such an election, the amount includible under the 4-year spread for the taxable year that includes the date of the decedent's death remains includible in the decedent's gross income and is reported on the decedent's final Federal income tax return. The election is made on either Form 8606 or Form 1040, in accordance with the instructions to the applicable form, for the taxable year that includes the decedent's date of death and cannot be changed after the due date (including extensions) for filing the Federal income tax return for the spouse's taxable year that includes the decedent's date of death.

(c) If a Roth IRA owner who is using the 4-year spread and who was married in 1998 subsequently files separately or divorces before the full taxable conversion amount has been included in gross income, the remainder of the taxable conversion amount must be included in the Roth IRA owner's gross income over the remaining years in the 4-year period (unless accelerated because of distribution or death).

Q–12. Can an individual convert a traditional IRA to a Roth IRA if he or she is receiving substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) from that traditional IRA?

A–12. Yes. Not only is the conversion amount itself not subject to the early distribution tax under section 72(t), but the conversion amount is also not treated as a distribution for purposes of determining whether a modification within the meaning of section 72(t)(4)(A) has occurred. Distributions from the Roth IRA that are part of the original series of substantially equal periodic payments will be nonqualified distributions from the Roth IRA until they meet the requirements for being a qualified distribution, described in § 1.408A–6 A–1(b). The additional 10-percent tax under section 72(t) will not apply to the extent that these nonqualified distributions are part of a series of substantially equal periodic payments. Nevertheless, to the extent that such distributions are allocable to a 1998 conversion contribution with respect to which the 4-year spread for the resultant income inclusion applies (see A–8 of this section) and are received during 1998, 1999, or 2000, the special acceleration rules of § 1.408A–6 A–6 apply. However, if the original series of substantially equal periodic payments does not continue to be distributed in substantially equal periodic payments from the Roth IRA after the conversion, the series of payments will have been modified and, if this modification occurs within 5 years of the first payment or prior to the individual becoming disabled or attaining age 59½, the taxpayer will be subject to the recapture tax of section 72(t)(4)(A).

Q–13. Can a 1997 distribution from a traditional IRA be converted to a Roth IRA in 1998?

A–13. No. An amount distributed from a traditional IRA in 1997 that is contributed to a Roth IRA in 1998 would not be a conversion contribution. See A–3 of this section regarding the remedy for a failed conversion.

[T.D. 8816, 64 FR 5603, Feb. 4, 1999]

§ 1.408A–5 Recharacterized contributions.

This section sets forth the following questions and answers that provide rules regarding recharacterizing IRA contributions:

Q–1. Can an IRA owner recharacterize certain contributions (i.e., treat a contribution made to one type of IRA as made to a different type of IRA) for a taxable year?

A–1. (a) Yes. In accordance with section 408A(d)(6), except as otherwise provided in this section, if an individual makes a contribution to an IRA (the FIRST IRA) for a taxable year and then transfers the contribution (or a portion of the contribution) in a trustee-to-trustee transfer from the trustee of the FIRST IRA to the trustee of another IRA (the SECOND IRA), the individual can elect to treat the contribution as having been made to the SECOND IRA, instead of to the FIRST IRA,

for Federal tax purposes. A transfer between the FIRST IRA and the SECOND IRA will not fail to be a trustee-to-trustee transfer merely because both IRAs are maintained by the same trustee. For purposes of section 408A(d)(6), redesignating the FIRST IRA as the SECOND IRA will be treated as a transfer of the entire account balance from the FIRST IRA to the SECOND IRA.

(b) This recharacterization election can be made only if the trustee-to-trustee transfer from the FIRST IRA to the SECOND IRA is made on or before the due date (including extensions) for filing the individual's Federal income tax return for the taxable year for which the contribution was made to the FIRST IRA. For purposes of this section, a conversion that is accomplished through a rollover of a distribution from a traditional IRA in a taxable year that, 60 days after the distribution (as described in section 408(d)(3)(A)(i)), is contributed to a Roth IRA in the next taxable year is treated as a contribution for the earlier taxable year.

Q–2. What is the proper treatment of the net income attributable to the amount of a contribution that is being recharacterized?

A–2. (a) The net income attributable to the amount of a contribution that is being recharacterized must be transferred to the SECOND IRA along with the contribution.

(b) If the amount of the contribution being recharacterized was contributed to a separate IRA and no distributions or additional contributions have been made from or to that IRA at any time, then the contribution is recharacterized by the trustee of the FIRST IRA transferring the entire account balance of the FIRST IRA to the trustee of the SECOND IRA. In this case, the net income (or loss) attributable to the contribution being recharacterized is the difference between the amount of the original contribution and the amount transferred.

(c) If paragraph (b) of this A–2 does not apply, then the net income attributable to the amount of a contribution is calculated in the manner prescribed by §1.408–4(c)(2)(ii) (disregarding the parenthetical clause in §1.408–4(c)(2)(iii)).

Q–3. What is the effect of recharacterizing a contribution made to the FIRST IRA as a contribution made to the SECOND IRA?

A–3. The contribution that is being recharacterized as a contribution to the SECOND IRA is treated as having been originally contributed to the SECOND IRA on the same date and (in the case of a regular contribution) for the same taxable year that the contribution was made to the FIRST IRA. Thus, for example, no deduction would be allowed for a contribution to the FIRST IRA, and any net income transferred with the recharacterized contribution is treated as earned in the SECOND IRA, and not the FIRST IRA.

Q–4. Can an amount contributed to an IRA in a tax-free transfer be recharacterized under A–1 of this section?

A–4. No. If an amount is contributed to the FIRST IRA in a tax-free transfer, the amount cannot be recharacterized as a contribution to the SECOND IRA under A–1 of this section. However, if an amount is erroneously rolled over or transferred from a traditional IRA to a SIMPLE IRA, the contribution can subsequently be recharacterized as a contribution to another traditional IRA.

Q–5. Can an amount contributed by an employer under a SIMPLE IRA Plan or a SEP be recharacterized under A–1 of this section?

A–5. No. Employer contributions (including elective deferrals) under a SIMPLE IRA Plan or a SEP cannot be recharacterized as contributions to another IRA under A–1 of this section. However, an amount converted from a SEP IRA or SIMPLE IRA to a Roth IRA may be recharacterized under A–1 of this section as a contribution to a SEP IRA or SIMPLE IRA, including the original SEP IRA or SIMPLE IRA.

Q–6. How does a taxpayer make the election to recharacterize a contribution to an IRA for a taxable year?

A–6. (a) An individual makes the election described in this section by notifying, on or before the date of the transfer, both the trustee of the FIRST IRA and the trustee of the SECOND IRA, that the individual has elected to

treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, for Federal tax purposes. The notification of the election must include the following information: the type and amount of the contribution to the FIRST IRA that is to be recharacterized; the date on which the contribution was made to the FIRST IRA and the year for which it was made; a direction to the trustee of the FIRST IRA to transfer, in a trustee-to-trustee transfer, the amount of the contribution and net income allocable to the contribution to the trustee of the SECOND IRA; and the name of the trustee of the FIRST IRA and the trustee of the SECOND IRA and any additional information needed to make the transfer.

(b) The election and the trustee-to-trustee transfer must occur on or before the due date (including extensions) for filing the individual's Federal income tax return for the taxable year for which the recharacterized contribution was made to the FIRST IRA, and the election cannot be revoked after the transfer. An individual who makes this election must report the recharacterization, and must treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, on the individual's Federal income tax return for the taxable year described in the preceding sentence in accordance with the applicable Federal tax forms and instructions.

(c) The election to recharacterize a contribution described in this A–6 may be made on behalf of a deceased IRA owner by his or her executor, administrator, or other person responsible for filing the final Federal income tax return of the decedent under section 6012(b)(1).

Q–7. If an amount is initially contributed to an IRA for a taxable year, then is moved (with net income attributable to the contribution) in a tax-free transfer to another IRA (the FIRST IRA for purposes of A–1 of this section), can the tax-free transfer be disregarded, so that the initial contribution that is transferred from the FIRST IRA to the SECOND IRA is treated as a recharacterization of that initial contribution?

A–7. Yes. In applying section 408A(d)(6), tax-free transfers between IRAs are disregarded. Thus, if a contribution to an IRA for a year is followed by one or more tax-free transfers between IRAs prior to the recharacterization, then for purposes of section 408A(d)(6), the contribution is treated as if it remained in the initial IRA. Consequently, an individual may elect to recharacterize an initial contribution made to the initial IRA that was involved in a series of tax-free transfers by making a trustee-to-trustee transfer from the last IRA in the series to the SECOND IRA. In this case the contribution to the SECOND IRA is treated as made on the same date (and for the same taxable year) as the date the contribution being recharacterized was made to the initial IRA.

Q–8. If a contribution is recharacterized, is the recharacterization treated as a rollover for purposes of the one-rollover-per-year limitation of section 408(d)(3)(B)?

A–8. No, recharacterizing a contribution under A–1 of this section is never treated as a rollover for purposes of the one-rollover-per-year limitation of section 408(d)(3)(B), 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 recharacterization of a contribution to the FIRST IRA.

Q–9. If an IRA owner converts an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA in a recharacterization, may the IRA owner subsequently reconvert that amount from the traditional IRA to a Roth IRA?

A–9. (a)(1) Except as otherwise provided in paragraph (b) of this A–9, an IRA owner who converts an amount from a traditional IRA to a Roth IRA during any taxable year and then transfers that amount back to a traditional IRA by means of a recharacterization may not reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the taxable year following the taxable year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on

which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by means of a recharacterization (regardless of whether the recharacterization occurs during the taxable year in which the amount was converted to a Roth IRA or the following taxable year). Thus, any attempted reconversion of an amount prior to the time permitted under this paragraph (a)(1) is a failed conversion of that amount. However, see §1.408A–4 A–3 for a remedy available to an individual who makes a failed conversion.

(2) For purposes of paragraph (a)(1) of this A–9, a failed conversion of an amount resulting from a failure to satisfy the requirements of §1.408A–4 A–1(a) is treated as a conversion in determining whether an IRA owner has previously converted that amount.

(b)(1) An IRA owner who converts an amount from a traditional IRA to a Roth IRA during taxable year 1998 and then transfers that amount back to a traditional IRA by means of a recharacterization may reconvert that amount once (but no more than once) on or after November 1, 1998 and on or before December 31, 1998; the IRA owner may also reconvert that amount once (but no more than once) during 1999. The rule set forth in the preceding sentence applies without regard to whether the IRA owner's initial conversion or recharacterization of the amount occurred before, on, or after November 1, 1998. An IRA owner who converts an amount from a traditional IRA to a Roth IRA during taxable year 1999 that has not been converted previously and then transfers that amount back to a traditional IRA by means of a recharacterization may reconvert that amount once (but no more than once) on or before December 31, 1999. For purposes of this paragraph (b)(1), a failed conversion of an amount resulting from a failure to satisfy the requirements of §1.408A–4 A–1(a) is not treated as a conversion in determining whether an IRA owner has previously converted that amount.

(2) A reconversion by an IRA owner during 1998 or 1999 for which the IRA owner is not eligible under paragraph (b)(1) of this A–9 will be deemed an excess reconversion (rather than a failed conversion) and will not change the IRA owner's taxable conversion amount. Instead, the excess reconversion and the last preceding recharacterization will not be taken into account for purposes of determining the IRA owner's taxable conversion amount, and the IRA owner's taxable conversion amount will be based on the last reconversion that was not an excess reconversion (unless, after the excess reconversion, the amount is transferred back to a traditional IRA by means of a recharacterization). An excess reconversion will otherwise be treated as a valid reconversion.

(3) For purposes of this paragraph (b), any reconversion that an IRA owner made before November 1, 1998 will not be treated as an excess reconversion and will not be taken into account in determining whether any later reconversion is an excess reconversion.

(c) In determining the portion of any amount held in a Roth IRA or a traditional IRA that an IRA owner may not reconvert under this A–9, any amount previously converted (or reconverted) is adjusted for subsequent net income thereon.

Q–10. Are there examples to illustrate the rules in this section?

A–10. The rules in this section are illustrated by the following examples:

Example 1. In 1998, Individual C converts the entire amount in his traditional IRA to a Roth IRA. Individual C thereafter determines that his modified AGI for 1998 exceeded $100,000 so that he was ineligible to have made a conversion in that year. Accordingly, prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides to recharacterize the conversion contribution. He instructs the trustee of the Roth IRA (FIRST IRA) to transfer in a trustee-to-trustee transfer the amount of the contribution, plus net income, to the trustee of a new traditional IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his IRA contribution (and provides the other information described in A–6 of this section). On the individual's Federal income tax return for 1998, he treats the original amount of the conversion as having been contributed to the SECOND IRA and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the SECOND IRA and not to the Roth IRA. The result would be the same if the conversion amount had been transferred in a

tax-free transfer to another Roth IRA prior to the recharacterization.

Example 2. In 1998, an individual makes a $2,000 regular contribution for 1998 to his traditional IRA (FIRST IRA). Prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides that he would prefer to contribute to a Roth IRA instead. The individual instructs the trustee of the FIRST IRA to transfer in a trustee-to-trustee transfer the amount of the contribution, plus attributable net income, to the trustee of a Roth IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his $2,000 contribution for 1998 (and provides the other information described in A–6 of this section). On the individual's Federal income tax return for 1998, he treats the $2,000 as having been contributed to the Roth IRA for 1998 and not to the traditional IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the Roth IRA for 1998 and not to the traditional IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another traditional IRA prior to the recharacterization.

Example 3. The facts are the same as in *Example 2*, except that the $2,000 regular contribution is initially made to a Roth IRA and the recharacterizing transfer is made to a traditional IRA. On the individual's Federal income tax return for 1998, he treats the $2,000 as having been contributed to the traditional IRA for 1998 and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the traditional IRA for 1998 and not the Roth IRA. The result would be the same if the contribution had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization, except that the only Roth IRA trustee the individual must notify is the one actually making the recharacterization transfer.

Example 4. In 1998, an individual receives a distribution from traditional IRA 1 and contributes the entire amount to traditional IRA 2 in a rollover contribution described in section 408(d)(3). In this case, the individual cannot elect to recharacterize the contribution by transferring the contribution amount, plus net income, to a Roth IRA, because an amount contributed to an IRA in a tax-free transfer cannot be recharacterized. However, the individual may convert (other than by recharacterization) the amount in traditional IRA 2 to a Roth IRA at any time, provided the requirements of §1.408A–4 A–1 are satisfied.

[T.D. 8816, 64 FR 5605, Feb. 4, 1999]

§ 1.408A–6 Distributions.

This section sets forth the following questions and answers that provide rules regarding distributions from Roth IRAs:

Q–1. How are distributions from Roth IRAs taxed?

A–1. (a) The taxability of a distribution from a Roth IRA generally depends on whether or not the distribution is a qualified distribution. This A–1 provides rules for qualified distributions and certain other nontaxable distributions. A–4 of this section provides rules for the taxability of distributions that are not qualified distributions.

(b) A distribution from a Roth IRA is not includible in the owner's gross income if it is a qualified distribution or to the extent that it is a return of the owner's contributions to the Roth IRA (determined in accordance with A–8 of this section). A qualified distribution is one that is both—

(1) Made after a 5-taxable-year period (defined in A–2 of this section); and

(2) Made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of section 72(m)(7), or to which section 72(t)(2)(F) applies (exception for first-time home purchase).

(c) An amount distributed from a Roth IRA will not be included in gross income to the extent it is rolled over to another Roth IRA on a tax-free basis under the rules of sections 408(d)(3) and 408A(e).

(d) Contributions that are returned to the Roth IRA owner in accordance with section 408(d)(4) (corrective distributions) are not includible in gross income, but any net income required to be distributed under section 408(d)(4) together with the contributions is includible in gross income for the taxable year in which the contributions were made.

Q–2. When does the 5-taxable-year period described in A–1 of this section (relating to qualified distributions) begin and end?

A–2. The 5-taxable-year period described in A–1 of this section begins on the first day of the individual's taxable

year for which the first regular contribution is made to any Roth IRA of the individual or, if earlier, the first day of the individual's taxable year in which the first conversion contribution is made to any Roth IRA of the individual. The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For example, if an individual whose taxable year is the calendar year makes a first-time regular Roth IRA contribution any time between January 1, 1998, and April 15, 1999, for 1998, the 5-taxable-year period begins on January 1, 1998. Thus, each Roth IRA owner has only one 5-taxable-year period described in A–1 of this section for all the Roth IRAs of which he or she is the owner. Further, because of the requirement of the 5-taxable-year period, no qualified distributions can occur before taxable years beginning in 2003. For purposes of this A–2, the amount of any contribution distributed as a corrective distribution under A–1(d) of this section is treated as if it was never contributed.

Q–3. If a distribution is made to an individual who is the sole beneficiary of his or her deceased spouse's Roth IRA and the individual is treating the Roth IRA as his or her own, can the distribution be a qualified distribution based on being made to a beneficiary on or after the owner's death?

A–3. No. If a distribution is made to an individual who is the sole beneficiary of his or her deceased spouse's Roth IRA and the individual is treating the Roth IRA as his or her own, then, in accordance with §1.408A–2 A–4, the distribution is treated as coming from the individual's own Roth IRA and not the deceased spouse's Roth IRA. Therefore, for purposes of determining whether the distribution is a qualified distribution, it is not treated as made to a beneficiary on or after the owner's death.

Q–4. How is a distribution from a Roth IRA taxed if it is not a qualified distribution?

A–4. A distribution that is not a qualified distribution, and is neither contributed to another Roth IRA in a qualified rollover contribution nor constitutes a corrective distribution, is includible in the owner's gross income to the extent that the amount of the distribution, when added to the amount of all prior distributions from the owner's Roth IRAs (whether or not they were qualified distributions) and reduced by the amount of those prior distributions previously includible in gross income, exceeds the owner's contributions to all his or her Roth IRAs. For purposes of this A–4, any amount distributed as a corrective distribution is treated as if it was never contributed.

Q–5. Will the additional tax under 72(t) apply to the amount of a distribution that is not a qualified distribution?

A–5. (a) The 10-percent additional tax under section 72(t) will apply (unless the distribution is excepted under section 72(t)) to any distribution from a Roth IRA includible in gross income.

(b) The 10-percent additional tax under section 72(t) also applies to a nonqualified distribution, even if it is not then includible in gross income, to the extent it is allocable to a conversion contribution, if the distribution is made within the 5-taxable-year period beginning with the first day of the individual's taxable year in which the conversion contribution was made. The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For purposes of applying the tax, only the amount of the conversion contribution includible in gross income as a result of the conversion is taken into account. The exceptions under section 72(t) also apply to such a distribution.

(c) The 5-taxable-year period described in this A–5 for purposes of determining whether section 72(t) applies to a distribution allocable to a conversion contribution is separately determined for each conversion contribution, and need not be the same as the 5-taxable-year period used for purposes of determining whether a distribution is a qualified distribution under A–1(b) of this section. For example, if a calendar-year taxpayer who received a distribution from a traditional IRA on December 31, 1998, makes a conversion

contribution by contributing the distributed amount to a Roth IRA on February 25, 1999 in a qualifying rollover contribution and makes a regular contribution for 1998 on the same date, the 5-taxable-year period for purposes of this A–5 begins on January 1, 1999, while the 5-taxable-year period for purposes of A–1(b) of this section begins on January 1, 1998.

Q–6. Is there a special rule for taxing distributions allocable to a 1998 conversion?

A–6. Yes. In the case of a distribution from a Roth IRA in 1998, 1999 or 2000 of amounts allocable to a 1998 conversion with respect to which the 4-year spread for the resultant income inclusion applies (see §1.408A–4 A–8), any income deferred as a result of the election to years after the year of the distribution is accelerated so that it is includible in gross income in the year of the distribution up to the amount of the distribution allocable to the 1998 conversion (determined under A–8 of this section). This amount is in addition to the amount otherwise includible in the owner's gross income for that taxable year as a result of the conversion. However, this rule will not require the inclusion of any amount to the extent it exceeds the total amount of income required to be included over the 4-year period. The acceleration of income inclusion described in this A–6 applies in the case of a surviving spouse who elects to continue the 4-year spread in accordance with §1.408A–4 A–11(b).

Q–7. Is the 5-taxable-year period described in A–1 of this section redetermined when a Roth IRA owner dies?

A–7. (a) No. The beginning of the 5-taxable-year period described in A–1 of this section is not redetermined when the Roth IRA owner dies. Thus, in determining the 5-taxable-year period, the period the Roth IRA is held in the name of a beneficiary, or in the name of a surviving spouse who treats the decedent's Roth IRA as his or her own, includes the period it was held by the decedent.

(b) The 5-taxable-year period for a Roth IRA held by an individual as a beneficiary of a deceased Roth IRA owner is determined independently of the 5-taxable-year period for the beneficiary's own Roth IRA. However, if a surviving spouse treats the Roth IRA as his or her own, the 5-taxable-year period with respect to any of the surviving spouse's Roth IRAs (including the one that the surviving spouse treats as his or her own) ends at the earlier of the end of either the 5-taxable-year period for the decedent or the 5-taxable-year period applicable to the spouse's own Roth IRAs.

Q–8. How is it determined whether an amount distributed from a Roth IRA is allocated to regular contributions, conversion contributions, or earnings?

A–8. (a) Any amount distributed from an individual's Roth IRA is treated as made in the following order (determined as of the end of a taxable year and exhausting each category before moving to the following category)—

(1) From regular contributions;

(2) From conversion contributions, on a first-in-first-out basis; and

(3) From earnings.

(b) To the extent a distribution is treated as made from a particular conversion contribution, it is treated as made first from the portion, if any, that was includible in gross income as a result of the conversion.

Q–9. Are there special rules for determining the source of distributions under A–8 of this section?

A–9. Yes. For purposes of determining the source of distributions, the following rules apply:

(a) All distributions from all an individual's Roth IRAs made during a taxable year are aggregated.

(b) All regular contributions made for the same taxable year to all the individual's Roth IRAs are aggregated and added to the undistributed total regular contributions for prior taxable years. Regular contributions for a taxable year include contributions made in the following taxable year that are identified as made for the taxable year in accordance with §1.408A–3 A–2. For example, a regular contribution made in 1999 for 1998 is aggregated with the contributions made in 1998 for 1998.

(c) All conversion contributions received during the same taxable year by all the individual's Roth IRAs are aggregated. Notwithstanding the preceding sentence, all conversion contributions made by an individual during 1999 that were distributed from a

traditional IRA in 1998 and with respect to which the 4-year spread applies are treated for purposes of A–8(b) of this section as contributed to the individual's Roth IRAs prior to any other conversion contributions made by the individual during 1999.

(d) A distribution from an individual's Roth IRA that is rolled over to another Roth IRA of the individual in accordance with section 408A(e) is disregarded for purposes of determining the amount of both contributions and distributions.

(e) Any amount distributed as a corrective distribution (including net income), as described in A–1(d) of this section, is disregarded in determining the amount of contributions, earnings, and distributions.

(f) If an individual recharacterizes a contribution made to a traditional IRA (FIRST IRA) by transferring the contribution to a Roth IRA (SECOND IRA) in accordance with §1.408A–5, then, pursuant to §1.408A–5 A–3, the contribution to the Roth IRA is taken into account for the same taxable year for which it would have been taken into account if the contribution had originally been made to the Roth IRA and had never been contributed to the traditional IRA. Thus, the contribution to the Roth IRA is treated as contributed to the Roth IRA on the same date and for the same taxable year that the contribution was made to the traditional IRA.

(g) If an individual recharacterizes a regular or conversion contribution made to a Roth IRA (FIRST IRA) by transferring the contribution to a traditional IRA (SECOND IRA) in accordance with §1.408A–5, then pursuant to §1.408A–5 A–3, the contribution to the Roth IRA and the recharacterizing transfer are disregarded in determining the amount of both contributions and distributions for the taxable year with respect to which the original contribution was made to the Roth IRA.

(h) Pursuant to §1.408A–5 A–3, the effect of income or loss (determined in accordance with §1.408A–5 A–2) occurring after the contribution to the FIRST IRA is disregarded in determining the amounts described in paragraphs (f) and (g) of this A–9. Thus, for purposes of paragraphs (f) and (g), the amount of the contribution is determined based on the original contribution.

Q–10. Are there examples to illustrate the ordering rules described in A–8 and A–9 of this section?

A–10. Yes. The following examples illustrate these ordering rules:

Example 1. In 1998, individual B converts $80,000 in his traditional IRA to a Roth IRA. B has a basis of $20,000 in the conversion amount and so must include the remaining $60,000 in gross income. He decides to spread the $60,000 income by including $15,000 in each of the 4 years 1998–2001, under the rules of §1.408A–4 A–8. B also makes a regular contribution of $2,000 in 1998. If a distribution of $2,000 is made to B anytime in 1998, it will be treated as made entirely from the regular contributions, so there will be no Federal income tax consequences as a result of the distribution.

Example 2. The facts are the same as in *Example 1,* except that the distribution made in 1998 is $5,000. The distribution is treated as made from $2,000 of regular contributions and $3,000 of conversion contributions that were includible in gross income. As a result, B must include $18,000 in gross income for 1998: $3,000 as a result of the acceleration of amounts that otherwise would have been included in later years under the 4-year-spread rule and $15,000 includible under the regular 4-year-spread rule. In addition, because the $3,000 is allocable to a conversion made within the previous 5 taxable years, the 10-percent additional tax under section 72(t) would apply to this $3,000 distribution for 1998, unless an exception applies. Under the 4-year-spread rule, B would now include in gross income $15,000 for 1999 and 2000, but only $12,000 for 2001, because of the accelerated inclusion of the $3,000 distribution.

Example 3. The facts are the same as in *Example 1,* except that B makes an additional $2,000 regular contribution in 1999 and he does not take a distribution in 1998. In 1999, the entire balance in the account, $90,000 ($84,000 of contributions and $6,000 of earnings), is distributed to B. The distribution is treated as made from $4,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $6,000 of earnings. Because a distribution has been made within the 4-year-spread period, B must accelerate the income inclusion under the 4-year-spread rule and must include in gross income the $45,000 remaining under the 4-year-spread rule in addition to the $6,000 of earnings. Because $60,000 of the distribution is allocable to a conversion made within the previous 5 taxable years, it is subject to the 10-percent additional tax under section 72(t)

as if it were includible in gross income for 1999, unless an exception applies. The $6,000 allocable to earnings would be subject to the tax under section 72(t), unless an exception applies. Under the 4-year-spread rule, no amount would be includible in gross income for 2000 or 2001 because the entire amount of the conversion that was includible in gross income has already been included.

Example 4. The facts are the same as in *Example 1*, except that B also makes a $2,000 regular contribution in each year 1999 through 2002 and he does not take a distribution in 1998. A distribution of $85,000 is made to B in 2002. The distribution is treated as made from the $10,000 of regular contributions (the total regular contributions made in the years 1998–2002), $60,000 of conversion contributions that were includible in gross income, and $15,000 of conversion contributions that were not includible in gross income. As a result, no amount of the distribution is includible in gross income; however, because the distribution is allocable to a conversion made within the previous 5 years, the $60,000 is subject to the 10-percent additional tax under section 72(t) as if it were includible in gross income for 2002, unless an exception applies.

Example 5. The facts are the same as in *Example 4*, except no distribution occurs in 2002. In 2003, the entire balance in the account, $170,000 ($90,000 of contributions and $80,000 of earnings), is distributed to B. The distribution is treated as made from $10,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $80,000 of earnings. As a result, for 2003, B must include in gross income the $80,000 allocable to earnings, unless the distribution is a qualified distribution; and if it is not a qualified distribution, the $80,000 would be subject to the 10-percent additional tax under section 72(t), unless an exception applies.

Example 6. Individual C converts $20,000 to a Roth IRA in 1998 and $15,000 (in which amount C had a basis of $2,000) to another Roth IRA in 1999. No other contributions are made. In 2003, a $30,000 distribution, that is not a qualified distribution, is made to C. The distribution is treated as made from $20,000 of the 1998 conversion contribution and $10,000 of the 1999 conversion contribution that was includible in gross income. As a result, for 2003, no amount is includible in gross income; however, because $10,000 is allocable to a conversion contribution made within the previous 5 taxable years, that amount is subject to the 10-percent additional tax under section 72(t) as if the amount were includible in gross income for 2003, unless an exception applies. The result would be the same whichever of C's Roth IRAs made the distribution.

Example 7. The facts are the same as in *Example 6*, except that the distribution is a qualified distribution. The result is the same as in Example 6, except that no amount would be subject to the 10-percent additional tax under section 72(t), because, to be a qualified distribution, the distribution must be made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of section 72(m)(7), or to which section 72(t)(2)(F) applies (exception for a first-time home purchase). Under section 72(t)(2), each of these conditions is also an exception to the tax under section 72(t).

Example 8. Individual D makes a $2,000 regular contribution to a traditional IRA on January 1, 1999, for 1998. On April 15, 1999, when the $2,000 has increased to $2,500, D recharacterizes the contribution by transferring the $2,500 to a Roth IRA (pursuant to § 1.408A–5 A–1). In this case, D's regular contribution to the Roth IRA for 1998 is $2,000. The $500 of earnings is not treated as a contribution to the Roth IRA. The results would be the same if the $2,000 had decreased to $1,500 prior to the recharacterization.

Example 9. In December 1998, individual E receives a distribution from his traditional IRA of $300,000 and in January 1999 he contributes the $300,000 to a Roth IRA as a conversion contribution. In April 1999, when the $300,000 has increased to $350,000, E recharacterizes the conversion contribution by transferring the $350,000 to a traditional IRA. In this case, E's conversion contribution for 1998 is $0, because the $300,000 conversion contribution and the earnings of $50,000 are disregarded. The results would be the same if the $300,000 had decreased to $250,000 prior to the recharacterization. Further, since the conversion is disregarded, the $300,000 is not includible in gross income in 1998.

Q–11. If the owner of a Roth IRA dies prior to the end of the 5-taxable-year period described in A–1 of this section (relating to qualified distributions) or prior to the end of the 5-taxable-year period described in A–5 of this section (relating to conversions), how are different types of contributions in the Roth IRA allocated to multiple beneficiaries?

A–11. Each type of contribution is allocated to each beneficiary on a pro-rata basis. Thus, for example, if a Roth IRA owner dies in 1999, when the Roth IRA contains a regular contribution of $2,000, a conversion contribution of $6,000 and earnings of $1,000, and the owner leaves his Roth IRA equally to four children, each child will receive

one quarter of each type of contribution. Pursuant to the ordering rules in A–8 of this section, an immediate distribution of $2,000 to one of the children will be deemed to consist of $500 of regular contributions and $1,500 of conversion contributions. A beneficiary's inherited Roth IRA may not be aggregated with any other Roth IRA maintained by such beneficiary (except for other Roth IRAs the beneficiary inherited from the same decedent), unless the beneficiary, as the spouse of the decedent and sole beneficiary of the Roth IRA, elects to treat the Roth IRA as his or her own (see A–7 and A–14 of this section).

Q–12. How do the withholding rules under section 3405 apply to Roth IRAs?

A–12. Distributions from a Roth IRA are distributions from an individual retirement plan for purposes of section 3405 and thus are designated distributions unless one of the exceptions in section 3405(e)(1) applies. Pursuant to section 3405(a) and (b), nonperiodic distributions from a Roth IRA are subject to 10-percent withholding by the payor and periodic payments are subject to withholding as if the payments were wages. However, an individual can elect to have no amount withheld in accordance with section 3405(a)(2) and (b)(2).

Q–13. Do the withholding rules under section 3405 apply to conversions?

A–13. Yes. A conversion by any method described in § 1.408A–4 A–1 is considered a designated distribution subject to section 3405. However, a conversion occurring in 1998 by means of a trustee-to-trustee transfer of an amount from a traditional IRA to a Roth IRA established with the same or a different trustee is not required to be treated as a designated distribution for purposes of section 3405. Consequently, no withholding is required with respect to such a conversion (without regard to whether or not the individual elected to have no withholding).

Q–14. What minimum distribution rules apply to a Roth IRA?

A–14. (a) No minimum distributions are required to be made from a Roth IRA under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) while the owner is alive. The post-death minimum distribution rules under section 401(a)(9)(B) that apply to traditional IRAs, with the exception of the at-least-as-rapidly rule described in section 401(a)(9)(B)(i), also apply to Roth IRAs.

(b) The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distribution commences before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, such spouse may delay distributions until the decedent would have attained age 70½ or may treat the Roth IRA as his or her own.

(c) Distributions to a beneficiary that are not qualified distributions will be includible in the beneficiary's gross income according to the rules in A–4 of this section.

Q–15. Does section 401(a)(9) apply separately to Roth IRAs and individual retirement plans that are not Roth IRAs?

A–15. Yes. An individual required to receive minimum distributions from his or her own traditional or SIMPLE IRA cannot choose to take the amount of the minimum distributions from any Roth IRA. Similarly, an individual required to receive minimum distributions from a Roth IRA cannot choose to take the amount of the minimum distributions from a traditional or SIMPLE IRA. In addition, an individual required to receive minimum distributions as a beneficiary under a Roth IRA can only satisfy the minimum distributions for one Roth IRA by distributing from another Roth IRA if the Roth IRAs were inherited from the same decedent.

Q–16. How is the basis of property distributed from a Roth IRA determined for purposes of a subsequent disposition?

A–16. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is

a qualified distribution. Thus, for example, if a distribution consists of a share of stock in XYZ Corp. with an FMV of $40.00 on the date of distribution, for purposes of determining gain or loss on the subsequent sale of the share of XYZ Corp. stock, it has a basis of $40.00.

Q–17. What is the effect of distributing an amount from a Roth IRA and contributing it to another type of retirement plan other than a Roth IRA?

A–17. Any amount distributed from a Roth IRA and contributed to another type of retirement plan (other than a Roth IRA) is treated as a distribution from the Roth IRA that is neither a rollover contribution for purposes of section 408(d)(3) nor a qualified rollover contribution within the meaning of section 408A(e) to the other type of retirement plan. This treatment also applies to any amount transferred from a Roth IRA to any other type of retirement plan unless the transfer is a recharacterization described in § 1.408A–5.

Q–18. Can an amount be transferred directly from an education IRA to a Roth IRA (or distributed from an education IRA and rolled over to a Roth IRA)?

A–18. No amount may be transferred directly from an education IRA to a Roth IRA. A transfer of funds (or distribution and rollover) from an education IRA to a Roth IRA constitutes a distribution from the education IRA and a regular contribution to the Roth IRA (rather than a qualified rollover contribution to the Roth IRA).

Q–19. What are the Federal income tax consequences of a Roth IRA owner transferring his or her Roth IRA to another individual by gift?

A–19. A Roth IRA owner's transfer of his or her Roth IRA to another individual by gift constitutes an assignment of the owner's rights under the Roth IRA. At the time of the gift, the assets of the Roth IRA are deemed to be distributed to the owner and, accordingly, are treated as no longer held in a Roth IRA. In the case of any such gift of a Roth IRA made prior to October 1, 1998, if the entire interest in the Roth IRA is reconveyed to the Roth IRA owner prior to January 1, 1999, the Internal Revenue Service will treat the gift and reconveyance as never having occurred for estate tax, gift tax, and generation-skipping tax purposes and for purposes of this A–19.

[T.D. 8816, 64 FR 5607, Feb. 4, 1999]

§ 1.408A–7 Reporting.

This section sets forth the following questions and answers that relate to the reporting requirements applicable to Roth IRAs:

Q–1. What reporting requirements apply to Roth IRAs?

A–1. Generally, the reporting requirements applicable to IRAs other than Roth IRAs also apply to Roth IRAs, except that, pursuant to section 408A(d)(3)(D), the trustee of a Roth IRA must include on Forms 1099–R and 5498 additional information as described in the instructions thereto. Any conversion of amounts from an IRA other than a Roth IRA to a Roth IRA is treated as a distribution for which a Form 1099–R must be filed by the trustee maintaining the non-Roth IRA. In addition, the owner of such IRAs must report the conversion by completing Form 8606. In the case of a recharacterization described in § 1.408A–5 A–1, IRA owners must report such transactions in the manner prescribed in the instructions to the applicable Federal tax forms.

Q–2. Can a trustee rely on reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations?

A–2. A trustee maintaining a Roth IRA is permitted to rely on reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations.

[T.D. 8816, 64 FR 5610, Feb. 4, 1999]

§ 1.408A–8 Definitions.

This section sets forth the following question and answer that provides definitions of terms used in the provisions of §§ 1.408A–1 through 1.408A–7 and this section:

Q–1. Are there any special definitions that govern in applying the provisions of §§ 1.408A–1 through 1.408A–7 and this section?

A–1. Yes, the following definitions govern in applying the provisions of §§ 1.408A–1 through 1.408A–7 and this section. Unless the context indicates

otherwise, the use of a particular term excludes the use of the other terms.

(a) *Different types of IRAs*—(1) *IRA*. Sections 408(a) and (b), respectively, describe an individual retirement account and an individual retirement annuity. The term IRA means an IRA described in either section 408(a) or (b), including each IRA described in paragraphs (a)(2) through (5) of this A–1. However, the term IRA does not include an education IRA described in section 530.

(2) *Traditional IRA*. The term traditional IRA means an individual retirement account or individual retirement annuity described in section 408(a) or (b), respectively. This term includes a SEP IRA but does not include a SIMPLE IRA or a Roth IRA.

(3) *SEP IRA*. Section 408(k) describes a simplified employee pension (SEP) as an employer-sponsored plan under which an employer can make contributions to IRAs established for its employees. The term SEP IRA means an IRA that receives contributions made under a SEP. The term SEP includes a salary reduction SEP (SARSEP) described in section 408(k)(6).

(4) *SIMPLE IRA*. Section 408(p) describes a SIMPLE IRA Plan as an employer-sponsored plan under which an employer can make contributions to SIMPLE IRAs established for its employees. The term SIMPLE IRA means an IRA to which the only contributions that can be made are contributions under a SIMPLE IRA Plan or rollovers or transfers from another SIMPLE IRA.

(5) *Roth IRA*. The term Roth IRA means an IRA that meets the requirements of section 408A.

(b) *Other defined terms or phrases*—(1) *4-year spread*. The term 4-year spread is described in § 1.408A–4 A–8.

(2) *Conversion*. The term conversion means a transaction satisfying the requirements of § 1.408A–4 A–1.

(3) *Conversion amount or conversion contribution*. The term conversion amount or conversion contribution is the amount of a distribution and contribution with respect to which a conversion described in § 1.408A–4 A–1 is made.

(4) *Failed conversion*. The term failed conversion means a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed from a traditional IRA or Simple IRA (including a transfer by redesignation) in a transaction that does not constitute a conversion under § 1.408A–4 A–1.

(5) *Modified AGI*. The term modified AGI is defined in § 1.408A–3 A–5.

(6) *Recharacterization*. The term recharacterization means a transaction described in § 1.408A–5 A–1.

(7) *Recharacterized amount or recharacterized contribution*.The term recharacterized amount or recharacterized contribution means an amount or contribution treated as contributed to an IRA other than the one to which it was originally contributed pursuant to a recharacterization described in § 1.408A–5 A–1.

(8) *Taxable conversion amount*. The term taxable conversion amount means the portion of a conversion amount includible in income on account of a conversion, determined under the rules of section 408(d)(1) and (2).

(9) *Tax-free transfer*. The term tax-free transfer means a tax-free rollover described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), 403(b)(8), 403(b)(10) or 408(d)(3), or a tax-free trustee-to-trustee transfer.

(10) *Treat an IRA as his or her own*. The phrase treat an IRA as his or her own means to treat an IRA for which a surviving spouse is the sole beneficiary as his or her own IRA after the death of the IRA owner in accordance with the terms of the IRA instrument or in the manner provided in the regulations under section 408(a)(6) or (b)(3).

(11) *Trustee*. The term trustee includes a custodian or issuer (in the case of an annuity) of an IRA (except where the context clearly indicates otherwise).

[T.D. 8816, 64 FR 5610, Feb. 4, 1999]

§ 1.408A–9 Effective date.

This section contains the following question and answer providing the effective date of §§ 1.408A–1 through 1.408A–8:

Q–1. To what taxable years do §§ 1.408A–1 through 1.408A–8 apply?

A–1 Sections 1.408A–1 through 1.408A–8 apply to taxable years beginning on or after January 1, 1998.

[T.D. 8816, 64 FR 5611, Feb. 4, 1999]

§ 1.409–1 Retirement bonds.

(a) *In general*. Section 409 authorizes the issuance of bonds under the Second Liberty Bond Act the purchase price of which would be deductible under section 219. Section 409 also prescribes the tax treatment of such bonds. See paragraph (b) of this section.

(b) *Income tax treatment of bonds*—(1) *General rule*. Except as provided in paragraph (b)(2) of this section, the entire proceeds upon redemption of a retirement bond described in section 409(a) shall be included in the gross income of the taxpayer entitled to such proceeds. If a bond has not been tendered for redemption by the registered owner before the close of the taxable year in which he attains age 70½, he must include in his gross income for such taxable year the amount of the proceeds he would have received if the bond had been redeemed at age 70½. The provisions of sections 72 and 1232 do not apply to a retirement bond.

(2) *Exceptions*. (i) If a retirement bond is redeemed within 12 months after the issue date, the proceeds are excluded from gross income if no deduction is allowed under section 219 on account of the purchase of such bond. For definition of issue date, see 31 CFR 346.1(c).

(ii) If a retirement bond is redeemed after the close of the taxable year in which the registered owner attains age 70½ the proceeds from the redemption of the bond are excludable from the gross income of the registered owner or his beneficiary to the extent that such proceeds were includible in the gross income of the registered owner for such taxable year.

(iii) If a retirement bond is surrendered for reissuance in the same or lesser face amount, the difference between current redemption value of the bond surrendered for reissuance and the current surrender value of the bond reissued is includible in the gross income of the registered owner.

(3) *Basis*. The basis of a retirement bond is zero.

(c) *Rollover*. The first sentence of paragraph (b)(1) of this section shall not apply in any case in which a retirement bond is redeemed by the registered owner before the close of the taxable year in which he attains the age of 70½ if he transfers the entire amount of the proceeds of such redemption to—

(1) An individual retirement account described in section 408(a) or an individual retirement annuity described in section 408(b) (other than an endowment contract described in § 1.408–3(e)), or

(2) An employees' trust which is described in section 401(a) which is exempt from tax under section 501(a), or an annuity plan described in section 403(a), for the benefit of the registered owner, on or before the 60th day after the day on which he received the proceeds of such redemption. This subparagraph shall not apply in the case of a transfer to a trust or plan described in (c)(2) of this section unless no part of the purchase price of the retirement bond redeemed is attributable to any source other than a rollover contribution from such an employees' trust or annuity plan (other than an annuity plan or employees' trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan).

(d) *Additional tax*—(1) *Early redemption*. Except as provided in paragraph (d)(2) of this section, under section 409(c) if a retirement bond is redeemed by the registered owner before he attains age 59½, his tax under chapter 1 of the Code is increased by an amount equal to 10 percent of the proceeds of the redemption includible in his gross income for the taxable year. Except in the case of the credits allowable under sections 31, 39, or 42, no credit can be used to offset the tax described in the preceding sentence.

(2) *Limitations*. Paragraph (d)(1) of this section shall not apply if—

(i) During the taxable year of the registered owner in which a retirement bond is redeemed, the registered owner becomes disabled within the meaning of section 72(m)(7), or

(ii) A retirement bond is tendered for redemption in accordance with paragraph (b)(2)(i) of this section.

[T.D. 7714, 45 FR 52799, Aug. 8, 1980]

§ 1.410(a)–1 Minimum participation standards; general rules.

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies—

(1) The minimum age and service requirements of section 410(a)(1) and § 1.410(a)–3,

(2) The maximum age requirements of section 410(a)(2) and § 1.410(a)–4, and

(3) The minimum coverage requirements of section 410(b)(1) and § 1.410(b)–1.

(b) *Organization of regulations relating to minimum participation standards*—(1) *General rules.* This section prescribes general rules relating to the minimum participation standards provided by Section 410.

(2) *Effective dates.* Section 1.410(a)–2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 410.

(3) *Age and service conditions.* Section 1.410(a)–3 provides rules under section 410(a)(1) relating to minimum age and service conditions.

(4) *Maximum age and time of participation.* Section 1.410(a)–4 provides rules under section 410(a) (2) and (4) relating to maximum age and time of participation.

(5) *Year of service; breaks in service.* For rules relating to years of service and breaks in service, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans). See § 1.410(a)–5 for rules under section 410(a)(3)(B) relating to seasonal industries and for certain rules under section 410(a)(5) relating to breaks in service.

(6) *Breaks in service.* Section 1.410(a)–6 provides special rules under section 1017(f) of the Employee Retirement Income Security Act of 1974 relating to amendment of break in service rules.

(7) *Elapsed time.* Section 1.410 (a)–7 provides rules under sections 410 and 411 relating to the elapsed time method of crediting years of service.

(8) *Coverage.* Section 1.410(b)–1 provides rules relating to the minimum coverage requirements provided by section 410(b)(1).

(9) *Church election.* Section 1.410(d)–1 provides rules relating to the election by a church to have participation, vesting, funding, etc., provisions apply.

(c) *Application of participation standards to certain plans*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, section 410 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),

(ii) A church plan (within the meaning of section 414(e) and the regulations thereunder) which has not made the election provided by section 410(d) and the regulations thereunder,

(iii) A plan which has not provided for employer contributions at any time after September 2, 1974, and

(iv) A plan established and maintained by a society, order, or association described in section 501(c) (8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

(2) *Participation requirements.* A plan described in subparagraph (1) of this paragraph shall, for purposes of section 401(a), be treated as meeting the requirements of section 410 if such plan meets the coverage requirements resulting from the application of section 401(a)(3) as in effect on September 1, 1974. Such coverage requirements include the rules in § 1.410(b)–1(d) (special rules relating to minimum coverage requirements), that interpret statutory provisions substantially identical to section 401(a)(3) as in effect on September 1, 1974. In applying the rules of that paragraph (d) to plans described in this paragraph (c) employees whose principal duties consist in supervising the work of other employees shall be treated as officers, shareholders, and highly compensated employees.

(d) *Supersession.* Section 11.410(a)–1 through 11.410(d)–1 inclusive, of the Temporary Income Tax Regulation

under the Employee Retirement Income Security Act of 1974 are superseded by this section and §§ 1.410(a)–2 through 1.410(d)–1.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47193, Sept. 20, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980; T.D. 7735, 45 FR 74722, Nov. 12, 1980]

§ 1.410(a)–2 Effective dates.

(a) *Plans not in existence on January 1, 1974.* Under section 1017(a) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was not in existence on January 1, 1974, section 410 and the regulations thereunder apply for plan years beginning after September 2, 1974. See paragraph (c) of this section for time plan is considered in existence.

(b) *Plans in existence on January 1, 1974.* Under section 1017(b) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was in existence on January 1, 1974, section 410 and the regulations thereunder apply for plan years beginning after December 31, 1975. See paragraph (c) of this section for time plan is considered to be in existence.

(c) *Time of plan existence*—(1) *General rule.* For purposes of this section, a plan is considered to be in existence on a particular day if—

(i) The plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholder), even though no amounts had been contributed under the plan as of such day, and

(ii) The plan was not terminated on or before that day.

(2) *Collectively bargained plan.* Notwithstanding subparagraph (1) of this paragraph, a plan described in section 413(a), relating to a plan maintained pursuant to a collective bargaining agreement, is considered to be in existance on a particular day if—

(i) On or before that day there is a legally enforceable agreement to establish such a plan signed by the employer, and

(ii) The employer contributions to be made to the plan are set forth in the agreement.

(3) *Special rule.* If a plan is considered to be in existence on January 1, 1974, under subparagraph (1) of this paragraph, any other plan with which such existing plan is merged or consolidated shall also be considered to be in existence on such date.

(d) *Certain existing plans may elect new provisions*—(1) *In general.* The plan administrator (as defined in section 414(g)) of a plan that was in existence on January 1, 1974, may elect to have the provisions of the Code relating to participation, vesting, funding, and form of benefit (as in effect from time to time) apply to a plan year selected by the plan year selected by the plan administrator which begins after September 2, 1974, but before the otherwise applicable effective dates determined under section 1017 (b) or (c), 1021, or 1024 of the Employee Retirement Income Security Act of 1974, and to all subsequent plan years. The provisions referred to are the amendments to the Code made by sections 1011, 1012, 1013, 1015, 1016(a) (1) through (11) and (13) through (27), 1021, and 1022(b) of the Employee Retirement Income Security Act of 1974.

(2) *Election is irrevocable.* Any election made under this paragraph, once made shall be irrevocable.

(3) *Procedure and time for making election.* An election under this paragraph shall be made by attaching a statement to either the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or to a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and, if trusteed, the exempt status under section 501(a) of the Code of a trust consituting a part of the plan. If the election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter. The statement shall indicate that the election is made under section 1017(d) of the Employee Retirement Income Security Act of 1974 and the first plan year for which the election is effective.

(e) *Examples*. The rules of this section are illustrated by the following examples:

Example (1). A plan is adopted on January 2, 1974, effective as of Janurary 1, 1974. The plan is not considered to have been in existence on Janurary 1, 1974.

Example (2). A plan was in existence on January 1, 1974, and was amended on November 1, 1974, to increase benefits. The fact that the plan was amended is not relevant and the amended plan is considered to be in existence on January 1, 1974.

Example (3). (i) A subsidiary business corporation is a member of a controlled group of corporations within the meaning of IRC section 1563(a). On November 1, 1974, the plan of the parent corporation is amended to provide coverage for employees of the subsidiary corporation. This amendment of the parent corporation's plan does not affect the effective date of section 410 with respect to the parent corporation's plan. No distinction is made for this purpose between employees of the parent corporation and employees of the subsidiary corporation.

(ii) If the subsidiary adopted a separate plan on November 1, 1974, under paragraph (a) of this section, section 410 would apply to that plan for its first plan year beginning after September 2, 1974. However, the adoption of a different plan by the subsidiary would not affect the time section 410 applies to the plan of the parent corporation. If, instead of adopting its own separate plan, the subsidiary merely executed an adoption agreement under the terms of the parent plan providing that a subsidiary, upon the execution of an adoption agreement, will become part of the parent plan, the effective date of section 410 with respect to such plan will not be affected by the adoption of the plan by the subsidiary.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47194, Sept. 20, 1977]

§ 1.410(a)–3 Minimum age and service conditions.

(a) *General rule*. Except as provided by paragraph (b) or (c) of this section, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan requires, as a condition of participation in the plan, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(1) *Age 25*. The date on which the employee attains the age of 25; or

(2) *One year of service*. The date on which the employee completes 1 year of service.

(b) *Special rule for plan with 3-year 100 percent vesting*. A plan which provides that after not more than 3 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) *Age 25*. The date on which the employee attains the age of 25; or

(2) *Three years of service*. The date on which the employee completes 3 years of service.

(c) *Special rule for employees of certain educational institutions*. A plan maintained exclusively for employees of an educational institution (as defined in section 170(b)(1)(A)(ii)) by an employer exempt from tax under section 501(a) which provides that after 1 year of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) *Age 30*. The date on which the employee attains the age of 30; or

(2) *One year of service*. The date on which the employee completes 1 year of service.

(d) *Other conditions*. Section 410(a), § 1.410(a)–4, and this section relate solely to age and service conditions and do not preclude a plan from establishing conditions, other than conditions relating to age or service, which must be satisfied by plan participants. For example, such provisions would not preclude a qualified plan from requiring, as a condition of participation, that an employee be employed within a specified job classification. See section 410(b) and the regulations thereunder for rules with respect to coverage of employees under qualified plans.

(e) *Age and service requirements*—(1) *General rule*. For purposes of applying the rules of this section, plan provisons may be treated as imposing age or

service requirements even though the provisions do not specifically refer to age or service. Plan provisions which have the effect of requiring an age or service requirement with the employer or employers maintaing the plan will be treated as if they imposed an age or service requirement. In general, a plan under which an employee cannot participate unless he retires will impose an age and service requirement. However, a plan may provide benefits which supplement benefits provided for employees covered under a pension plan, as defined in section 3(2) of the Employee Retirement Income Security Act of 1974, satisfying the requirements of section 410(a)(1) without violating the age and service rules.

(2) *Examples*. The rules of this paragraph are illustrated by the following examples:

Example (1). Corporation A is divided into two divisions. In order to work in division 2 an employee must first have been employed in division 1 for 5 years. A plan provision which required division 2 employment for participation will be treated as a service requirement because such a provision has the effect of requiring 5 years of service.

Example (2). Plan B requires as a condition of participation that each employee have had a driver's license for 15 years or more. This provision will be treated as an age requirement because such a provision has the effect of requiring an employee to attain a specified age.

Example (3). A plan which requires 1 year of service as a condition of participation also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or 5 months in any plan year. The plan does not qualify because the provision could result in the exclusion by reason of a minimum service requirement of an employee who has completed a year of service. The plan would not qualify even though after excluding all such employees, the plan satisfied the coverage requirements of section 410(b).

Example (4). Employer A establishes a plan which covers employees after they retire and does not cover current employees unless they retire. Any employee who works past age 60 is treated as retired. The plan fails to satisfy the requirements of section 410(a) because the plan imposes a minimum age and service requirement in excess of that allowed by this section.

Example (5). Employer B establishes plan X, which provides that employees covered by qualified plan Y will receive benefits supplementing their benefits under plan Y to take into account cost of living increases after retirement. Plan X is not treated as imposing an age of service requirement.

Example (6). Employer C establishes a qualified plan satisfying the minimum age and service requirements. At a later time, entry into the plan is frozen so that employees not covered at that time cannot participate in the plan. The limitation on new participants is not treated as imposing a minimum age and service requirement.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47194, Sept. 20, 1977]

§ 1.410(a)–3T Minimum age and service conditions (temporary).

(a) [Reserved]

(b) *Special rule for plan with 2-year 100 percent vesting*. A plan which provides that after not more than 2 years of service each participant's right to his or her accrued benefit under the plan is completely nonforeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) [Reserved]

(2) *Two years of service*. The date on which the employee completes 2 years of service. For employees not described in §1.411(a)–3T(e)(1), which describes employees with one hour of service in any plan year beginning after December 31, 1988, or later in the case of certain collectively bargained plans, the preceding sentence shall be applied by substituting ''3 years of service'' for ''2 years of service''.

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(a)–4 Maximum age conditions and time of participation.

(a) *Maximum age conditions*—(1) *General rule*. A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan excludes from participation (on the basis of age) an employee who has attained an age specified by the plan unless—

(i) The plan is a defined benefit plan or a target benefit plan, and

(ii) The employee begins employment with the employer after the employee has attained an age specified by the plan, which age is not more than 5

years before normal retirement age (within the meaning of section 411(a)(8) and §1.411(a)–7.

For purposes of this paragraph, a target benefit plan is a defined contribution plan under which the amount of employer contributions allocated to each participant is determined under a plan formula which does not allow employer discretion and on the basis of the amount necessary to provide a target benefit specified by the plan for such participant. Such target benefit must be the type of benefit which is provided by a defined benefit plan and the targeted benefit must not discriminate in favor of employees who are officers, shareholders, or highly compensated. For purposes of this paragraph, in the determination of the time an employee begins employment, any such time which is included in a period of service which may be disregarded under the break in service rules need not be taken into account.

(2) *Examples*. The rules provided by this paragraph are illustrated by the following examples:

Example (1). A defined benefit plan provides that an employee will become a participant upon completion of 3 years of service if at such time the employee is less than age 60. The normal retirement age under the plan is age 65. The plan also provides full and immediate vesting for each of the plan's participants. Under the plan, an employee hired at age 58 would be denied participation on account of service for the first 3 years and on account of maximum age for the remaining years even though the employee was hired more than 5 years prior to the normal retirement date. The plan therefore does not satisfy section 410(a)(2).

Example. (2). A defined benefit plan provides a normal retirement age of the later of age 65 or completion of 10 years of service. Because no employee could ever be hired within 5 years of his normal retirement age, the plan could not exclude employees for being over a specified age.

Example (3). Prior to the effective date of section 410, a defined benefit plan with a normal retirement age of 65 contained a maximum age 55 requirement for participation. Because of the maximum age requirement, and employee hired at age 58 was excluded from the plan. This employee is age 61 at the time that section 410 first applies to the plan. The employee cannot be excluded from participation because of age. The exclusion under section 410(a)(2) is not applicable in this instance because the employee's age at the time of hire, 58, was not within 5 years of the normal retirement age specified in the plan.

Example (4). Employee A was hired at age 50 and participated in a defined benefit plan until separating from service at age 55 with 5 years of service and with no vested benefit. At age 61, employee A was rehired within 5 years of the normal retirement age of 65 after he incurred 6 consecutive breaks in service. Because A's consecutive number of 1-year breaks (6) exceeds his years of service prior to such breaks (5), his service before the breaks may be disregarded. Consequently, A's initial employment date falling within such period may be disregarded and the plan could exclude A on account of his age because his employment commenced within 5 years of normal retirement age.

(b) *Time of participation*—(1) *General rule*. A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless under the plan any employee who has satisfied the applicable minimum age and service requirements specified in §1.410(a)–3, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(i) The first day of the first plan year beginning after the date on which such employee first satisfied such requirements, or

(ii) The date 6 months after the date on which he first satisfied such requirements,

unless such employee was separated from service and has not returned before the date referred to in subdivision (i) or (ii), whichever is applicable. If such separated employee returns to service after either of such dates without incurring a 1-year break in service, the employee must commence participation immediately upon his return. In the case of a plan using the elapsed time method described in §1.410(a)–7, such an employee who has a period of absence commencing before the date referred to in subdivision (i) or (ii) (whichever is applicable) must commence participation as of such applicable date no later than the date such absence ended. However, if an employee's prior service is disregarded on account of the plan's break-in-service rules then, for purposes of this subparagraph, such service is also disregarded for purposes of determining the date on

which such employee first satisfied the minimum age and service requirements.

(2) *Examples*. The rules provided by this paragraph are illustrated by the following examples:

Example (1). A calendar year plan provides that an employee may enter the plan only on the first semi-annual entry date, January 1 or July 1, after he has satisfied the applicable minimum age and service requirements specified in section 410(a)(1). The plan satisfies the requirements of this paragraph because an employee is eligible to participate no later than the earlier of (1) the first day of the first plan year beginning after he satisfied the applicable minimum age and service requirements, or (2) the date 6 months after he satisfied such requirements.

Example (2). A plan provides that an employee is not eligible to participate until the first day of the first plan year beginning after he has satisfied the minimum age and service requirements of section 410(a)(1). In this case, an employee who satisfies the ''6 month'' rule described in subparagraph (1) of this paragraph will not be eligible to participate in the plan. Therefore, the plan does not satisfy the requirements of this paragraph.

Example (3). A calendar year plan provides that an employee may enter the plan only on the first semi-annual entry date, January 1 or July 1, after he has satisfied the applicable minimum age and service requirements specified in section 410(a)(1). Employee A after 10 years of service separated from service in 1976 with a vested benefit. On February 1, 1990, A returns to employment covered by the plan. Assuming A completes a year of service after his return, A must participate immediately on his return, February 1. A's prior service cannot be disregarded, because he had a vested benefit when he separated from service. Therefore, the plan may not postpone his participation until July 1.

Example (4). Assume the same facts as in example (3). The plan has the break-in-service rule described in section 410(a)(5)(D) and § 1.410(a)–5(c)(4). Employee B, after he had 5 years of service but no vested benefit incurs 5 consecutive 1-year breaks. Because B's prior service can be disregarded, the plan may postpone B's participation in the plan under the rule described in section 410(a)(4) and this paragraph.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47195, Sept. 20, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)–5 Year of service; break in service.

(a) *Year of service*. For the rules relating to years of service under subparagraphs (A), (C), and (D) of section 410(a)(3), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

Rules relating to a general rule for a year of service, hours of service, and maritime industries apply for purposes of section 410(a) and the regulations thereunder.

(b) *Seasonal industries*. For rules which relate to seasonal industries under section 410(a)(3)(B), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefits plans.

(c) *Breaks in service*—(1) *General rule*. This paragraph provides rules with respect to breaks in service under section 410(a)(5). Except as provided in subparagraphs (2), (3), (4), and (5) of this paragraph, all of an employee's years of service with the employer or employers maintaining a plan are taken into account in computing his period of service under the plan for purposes of section 410(a)(1) and § 1.410(a)–3.

(2) *Employees under 3-year 100 percent vesting schedule—(* i) *General rule*. In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 3 years of service, each participant's right to his accrued benefit under the plan in completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and § 1.410(a)-3 if such employee has not satisfied such service requirement.

(ii) *Example*. The rules of this subparagraph are illustrated by the following example.

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that

an employee complete 3 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a) (5). However, such a plan can require 3 years without a break in service, i.e., 3 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees whould become eligible to participate.

Year	Hours of service completed		
	Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	1,000	500
3	1,000	700	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000
6	1,000	1,000	1,000

NOTE.— Employee A will have satisfied the plan's service requirement at the end of year 3. Employee B at the end of year 4, and Employee C at the end of year 6.

(3) *One-year break in service*—(i) *In general*. In computing the period of service of an employee who has incurred a 1-year break in service, for purposes of section 410(a)(1) and §1.410(a)–3, a plan may disregard the employee's service before the break until the employee completes a year of service after such break in service.

(ii) *Examples*. The rules provided by this subparagraph are illustrated by the following examples.

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1980, and incurs a 1-year break in service for the 12-month period ending December 31, 1981. The plan does not contain the provisions permitted by section 410(a)(5)(B) (relating to 3-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1982, in computing his period of service under the plan his service prior to December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and §1.410 (a)–3.

Example (2). The employee in example (1) completes a year of service for the 12-month period ending December 31, 1982. Prior to December 31, 1982, in computing the employee's period of service as of any date occurring in 1982, the employee's service before December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and §11.410(a)–3. Because the employee completed a year of service for the 12-month period ending December 31, 1982, however, his period of service is redetermined as of January 1, 1982. Upon completion of a year of service for 1982, the employee's period of service, determined as of any date occurring in 1982, includes service prior to December 31, 1981.

(4) *Nonvested participants*—(i) *General rule*. In the case of a participant in a plan who does not have any nonforfeitable right under the plan to his employer-derived accrued benefit and who incurs a 1-year break in service, for purposes of section 410(a)(1) and §1.410.(a)–3 the plan may disregard his years of service prior to such break if the number of his consecutive 1-year breaks in service equals or exceeds his aggregate number of years of service prior to such break. In the case of a plan using the elapsed time method described in Department of Labor regulations, the plan may disregard such years of service prior to such break if the period of severance is at least 1 year and the period of severance equals or exceeds the prior period of service, whether or not consecutive, completed before such period of severance. The plan may in computing such aggregate number of years of service prior to such break disregard any years of service which could have been disregarded under this subparagraph by reason of any prior break in service.

(ii) *Examples*. The rules of this subparagraph are illustrated by the following example:

Example. In 1980, A, who was hired at age 35, separates from the service of X Corporation after completing 4 years of service. At this time A had no vested benefits. In 1985, after incurring 5 consecutive one-year breaks in service, A was reemployed. Under section 410(a)(5)(D), A's 4 years of service may be disregarded because they are exceeded by the number of years of consecutive one-year breaks (5) after such service.

(d) *Special continuity rule for certain plans*. For special rules for computing years of service in the case of a plan maintained by more than one employer, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47196, Sept. 20, 1977; T.D. 7508, 42 FR 57123, Nov. 1, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)–6 Amendment of break in service rules; Transition period.

(a) *In general.* Under section 1017(f) (1) of the Employee retirement Income Security Act of 1974, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the rules of the plan relating to breaks in service are amended, and—

(1) Such amendment is effective after January 1, 1974, and before the date on which section 410 becomes applicable to the plan, and

(2) Under such amendment, any employee's participation in the plan commences at any date later than the later of—

(i) The date on which his participation would commence under the break in service rules of section 410(a)(5), or

(ii) The earliest date on which his participation would commence under the plan as in effect on or after January 1, 1974.

(b) *Break in service rules.* For purposes of paragraph (a), the term ''break in service rules'' means the rules provided by a plan relating to circumstances under which a period of an employee's service or plan participation is disregarded for purposes of determining his rights to participate in the plan, if under such rules such service is disregarded by reason of the employee's failure to complete a required period of service within a specified period of time.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47197, Sept. 20, 1977; 43 FR 2721, Jan. 19, 1978]

§ 1.410(a)–7 Elapsed time.

(a) *In general*—(1) *Introduction to elapsed time method of crediting service.* (i) 29 CFR 2530.200b–2 sets forth the general method of crediting service for an employee. The general method is based upon the actual counting of hours of service during the applicable 12-consecutive-month computation period. The equivalencies set forth in 29 CFR 2530.200b–3 are also methods for crediting hours of service during computaton periods. Under the general method and the equivalencies an employee receives a year's credit (in units of years of service or years of participation) for a computation period during which the employee is credited with a specified number of hours of service. In general, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is determined by totalling the number of years' credit to which an employee is entitled.

(ii) Under the alternative method set forth in this section, by contrast, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is not based upon the actual completion of a specified number of hours of service during a 12-consecutive-month period. Instead, such entitlement is determined generally with reference to the total period of time which elapses while the employee is employed (i.e., while the employment relationship exists) with the employer or employers maintaining the plan. The alternative method set forth in this section is designed to enable a plan to lessen the administrative burdens associated with the maintenance of records of an employee's hours of service by permitting each employee to be credited with his or her total period of service with the employer or employers maintaining the plan, irrespective of the actual hours of service completed in any 12-consecutive-month period.

(2) *Overview of the operation of the elapsed time method.* (i) Under the elapsed time method of crediting service, a plan is generally required to take into account the period of time which elapses while the employee is employed (*i.e.*, while the employment relationship exists) with the employer or employers maintaining the plan, regardless of the actual number of hours he or she completes during such period. Under this alternative method of crediting service, an employee's service is required to be taken into account for purposes of eligibility to participate and vesting as of the date he or she first performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a)(1) for the employer or employers maintaining the plan. Service is required to be taken into account for the period of time from the date the employee first performs such an hour of service until the date he or she severs

from service with the employer or employers maintaining the plan.

(ii) The date the employee severs from service is the earlier of the date the employee quits, is discharged, retires or dies, or the first anniversary of the date the employee is absent from service for any other reason (e.g., disability, vacation, leave of absence, layoff, etc.). Thus, for example, if an employee quits, the severance from service date is the date the employee quits. On the other hand, if an employee is granted a leave of absence (and if no intervening event occurs), the severance from service date will occur one year after the date the employee was first absent on leave, and this one year of absence is required to be taken into account as service for the employer or employers maintaining the plan. Because the severance from service date occurs on the earlier of two possible dates (*i.e.*, quit, discharge, retirement or death *or* the first anniversary of an absence from service for any other reason), a quit, discharge, retirement or death within the year after the beginning of an absence for any other reason results in an immediate severance from service. Thus, for example, if an employee dies at the end of a four-week absence resulting from illness, the severance from service date is the date of death, rather than the first anniversary date of the first day of absence for illness.

(iii) In addition, for purposes of eligibility to participate and vesting under the elapsed time method of crediting service, an employee who has severed from service by reason of a quit, discharge or retirement may be entitled to have a period of time of 12 months or less taken into account by the employer or employers maintaining the plan if the employee returns to service within a certain period of time and performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a) (1). In general, the period of time during which the employee must return to service begins on the date the employee severs from service as a result of a quit, discharge or retirement and ends on the first anniversary of such date. However, if the employee is absent for any other reason (e.g., layoff) and then quits, is discharged or retires, the period of time during which the employee may return and receive credit begins on the severance from service date and ends one year after the first day of absence (e.g., first day of layoff). As a result of the operation of these rules, a severance from service (e.g., a quit), or an absence (e.g., layoff) followed by a severance from service, never results in a period of time of more than one year being required to be taken into account after an employee severs from service or is absent from service.

(iv) For purposes of benefit accrual under the elapsed time method of crediting service, an employee is entitled to have his or her service taken into account from the date he or she begins to participate in the plan until the severance from service date. Periods of severance under any circumstances are not required to be taken into account. For example, a participant who is discharged on December 14, 1980 and rehired on October 14, 1981 is not required to be credited with the 10 month period of severance for benefit accrual purposes.

(3) *Overview of certain concepts relating to the elapsed time method*—(i) *In general.* The rules with respect to the elapsed time method of crediting service are based on certain concepts which are defined in paragraph (b) of this section. These concepts are applied in the substantive rules contained in paragraphs (c), (d), (e), (f) and (g) of this section. The purpose of this subparagraph is to summarize these concepts.

(ii) *Employment commencement date.* (A) A concept which is necessary in order to credit service accurately under any service crediting method is the establishment of a starting point for crediting service. The employment commencement date, which is the date on which an employee first performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a) (1) for the employer or employers maintaining the plan, is used to establish the date upon which an employee must begin to receive credit for certain purposes (e.g., eligibility to participate and vesting).

(B) In order to credit accurately an employee's total service with an employer or employers maintaining the plan, a plan also may provide for an

''adjusted'' employment commencement date (*i.e.*, a recalculation of the employment commencement date to reflect noncreditable periods of severance) or a reemployment commencement date as defined in paragraph (b)(3) of this section. Fundamentally, all three concepts rely upon the performance of an hour of service to provide a starting point for crediting service. One purpose of these three concepts is to enable plans to satisfy the requirements of this section in a variety of ways.

(C) The fundamental rule with respect to these concepts is that any plan provision is permissible so long as it satisfies the minimum standards. Thus, for example, although the rules of this section provide that credit must begin on the employment commencement date, a plan is permitted to ''adjust'' the employment commencement date to reflect periods of time for which service is not required to be credited. Similarly, a plan may wish to credit service under the elapsed time method as discrete periods of service and provide for a reemployment commencement date. Certain plans may wish to provide for both concepts, although it is not a requirement of this section that plans so provide.

(iii) *Severance from service date.* Another fundamental concept of the elapsed time method of crediting service is the severance from service date, which is defined as the earlier of the date on which an employee quits, retires, is discharged or dies, or the first anniversary of the first date of absence for any other reason. One purpose of the severance from service date is to provide the endpoint for crediting service under the elapsed time method. As a general proposition, service is credited from the employment commencement date (*i.e.*, the starting point) until the severance from service date (*i.e.*, the endpoint). A complementary purpose of the severance from service date is to establish the starting point for measuring a period of severance from service in order to determine a ''break in service'' (see paragraph (a)(3)(v) of this section). A third purpose of such date is to establish the starting point for measuring the period of time which may be required to be taken into account under the service spanning rules (see paragraph (a)(3)(vi) of this section).

(iv) *Period of service.* A third elapsed time concept is the use of the ''period of service'' rather than the ''year of service'' in determining service to be taken into account for purposes of eligibility to participate, vesting and benefit accrual. For purposes of eligibility to participate and vesting, the period of service runs from the employment commencement date or reemployment commencement date until the severance from service date. For purposes of benefit accrual, a period of service runs from the date that a participant commences participation under the plan until the severance from service date. Because the endpoint of the period of service is marked by the severance from service date, an employee is credited with the period of time which runs during any absence from service (other than for reason of a quit, retirement, discharge or death) which is 12 months or less. Thus, for example, a three week absence for vacation is taken into account as part of a period of service and does not trigger a severance from service date.

(v) *Period of severance.* A period of severance begins on the severance from service date and ends when an employee returns to service with the employer or employers maintaining the plan. The purpose of the period of severance is to apply the statutory ''break in service'' rules to an elapsed time method of crediting service.

(vi) *Service spanning.* Under the elapsed time method of crediting service, a plan is required to credit periods of service and, under the service spanning rules, certain periods of severance of 12 months or less for purposes of eligibility to participate and vesting. Under the first service spanning rule, if an employee severs from service as a result of quit, discharge or retirement and then returns to service within 12 months, the period of severance is required to be taken into account. Also, a situation may arise in which an employee is absent from service for any reason other than quit, discharge, retirement or death and during the absence a quit, discharge or retirement occurs. The second service spanning

rule provides in that set of circumstances that a plan is required to take into account the period of time between the severance from service date (*i.e.*, the date of quit, discharge or retirement) and the first anniversary of the date on which the employee was first absent, if the employee returns to service on or before such first anniversary date.

(4) *Organization and applicability.* (i) The substantive rules for crediting service under the elapsed time method with respect to eligibility to participate are contained in paragraph (c), the rules with respect to vesting are contained in subparagraph (d), and the rules with respect to benefit accrual are contained in paragraph (e). The format of the rules is designed to enable a plan to use the elapsed time method of crediting service either for all purposes or for any one or combination of purposes under sections 410 and 411. Thus, for example, a plan may credit service for eligibility to participate purposes by the use of the general method of crediting service set forth in 29 CFR 2530.200b–2 or by the use of any of the equivalences set forth in 29 CFR 2530.200b–3, while the plan may credit service for vesting and benefit accrual purposes by the use of the elapsed time method of crediting service.

(ii) A plan using the elapsed time method of crediting service for one or more classifications of employees covered under the plan may use the general method of crediting service set forth in 29 CFR 2530.200b–2 or any of the equivalencies set forth in 29 CFR 2530.200b–3 for other classifications of employees, provided that such classifications are reasonable and are consistently applied. Thus, for example, a plan may provide that part-time employees are credited under the general method of crediting service set forth in 29 CFR 2530.200b–2 and full-time employees are credited under the elapsed time method. A classification, however, will not be deemed to be reasonable or consistently applied if such classification is designed with an intent to preclude an employee or employees from attaining his or her statutory entitlement with respect to eligibility to participate, vesting or benefit accrual. For example, a classification applied so that any full-time employee credited with less than 1,000 hours of service during a given 12-consecutive-month period would be considered part-time and subject to the general method of crediting service rather than the elapsed time method would not be reasonable.

(iii) Notwithstanding paragraph (a)(4)(i) and (ii) of this section, the use of the elapsed time method for some purposes or the use of the elapsed time method for some employees may, under certain circumstances, result in discrimination prohibited under section 401(a)(4), even though the use of the elapsed time method for such purposes, and for such employees, is permitted under this section.

(5) *More than one employer plans.* For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(b) *Definitions*—(1) *Employment commencement date.* For purposes of this section, the term ''employment commencement date'' shall mean the date on which the employee first performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a)(1) for the employer or employers maintaining the plan.

(2) *Severance from service date.* For purposes of this section, a ''severance from service'' shall occur on the earlier of—

(i) The date on which an employee quits, retires, is discharged or dies; or

(ii) The first anniversary of the first date of a period in which an employee remains absent from service (with or without pay) with the employer or employers maintaining the plan for any reason other than quit, retirement, discharge or death, such as vacation, holiday, sickness, disability, leave of absence or layoff.

(3) *Reemployment commencement date.* For purposes of this section, the term ''reemployment commencement date'' shall mean the first date, following a period of severance from service which is not required to be taken into account under the service spanning rules in paragraphs (c)(2)(iii) and (d)(1)(iii) of

this section, on which the employee performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan.

(4) *Participation commencement date.* For purposes of this section, the term ''participation commencement date'' shall mean the date a participant first commences participation under the plan.

(5) *Period of severance.* For purposes of this section, the term ''period of severance'' shall mean the period of time commencing on the severance from service date and ending on the date on which the employee again performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for an employer or employers maintaining the plan.

(6) *Period of service*—(i) *General rule.* For purposes of this section, the term ''period of service'' shall mean a period of service commencing on the employee's employment commencement date or reemployment commencement date, whichever is applicable, and ending on the severance from service date.

(ii) *Aggregation rule.* Unless a plan provides in some manner for an ''adjusted'' employment commencement date or similar method of consolidating periods of service, periods of service shall be aggregated unless such periods may be disregarded under section 410(a)(5) or 411(a)(4).

(iii) *Other federal law.* Nothing in this section shall be construed to alter, amend, modify, invalidate, impair or supersede any law of the United States or any rule or regulation issued under such law. Thus, for example, nothing in this section shall be construed as denying an employee credit for a ''period of service'' if credit is required by a separate federal law. Furthermore, the nature and extent of such credit shall be determined under such law.

(c) *Eligibility to participate*—(1) *General rule.* For purposes of section 410(a)(1)(A), a plan generally may not require as a condition of participation in the plan that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(i) The date on which the employee attains the age of 25; or

(ii) The date on which the employee completes a one-year period of service. See the regulations under section 410(a) (relating to eligibility to participate).

(2) *Determination of one-year period of service.* (i) For purposes of determining the date on which an employee satisfies the service requirement for initial eligibility to participate under the plan, a plan using the elapsed time method of crediting service shall provide that an employee who completes the 1-year period of service requirement on the first anniversary of his employment commencement date satisfies the minimum service requirement as of such date. In the case of an employee who fails to complete a one-year period of service on the first anniversary of his employment commencement date, a plan which does not contain a provision permitted by section 410(a)(5)(D) (rule of parity) shall provide for the aggregation of periods of service so that a one-year period of service shall be completed as of the date the employee completes 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service.

(ii) For purposes of section 410(a)(1)(B)(i), a ''3-year period of service'' shall be deemed to be ''3 years of service.''

(iii) *Service spanning rules.* In determining a 1-year period of service for purposes of initial eligibility to participate and a period of service for purposes of retention of eligibility to participate, in addition to taking into account an employee's period of service, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Notwithstanding paragraph (c)(2)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit,

discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's retention of eligibility to participate in the plan, a plan shall take into account an employee's entire period of service unless certain periods of service may be disregarded under section 410(a)(5) of the Code.

(v) *Example*. Employee W, age 31, completed 6 months of service and was laid off. After 2 months of layoff, W quit. Five months later, W returned to service. For purposes of eligibility to participate, W was required to be credited with 13 months of service (8 months of service and 5 months of severance). If, on the other hand, W had not returned to service within the first 10 months of severance (*i.e.*, within 12 months after the first day of layoff), W would be required to be credited with only 8 months of service.

(3) *Entry date requirements*—(i) *General rule*. For purposes of section 410(a)(4), it is necessary for a plan to provide that any employee who has satisfied the minimum age and service requirements, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(A) The first day of the first plan year beginning after the date on which such employee satisfied such requirements, or

(B) The date six months after the date on which he satisfied such requirements, unless such employee was separated from service before the date referred to in subdivision (i) (A) or (B), whichever is applicable. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) *Separation from service*—(A) *Definition*. For purposes of this section, the term ''separated from service'' includes a severance from service or an absence from service for any reason other than a quit, discharge, retirement or death, regardless of the duration of such absence. Accordingly, if an employee is laid off for a period of six weeks, the employee shall be deemed to be ''separated from service'' during such period for purposes of the entry date requirements.

(B) *Application*. A period of severance which is taken into account under the service spanning rules in paragraph (c)(2)(iii) of this section or an absence of 12 months or less may result in an employee satisfying the plan's minimum service requirement during such period of time. In addition, once an employee satisfies the plan's minimum service requirement, either before or during such period of time, such period of time may contain an entry date applicable to such employee. In the case of an employee whose period of severance is taken into account and such period contains an entry date applicable to the employee, he or she shall be made a participant in the plan (if otherwise eligible) no later than the date on which he or she ended the period of severance. In the case of an employee whose period of absence contains an entry date applicable to such employee, he or she, no later than the date such absence ended, shall be made a participant in the plan (if otherwise eligible) as of the first applicable entry date which occurred during such absence from service.

(iii) *Examples*. For purposes of the following examples, assume that the plan provides for a minimum age requirement of 25 and a minimum service requirement of one year, and provides for semi-annual entry dates.

(A) Employee A, age 35, worked for 10 months in a job classification covered under the plan, became disabled for nine consecutive months and then returned to service. During the period of absence, A completed a 1-year period of service and passed a semi-annual entry date after satisfying the minimum service requirement. Accordingly, the plan is required to make A a participant no later than his return to service effective as of the applicable entry date.

(B) Employee B, after satisfying the minimum age and service requirements, quit work before the next semi-annual entry date, and then returned to service before incurring a 1-year period of severance, but after such semi-

annual entry date. Employee B is entitled to become a participant immediately upon his return to service effective as of the date of his return.

(4) *Break in service.* For purposes of applying the break in service rules under section 410(a)(5) (B) and (C), the term ''1-year period of severance'' shall be substituted for the term ''1-year break in service''. A 1-year period of severance shall be determined on the basis of a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period does not perform an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan.

(5) *One-year hold-out*—(i) *General rule.* (A) For purposes of section 410(a)(5)(C), in determining the period of service of an employee who has incurred a 1-year period of severance, a plan may disregard the employee's period of service before such period of severance until the employee completes a 1-year period of service after such period of severance.

(B) *Example.* Assume that a plan provides for a minimum service requirement of 1-year and provides for semi-annual entry dates, but does not contain the provisions permitted by section 410(a)(5)(D) (relating to the rule of parity). Employee G, age 40, completed a seven-month period of service, quit and then returned to service 15 months later, thereby incurring a 1-year period of severance. After working four months, G was laid off for nine months and then returned to work again. Although the plan may hold employee G out from participation in the plan until the completion of a 1-year period of service after the 1-year (or greater) period of severance, once the 1-year hold-out is completed, the plan is required to provide the employee with such statutory entitlement as arose during the 1-year hold-out. Accordingly, employee G satisfied the 1-year hold-out requirement as of the eighth month of layoff, and G is entitled to become a participant in the plan immediately upon his return to service after the nine-month layoff effective as of the first applicable entry date occurring after the date on which he satisfied the 1-year of service requirement (*i.e.*, the first applicable entry date after the first month of layoff). See the regulations under section 410 (a) (relating to eligibility to participate).

(6) *Rule of parity*—(i) *General rule.* For purposes of section 410(a)(5)(D), in the case of a participant who does not have any nonforfeitable right under the plan to his accrued benefit derived from employer contributions and who incurs a 1-year period of severance, a plan, in determining an employee's period of service for purposes of section 410(a)(1), may disregard his period of service if his latest period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) In determining whether a completely nonvested employee's service may be disregarded under the rule of parity, a plan is not permitted to apply the rule until the employee incurs a 1-year period of severance. Accordingly, a plan may not disregard a period of service of less than one year until an employee has incurred a period of severance of at least one year.

(iii) *Example.* Assume that a plan provides for a minimum service requirement of one year and provides for the rule of parity. An employee works for three months, quits and then is rehired 10 months later. Such employee is entitled to receive 13 months of credit for purposes of eligibility to participate and vesting (see the service spanning rules). Although the period of severance exceeded the period of service, the three months of service may not be disregarded because no 1-year period of severance occurred.

(d) *Vesting*—(1) *General rule.* (i) For purposes of section 411(a)(2), relating to vesting in accrued benefits derived from employer contributions, a plan which determines service to be taken in account on the basis of elapsed time shall provide that an employee is credited with a number of years of service equal to at least the number of whole years of the employee's period of service, whether or not such periods of service were completed consecutively.

(ii) In order to determine the number of whole years of an employee's period of service, a plan shall provide that non-successive periods of service must be aggregated and that less than whole year periods of service (whether or not consecutive) must be aggregated on the basis that 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service equal a whole year of service.

(iii) *Service spanning rules.* In determining a participant's period of service for vesting purposes, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Nothwithstanding paragraph (d)(1)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory five to fifteen year graded vesting, an employee with a period (or periods) of service which yield 5 whole year periods of service and an additional 321-day period of service is twenty-five percent vested in his or her employer-derived accrued benefits (based solely on the 5 whole year periods of service).

(2) *Service which may be disregarded.* (i) For purposes of section 411(a)(4), in determining the nonforfeitable percentage of an employee's right to his or her accrued benefits derived from employer contributions, all of an employee's period or periods of service with an employer or employers maintaining the plan shall be taken into account unless such service may be disregarded under paragraph (d)(2)(ii) of this section.

(ii) For purposes of paragraph (d)(2)(i) of this section, the following periods of service may be disregarded—

(A) The period of service completed by an employee before the date on which he attains age 22;

(B) In the case of a plan which requires mandatory employee contributions, the period of service which falls within the period of time to which a particular employee contribution relates, if the employee had the opportunity to make a contribution for such period of time and failed to do so;

(C) The period of service during any period for which the employer did not maintain the plan or a predecessor plan;

(D) The period of service which is not required to be taken into account by reason of a period of severance which constitutes a break in service within the meaning of paragraph (d)(4) of this section;

(E) The period of service completed by an employee prior to January 1, 1971, unless the employee completes a period of service of at least 3 years at any time after December 31, 1970; and

(F) The period of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service in effect at that time. See the regulations under section 411(a) (relating to vesting).

(3) *Seasonal industry.* [Reserved]

(4) *Break in service.* For purposes of applying the break in service rules, the term ''1-year period of severance'' shall be substituted for the term ''1-year break in service''. A 1-year period of severance shall be a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period fails to

perform an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for an employer or employers maintaining the plan.

(5) *One-year hold-out.* For purposes of section 411(a)(6)(B), in determining the nonforfeitable percentage of the right to accrued benefits derived from employer contributions of an employee who has incurred a 1-year period of severance, the period of service completed before such period of severance is not required to be taken into account until the employee has completed a 1-year period of service after his return to service. See the regulations under section 411(a) (relating to vesting).

(6) *Vesting in pre-break accruals.* For purposes of section 411(a)(6)(C), a ''1-year period of severance'' shall be deemed to constitute a ''1-year break in service.'' See the regulations under section 411(a) (relating to vesting).

(7) *Rule of partity*—(i) *General rule.* For purposes of section 411(a)(6)(D), in the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year period of severance, the period of service completed by such participant before such period of severance is not required to be taken into account for purposes of determining the vested percentage of his or her right to employer-derived benefits if at such time the consecutive period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 411(a) (relating to vesting).

(e) *Benefit accrual.* (1) For purposes of section 411(b), a plan may provide that a participant's service with an employer or employers maintaining the plan shall be determined on the basis of the participant's total period of service beginning on the participation commencement date and ending on the severance from service date.

(2) Under section 411(b)(3)(A), a defined benefit pension plan may determine an employee's service for purposes of benefit accrual on any basis which is reasonable and consistent and which takes into account all service during the employee's participation in the plan which is included in a period of service required to be taken into account under section 410(a)(5) (relating to service which must be taken into account for purposes of determining an employee's eligibility to participate). A plan which provides for the determination of an employee's service with an employer or employers maintaining the plan on the basis permitted under paragraph (e)(1) of this section will be deemed to meet the requirements of section 411(b)(3)(A), provided that the plan meets the requirements of 29 CFR 2530.204–3, relating to plans which determine an employee's service for purposes of benefit accrual on a basis other than computation periods. Specifically, under 29 CFR 2530.204–3, it must be possible to prove that, despite the fact that benefit accrual under such a plan is not based on computation periods, the plan's provisions meet at least one of the three benefit accrual rules of section 411(b)(1) under all circumstances. Further, 29 CFR 2530.204–3 prohibits such a plan from disregarding service under section 411(b)(3)(C) (which would otherwise permit a plan to disregard service performed by an employee during a computation period in which the employee is credited with less than 1,000 hours). See the regulations under section 411(b) (relating to benefit accrual).

(f) *Transfers between methods of crediting service*—(1) *Single plan.* A plan may provide that an employee's service for purposes of eligibility to participate, vesting or benefit accrual shall be determined on the basis of computation periods under the general method set forth in 29 CFR 2530.200b–2 for certain classes of employees but under the alternative method permitted under this section for other classes of employees if the plan provides as follows—

(i) In the case of an employee who transfers from a class of employees whose service is determined on the basis of computation periods to a class of employees whose service is determined on the alternative basis permitted under this section, the employee shall receive credit for a period of service consisting of—

(A) A number of years equal to the number of years of service credited to the employee before the computation period during which the transfer occurs; and

(B) The greater of *(1)* the period of service that would be credited to the employee under the elapsed time method for his service during the entire computation period in which the transfer occurs or *(2)* the service taken into account under the computation periods method as of the date of the transfer.

In addition, the employee shall receive credit for service subsequent to the transfer commencing on the day after the last day of the computation period in which the transfer occurs.

(ii) In the case of an employee who transfers from a class of employees whose service is determined on the alternative basis permitted under this section to a class of employees whose service is determined on the basis of computation periods—

(A) The employee shall receive credit, as of the date of the transfer, for a number of years of service equal to the number of 1-year periods of service credited to the employee as of the date of the transfer, and

(B) The employee shall receive credit, in the computation period which includes the date of the transfer, for a number of hours of service determined by applying one of the equivalencies set forth in 29 CFR 2530.200b–3 (e) (1) to any fractional part of a year credited to the employee under this section as of the date of the transfer. Such equivalency shall be set forth in the plan and shall apply to all similarly situated employees.

(2) *More than one plan.* In the case of an employee who transfers from a plan using either the general method of determining service on the basis of computation periods set forth in 29 CFR 2530.200b–2 or the method of determining service permitted under this section to a plan using the other method of determining service, all service required to be credited under the plan to which the employee transfers shall be determined by applying the rules of paragraph (f)(1) of this section.

(g) *Amendments to change method of crediting service.* A plan may be amended to change the method of crediting service for any purpose or for any class of employees between the general method set forth in 29 CFR 2530.200–2 and the method permitted under this section, if such amendment contains provisions under which each employee with respect to whom the method of crediting service is changed is treated in the same manner as an employee who transfers from one class of employees to another under paragraph (f)(1) of this section.

(h) *Transitional rule.* For plans in existence on [insert the date of the publication of this document], the provisions of paragraph (f) of this section are effective for plan years beginning after December 31, 1983.

[T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)–8 Five consecutive 1-year breaks in service, transitional rules under the Retirement Equity Act of 1984.

Sections 410(a)(5)(D) and 411(a)(6)(D), as amended by the Retirement Equity Act of 1984 (REA 1984), permit a plan to disregard years of service that were disregarded under the plan provisions satisfying those sections (as in effect on August 22, 1984) as of the day before the REA amendments apply to the plan. Under section 302(a) of REA 1984, the new break-in-service rules generally apply to plan years beginning after December 31, 1984. Thus, for example, assume a plan has a calendar plan year and disregarded years of service as permitted by sections 410(a)(5)(D) and 411(a)(6)(D) as in effect on August 22, 1984. An employee completed two years of service in 1981 and 1982, and then incurred two consecutive 1-year breaks in service in 1983 and 1984. The plans may disregard the prior years of service even though the employee did not incur five consecutive 1-year breaks in service. On the other hand, assume the employee completed three consecutive years of service beginning in 1980, and incurred two 1-year breaks in service in 1983 and 1984. Because, as of December 31, 1984, the years of service credited before 1983 could not be disregarded, whether the plan may subsequently disregard those years of service would be governed by the rules enacted by REA 1984.

[T.D. 8219, 53 FR 31851, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.410(a)–8T Year of service; break in service (temporary).

(a)–(b) [Reserved]

(c) *Breaks in service.*

(1) [Reserved]

(2) *Employees under 2-year 100 percent vesting schedule*—(i) *General rule.* In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 2 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and § 1.410(a)–3 if such employee has not satisfied such service requirement.

(ii) *Example.* The rules of this subparagraph are illustrated by the following example:

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that an employee complete 2 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a)(5). However, such a plan can require 2 years without a break in service, i.e., 2 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees would become eligible to participate.

Year	Hours of service completed		
	Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	700	500
3	1,000	1,000	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000

NOTE: Employee A will have satisfied the plan's service requirement at the end of year 2, Employee B at the end of year 3, and Employee C at the end of year 5.

(3) *One-year break in service*—

(i) [Reserved]

(ii) *Examples.* The rules provided by this subparagraph are illustrated by the following examples:

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1989, and incurs a 1-year break in service for the 12-month period ending December 31, 1990. The plan does not contain the provisions permitted by section 410(a)(5)(B) (relating to 2-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1991, in computing his period of service under the plan his service prior to December 31, 1990, is not required to be taken into account for purposes of section 410(a)(1) and § 1.410(a)–3.

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(a)–9 Maternity and paternity absence.

(a) *Elapsed time*—(1) *Rule.* For purposes of applying the rules of § 1.410(a)–7 (relating to the elapsed time method of crediting service) to absences described in sections 410(a)(5)(E) and 411(a)(6)(E) (relating to maternity or paternity absence), the severance from service date of an employee who is absent from service beyond the first anniversary of the first day of absence by reason of a maternity or paternity absence described in section 410(a)(5)(E)(i) or 411(a)(6)(E)(i) is the second anniversary of the first day of such absence. The period between the first and second anniversaries of the first day of absence from work is neither a period of service nor a period of severance. This rule applies to maternity and paternity absences beginning on or after the first day of the first plan year in which the plan is required to credit service under sections 410(a)(5)(E) and 411(a)(6)(E).

(2) *Example.* The rules of this section are illustrated by the following example:

Assume an individual works until June 30, 1986; is first absent from employment on July 1, 1986, on account of maternity or paternity absence; and on July 1, 1989, performs an hour of service. The period of service must include the period from employment commencement date until June 30, 1987 (one year after the date of separation for any reason other than a quit, discharge, retirement, or death). The period from July 1, 1987, to June 30, 1988, is neither a period of service nor a period of severance. The period of severance would be from July 1, 1988, to June 30, 1989.

(b) *Other methods.* This paragraph provides a safe harbor for plans that compute years of service under the

hours of service methods or permitted equivalencies. Such a plan will be treated as satisfying the requirements of sections 410(a)(5)(E) and 411(a)(6)(E) if the plan increases the minimum period of consecutive 1-year breaks required to disregard any service (or deprive any employee of any right) by one. Thus, a plan will satisfy sections 410(a)(5)(E) and 411(a)(6)(E) without having to compute service for maternity or paternity and sections 410(a)(5)(D) and 411 (a)(4)(D) and (a)(6)(C), by increasing the period of consecutive breaks–in–service from 5 to 6.

[T.D. 8219, 53 FR 31852, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.410(a)–9T Elapsed time (temporary).

(a)–(b) [Reserved]

(c) *Eligibility to participate.*

(1) [Reserved]

(2) *Determination of one-year period of service.*

(i) [Reserved]

(ii) For purposes of section 410(a)(1)(B)(i), a ''2-year period of service'' shall be deemed to be ''2 years of service.''

(d) *Vesting*—(1) *General rule.*

(i)–(iii) [Reserved]

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory three to seven year graded vesting, an employee with a period (or periods) of service which yields 3 whole year periods of service and an additional 321-day period of service is twenty percent vested in his or her employer-derived accrued benefits (based solely on the 3 whole year periods of service).

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(b)–0 Table of contents.

This section contains a listing of the major headings of §§ 1.410(b)–1 through 1.410(b)–10.

§ 1.410(b)–1 Minimum coverage requirements (before 1994).

(a) In general.

(b) Coverage tests.

(1) Percentage test.

(2) Classification test.

(c) Exclusion of certain employees.

(1) Bargaining unit.

(2) Air pilots.

(3) Nonresident aliens.

(d) Special rules.

(1) Highly compensated.

(2) Discrimination.

(3) Multiple plans.

(4) Profit-sharing plans.

(5) Certain classifications.

(6) Integration with Social Security Act.

(7) Different age and service requirements.

(i) Application.

(ii) General rule.

(8) Certain controlled groups.

(9) Transitional rule.

(e) Example.

§ 1.410(b)–2 Minimum coverage requirements (after 1993).

(a) In general.

(b) Requirements with respect to employees.

(1) In general.

(2) Ratio percentage test.

(i) In general.

(ii) Examples.

(3) Average benefit test.

(4) Certain tax credit employee stock ownership plans.

(5) Employers with no nonhighly compensated employees.

(6) Plans benefiting no highly compensated employees.

(7) Plans benefiting collectively bargained employees.

(c) Requirements with respect to former employees.

(1) Former employees tested separately.

(2) Testing former employees.

(d) Nonelective contributions under section 403(b) plans.

(e) Certain governmental and church plans.

(f) Certain acquisitions or dispositions.

(g) Additional rules.

§ 1.410(b)–3 Employees and former employees who benefit under a plan.

(a) Employees benefiting under a plan.

(1) In general.

(2) Exceptions to allocation or accrual requirement.

(i) Section 401(k) and 401(m) plans.

(ii) Section 415 limits.

(iii) Certain employees treated as benefiting.

(iv) Section 412(i) plans.

(3) Examples.

(b) Former employees benefiting under a plan.

(1) In general.

(2) Examples.

§ 1.410(b)–4 Nondiscriminatory classification test.
(a) In general.
(b) Reasonable classification established by the employer.
(c) Nondiscriminatory classification.
(1) General rule.
(2) Safe harbor.
(3) Facts and circumstances.
(i) General rule.
(ii) Factual determination.
(4) Definitions.
(i) Safe harbor percentage.
(ii) Unsafe harbor percentage.
(iii) Nonhighly compensated employee concentration percentage.
(iv) Table.
(5) Examples.
§ 1.410(b)–5 Average benefit percentage test.
(a) General rule.
(b) Determination of average benefit percentage.
(c) Determination of actual benefit percentage.
(d) Determination of employee benefit percentages.
(1) Overview.
(2) Employee contributions and employee-provided benefits disregarded.
(3) Plans and plan years taken into account.
(i) Testing group.
(ii) Testing period.
(4) Contributions or benefits basis.
(5) Determination of employee benefit percentage.
(i) General rule.
(ii) Plans with differing plan years.
(iii) Options and consistency requirements.
(6) Permitted disparity.
(i) In general.
(ii) Plans which may not use permitted disparity.
(7) Requirements for certain plans providing early retirement benefits.
(i) General rule.
(ii) Exception.
(e) Additional optional rules.
(1) Overview.
(2) Determination of employee benefit percentages as the sum of separately determined rates.
(i) In general.
(ii) Exception from consistency requirement.
(iii) Permitted inconsistencies.
(3) Determination of employee benefit percentages without regard to plans of another type.
(i) General rule.
(ii) Restriction on use of separate testing group determination method.
(iii) Treatment of permitted disparity.
(iv) Example.
(4) Simplified method for determining employee benefit percentages for certain defined benefit plans.
(i) In general.
(ii) Simplified method.
(5) Three-year averaging period.
(6) Alternative methods of determining compensation.
(f) Special rule for certain collectively bargained plans.
§ 1.410(b)–6 Excludable employees.
(a) Employees.
(1) In general.
(2) Rules of application.
(b) Minimum age and service exclusions.
(1) In general.
(2) Multiple age and service conditions.
(3) Plans benefiting certain otherwise excludable employees.
(i) In general.
(ii) Testing portion of plan benefiting otherwise excludable employees.
(4) Examples.
(c) Certain nonresident aliens.
(1) General rule.
(2) Special treaty rule.
(d) Collectively bargained employees.
(1) General rule.
(2) Definition of collectively bargained employee.
(1) In general.
(ii) Special rules for certain employees in multiemployer plans.
(iii) Covered by a collective bargaining agreement.
(iv) Examples.
(e) Employees of qualified separate lines of business.
(f) Certain terminating employees.
(1) In general.
(2) Hours of service.
(3) Examples.
(g) Employees of certain governmental or tax-exempt entities precluded from maintaining a section 401(k) plan.
(h) Former employees.
(1) In general.
(2) Employees terminated before a specified date.
(3) Previously excludable employees.
(i) Former employees treated as employees.
§ 1.410(b)–7 Definition of plan and rules governing plan disaggregation and aggregation.
(a) In general.
(b) Separate asset pools are separate plans.
(c) Mandatory disaggregation of certain plans.
(1) Section 401(k) and section 401(m) plans.
(2) ESOPs and non-ESOPs.
(3) Plans benefiting otherwise excludable employees.
(4) Plans benefiting certain disaggregation populations of employees.
(i) In general.
(ii) Definition of disaggregation population.
(5) Additional rules for plans benefiting employees of more than one qualified separate line of business.

(d) Permissive aggregation for ratio percentage and nondiscriminatory classification tests.
(1) In general.
(2) Rules of disaggregation.
(3) Duplicative aggregation.
(4) Special rule for plans benefiting employees of a qualified separate line of business.
(5) Same plan year requirement.
(e) Determination of plans in testing group for average benefit percentage test.
(1) In general.
(2) Example.
(f) Section 403(b) plans.

§ 1.410(b)–8 Additional rules.
(a) Testing methods.
(1) In general.
(2) Daily testing option.
(3) Quarterly testing option.
(4) Annual testing option.
(5) Example.
(b) Family member aggregation rule.

§ 1.410(b)–9 Definitions.
Collectively bargained employee.
Defined benefit plan.
Defined contribution plan.
Employee.
Employer.
ESOP.
Former employee.
Highly compensated employee.
Highly compensated former employee.
Multiemployer plan.
Noncollectively bargained employee.
Nonhighly compensated employee.
Nonhighly compensated former employee.
Plan year.
Plan year compensation.
Professional employee.
Ratio percentage.
Section 401(k) plan.
Section 401(*l*) plan.
Section 401(m) plan.

§ 1.410(b)–10 Effective dates and transition rules.

(a) Statutory effective dates.
(1) In general.
(2) Special statutory effective date for collective bargaining agreements.
(i) In general.
(ii) Example.
(iii) Plan maintained pursuant to a collective bargaining agreement.
(b) Regulatory effective dates.
(1) In general.
(2) Plans of tax-exempt organizations.
(c) Compliance during transition period.
(d) Effective date for governmental plans.

[T.D. 8363, 56 FR 47641, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46838, Sept. 3, 1993; T.D. 8548, 59 FR 32914, June 27, 1994]

§ 1.410(b)–1 Minimum coverage requirements (before 1994).

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of the plan is not a qualified trust) unless the plan satisfies section 410(b)(1). For plan years prior to the applicable effective date set forth in § 1.410(b)–10, a plan satisfies section 410(b)(1) if it satisfies the requirements of paragraph (b)(1) or (b)(2) of this section. See also § 1.410(b)–2 for plan years beginning on or after the applicable effective date set forth in § 1.410(b)–10.

(b) *Coverage tests*—(1) *Percentage test.* A plan satisfies the requirements of this subparagraph if it benefits—

(i) Seventy percent or more of all employees, or

(ii) Eighty percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan,

excluding in each case employees who have not satisfied the minimum age and service requirements (if any) prescribed by the plan, as of the date coverage is tested, as a condition of participation and employees permitted to be excluded under paragraph (c) of this section. The percentage requirements of this subparagraph refer to a percentage of active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(2) *Classification test.* A plan satisfies the requirements of section 410(b)(1) and this subparagraph if it benefits such employees as qualify under a classification of employees set up by the employer, which classification is found by the Internal Revenue Service not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated. For purposes of this subparagraph, except as provided by paragraph (c) of this section, all active employees (including employees who do not satisfy the minimum age or service requirements of the plan) are taken into account.

(c) *Exclusion of certain employees.* Under section 410(b)(2), for purposes of section 410(b)(1) and paragraph (b) of this section, there shall be excluded

from consideration employees described in subparagraphs (1), (2), and (3) of this paragraph.

(1) *Bargaining unit.* Under section 410(b)(2)(A) and this paragraph, there may be excluded from consideration employees not included in the plan who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if the Internal Revenue Service finds that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. For purposes of determining whether such bargaining occurred, it is not material that such employees are not covered by another plan or that the plan was not considered in such bargaining.

(2) *Air pilots.* Under section 410(b)(2)(B) and this paragraph there may be excluded from consideration, in the case of a plan established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with title II of the Railway Labor Act and one or more employers all employees not covered by such agreement. Section 410(b)(2)(B) and this subparagraph do not apply to a plan if the plan provides contributions or benefits for employees whose principal duties are not customarily performed aboard aircraft in flight.

(3) *Nonresident aliens.* Under section 410(b)(2)(C) and this paragraph, there may be excluded from consideration employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(b) and the regulations thereunder) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3) and the regulations thereunder).

(d) *Special rules*—(1) *Highly compensated.* The classification of an employee as highly compensated for purposes of section 410(b)(1)(B) and § 1.410(b)–1(b)(2) is made on the basis of the facts and circumstances of each case, taking into account the level of the employee's compensation and the level of compensation paid by the employer to other employees, whether or not covered by the plan. Average compensation levels determined on a local, regional, or national basis, are not relevant for this purpose. Further, the classification of an employee as highly compensated is not made solely on the basis of the number or percentage of employees whose compensation exceeds, or is exceeded by, the employee's.

(2) *Discrimination.* The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated is made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the ratio of such employees benefited by the plan to all such employees of the employer and the ratio of the employees (other than officers, shareholders, or highly compensated) of the employer benefited by the plan to all employees (other than officers, shareholders, or highly compensated). A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, is not in itself sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

(3) *Multiple plans*—(i) An employer may designate two or more plans as constituting a single plan which is intended to qualify for purposes of section 410(b)(1) and this section, in which case all plans so designated shall be considered as a single plan in determining whether the requirements of such section are satisfied by each of the separate plans. A determination that the combination of plans so designated does not satisfy such requirements does not preclude a determination that one or more of such plans, considered separately, satisfies such requirements.

(ii) Notwithstanding subdivision (i) of this subparagraph, a plan which is subject to the limitations of section 401(a)(17) of the Code or section 301(d)(3) of the Tax Reduction Act of 1975 cannot be considered with any other plan which covers any employee covered by such plan.

(4) *Profit-sharing plans.* Employees under a profit-sharing plan who receive the amounts allocated to their accounts before the expiration of a period of time or the occurrence of a contingency specified in the plan shall not be considered covered by the plan. Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit-sharing plan for them, the employees who receive the shares immediately shall not be considered covered by the plan.

(5) *Certain classifications.* See section 401(a)(5) and the regulations thereunder for rules relating to classifications of employees which are not considered to be discriminatory per se for purposes of section 410(b)(1)(B) and § 1.410(b)–1(b)(2).

(6) *Integration with Social Security Act.* See section 401(a)(5) and the regulations thereunder for rules relating to integration of plans with the Social Security Act.

(7) *Different age and service requirements*—(i) *Application.* The rules of this subparagraph (7) apply to a plan which must satisfy the minimum age and service requirements of section 410(a)(1)(A) in order to be a qualified plan. Accordingly, the rules are inapplicable to plans described in section 410(c)(1) (see § 1.410(a)–1(c)(1)); plans satisfying the alternative minimum age and service requirements of section 410(a)(1)(B) but not satisfying the requirements of section 410(a)(1)(A); and plans which provide contributions or benefits for employees, some or all of whom are owner-employees (see section 401(a)(10)).

(ii) *General rules.* A provision for different age and service requirements for present and future employees either upon establishment or subsequent amendment is not, of itself, discriminatory under section 410(b)(1)(B) even though present employees who are officers, shareholders, or highly compensated cannot meet the age and service requirements for future employees at the time the plan is established or amended and even though present participants who are officers, shareholders, or highly compensated would not have satisfied the age and service requirements for future employees at the time they became participants in the plan. Furthermore, prohibited discrimination will be deemed not to arise in operation, solely because of such different requirements, when future employees are added to the employer's work force.

(8) *Certain controlled groups.* In applying the percentage test and classification test described in paragraph (b) (1) and (2) of this section for a year, all the employees of corporations or trades and businesses whose employees are treated as employed by a single employer by reason of section 414 (b) or (c) must be taken into account. The preceding sentence shall apply for a plan year if, on 1 day in each quarter of such plan year, such corporations are members of a controlled group of corporations (within the meaning of section 414(b)) of such trades or businesses are under common control (within the meaning of section 414(c)).

(9) *Transitional rule.* In the case of a cash and deferred profit-sharing plan, in existence on June 27, 1974, the requirements of paragraph (b)(2) of this section are satisfied if over one-half of the participants in the plan are among the lowest paid two-thirds of all eligible employees. This subparagraph shall not apply after December 31, 1977.

(e) *Example.* The rules provided by this section are illustrated by the following example:

Example. An employer established a noncontributory defined benefit plan covering all employees of its ABC Division who are hired prior to age 60 and who are at least 25 years old. The normal retirement age under the plan is age 65. The employer has 100 employees including 20 employees who are under age 25 and 10 employees who were hired over age 60. The plan does not cover 15 employees who are over age 25 and were hired before age 60 because they are not in the ABC Division. Of these 15 excluded employees, 3 have less than 1 year of service. In addition, 12 of the 55 employees covered have less than one year of service. The plan can be shown not to satisfy the requirements of IRC section 410(b)(1)(A) as follows:

(i) Number of employees	100
(ii) Number of employees excluded on account of minimum age and service	20
(iii) (i)–(ii)	80
(iv) Number of employees who must be covered if plan is to satisfy IRC section 410(b)(1)(A), 70% of (iii)	56
(v) Number of employees actually covered	55

Because the number of employees covered is less than the number of employees who must

be covered, the plan does not satisfy the percentage coverage requirements of IRC section 410(b)(1)(A).

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47197, Sept. 20, 1977, as amended by T.D. 7735, 45 FR 74722, Nov. 12, 1980; T.D. 8363, 56 FR 47643, Sept. 19, 1991; T.D. 8487, 58 FR 46839, Sept. 3, 1993]

§ 1.410(b)–2 Minimum coverage requirements (after 1993).

(a) *In general.* A plan is a qualified plan for a plan year only if the plan satisfies section 410(b) for the plan year. A plan satisfies section 410(b) for a plan year if and only if it satisfies paragraph (b) of this section with respect to employees for the plan year and paragraph (c) of this section with respect to former employees for the plan year. The rules in paragraphs (a), (b), and (c) of this section apply to all plans as a condition of qualification, including plans under which no employee is able to accrue any additional benefits (for example, frozen plans). Paragraphs (d), (e), and (f) of this section provide special rules for nonelective section 403(b) plans subject to section 403(b)(12)(A)(i), for governmental and church plans subject to section 410(c), and for certain acquisitions or dispositions, respectively. See § 1.410(b)–7 for rules for determining the ''plan'' subject to section 410(b).

(b) *Requirements with respect to employees*—(1) *In general.* A plan satisfies this paragraph (b) for a plan year if and only if it satisfies at least one of the tests in paragraphs (b)(2) through (b)(7) of this section for the plan year.

(2) *Ratio percentage test*—(i) *In general.* A plan satisfies this paragraph (b)(2) for a plan year if and only if the plan's ratio percentage for the plan year is at least 70 percent. This test incorporates both the percentage test of section 410(b)(1)(A) and the ratio test of section 410(b)(1)(B). See § 1.410(b)–9 for the definition of ratio percentage.

(ii) *Examples.* The following examples illustrate the ratio percentage test of this paragraph (b)(2).

Example 1. For a plan year, Plan A benefits 70 percent of an employer's nonhighly compensated employees and 100 percent of the employer's highly compensated employees. The plan's ratio percentage for the year is 70 percent (70 percent/100 percent), and thus the plan satisfies the ratio percentage test.

Example 2. For a plan year, Plan B benefits 40 percent of the employer's nonhighly compensated employees and 60 percent of the employer's highly compensated employees. Plan B fails to satisfy the ratio percentage test because the plan's ratio percentage is only 66.67 percent (40 percent/60 percent).

(3) *Average benefit test.* A plan satisfies this paragraph (b)(3) for a plan year if and only if the plan satisfies both the nondiscriminatory classification test of § 1.410(b)–4 and the average benefit percentage test of § 1.410(b)–5 for the plan year.

(4) *Certain tax credit employee stock ownership plans.* A plan satisfies this paragraph (b)(4) for a plan year if and only if the plan—

(i) Is a tax credit employee stock ownership plan (as defined in section 409(a)),

(ii) Is the only plan of the employer that is intended to qualify under section 401(a), and

(iii) Is a plan that satisfies the rule set forth in section 410(b)(6)(D).

This paragraph (b)(4) is available only for plan years for which the tax credit employee stock ownership plan receives contributions for which the employer is allowed a tax credit under section 41 (as in effect prior to its repeal by the Tax Reform Act of 1986) or section 48(n) (as in effect prior to its amendment by the Tax Reform Act of 1984). The requirement of this paragraph (b)(4) that the plan be the only plan of the employer that is intended to qualify under section 401(a) is not satisfied if the employer has only one plan, but that plan is treated as two or more separate plans under the mandatory disaggregation rules of § 1.410(b)–7(c).

(5) *Employers with no nonhighly compensated employees.* A plan satisfies this paragraph (b)(5) for a plan year if and only if the plan is maintained by an employer that has no nonhighly compensated employees at any time during the plan year.

(6) *Plans benefiting no highly compensated employees.* A plan satisfies this paragraph (b)(6) for a plan year if and only if the plan benefits no highly compensated employees for the plan year.

(7) *Plans benefiting collectively bargained employees.* A plan that benefits

solely collectively bargained employees for a plan year satisfies this paragraph (b)(7) for the plan year. If a plan (within the meaning of §1.410(b)–7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, §1.410(b)–7(c)(4) provides that the portion of the plan that benefits collectively bargained employees is treated as a separate plan from the portion of the plan that benefits noncollectively bargained employees. Thus, the mandatorily disaggregated portion of the plan that benefits the collectively bargained employees automatically satisfies this paragraph (b)(7) for the plan year and hence section 410(b). See §1.410(b)–9 for the definitions of collectively bargained employee and noncollectively bargained employee.

(c) *Requirements with respect to former employees*—(1) *Former employees tested separately*. Former employees are tested separately from employees for purposes of section 410(b). Thus, former employees are disregarded in applying the ratio percentage test, the nondiscriminatory classification test, and the average benefit percentage test with respect to the coverage of employees under a plan, and employees are disregarded in applying this section with respect to the coverage of former employees under a plan.

(2) *Testing former employees*. A plan satisfies section 410(b) with respect to former employees if and only if, under all of the relevant facts and circumstances (including the group of nonexcludable former employees not benefiting under the plan), the group of former employees benefiting under the plan does not discriminate significantly in favor of highly compensated former employees.

(d) *Nonelective contributions under section 403(b) plans*. For plan years beginning on or after January 1, 1989, a plan subject to section 403(b)(12)(A)(i) with respect to nonelective contributions (i.e., contributions not made pursuant to a salary reduction agreement) is treated as a plan subject to the requirements of this section. For this purpose, a plan described in the preceding sentence must satisfy the requirements of this section without regard to section 410(c) and paragraph (e) of this section. For plan years beginning before the effective date set forth in §1.410(b)–10(d), any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies the requirements of this section.

(e) *Certain governmental and church plans*. The requirements of section 410(b) do not apply to a plan described in section 410(c)(1) (other than a plan subject to section 403(b)(12)(A)(i) or a plan with respect to which an election has been made under section 410(d)). Such a plan must satisfy section 401(a)(3) as in effect on September 1, 1974. For this purpose, a plan that satisfies section 410(b) (without regard to this paragraph (e)) is treated as satisfying section 401(a)(3) as in effect on September 1, 1974. For plan years beginning before the effective date set forth in §1.410(b)–10(d), any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies the requirements of this section and is thus treated as satisfying the requirements of section 401(a)(3) as in effect on September 1, 1974. See §1.410(b)–10(b)(2) for a special rule for plans of tax-exempt organizations.

(f) *Certain acquisitions or dispositions*. Section 410(b)(6)(C) (relating to certain acquisitions or dispositions) provides a special rule whereby a plan may be treated as satisfying section 410(b) for a limited period of time after an acquisition or disposition if it satisfies section 410(b) (without regard to the special rule) immediately before the acquisition or disposition and there is no significant change in the plan or in the coverage of the plan other than the acquisition or disposition. For purposes of section 410(b)(6)(C) and this paragraph (f), the terms ''acquisition'' and ''disposition'' refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business.

(g) *Additional rules*. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the minimum coverage requirements of section 410(b), including (without limitation) additional rules limiting or expanding the methods in

§ 1.410(b)–5(d) and (e) for determining employee benefit percentages.

[T.D. 8363, 56 FR 47643, Sept. 19, 1991; 57 FR 10817, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46839, Sept. 3, 1993; T.D. 8548, 59 FR 32914, June 27, 1994]

§ 1.410(b)–3 Employees and former employees who benefit under a plan.

(a) *Employees benefiting under a plan*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an employee is treated as benefiting under a plan for a plan year if and only if for that plan year, in the case of a defined contribution plan, the employer receives an allocation taken into account under § 1.401(a)(4)–2(c)(2)(ii), or in the case of a defined benefit plan, the employee has an increase in a benefit accrued or treated as an accrued benefit under section 411(d)(6).

(2) *Exceptions to allocation or accrual requirement*—(i) *Section 401(k) and 401(m) plans.* Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under a section 401(k) plan for a plan year if and only if the employee is an eligible employee under the plan as defined in § 1.401(k)–1(g)(4) for the plan year. Similarly, an employee is treated as benefiting under a section 401(m) plan for a plan year if and only if the employee is an eligible employee as defined in § 1.401(m)–1(f)(4) for the plan year.

(ii) *Section 415 limits*—(A) *General rule for defined benefit plans.* In determining whether an employee is treated as benefiting under a defined benefit plan for a plan year, plan provisions that implement the limits of section 415 are disregarded. Any plan provision that provides for increases in an employee's accrued benefit under the plan due solely to adjustments under section 415(d)(1), additional years of participation or service under section 415(b)(5), or changes in the defined contribution fraction under section 415(e) is also disregarded, but only if such provision applies uniformly to all employees in the plan.

(B) *Defined benefit plans taking section 415 limits into account under section 401(a)(4) testing.* Paragraph (a)(2)(ii)(A) of this section does not apply in the case of a defined benefit plan that uses the option in § 1.401(a)(4)–3(d)(2)(ii)(B) to take into account plan provisions implementing the provisions of section 415 in determining accrual rates under the section 401(a)(4) general test.

(C) *Defined contribution plans.* A defined contribution plan is permitted to apply the rule in the first sentence of paragraph (a)(2)(ii)(A) of this section in determining whether an employee is treated as benefiting under the plan, provided it applies the rule on a consistent basis for all employees in the plan.

(iii) *Certain employees treated as benefiting*—(A) *In general.* An employee is treated as benefiting under a plan for a plan year if the employee satisfies all of the applicable conditions for accruing a benefit or receiving an allocation for the plan year but fails to have an increase in accrued benefit or to receive an allocation solely because of one or more of the conditions set forth in paragraphs (a)(2)(iii) (B) through (F) of this section.

(B) *Certain plan limits.* The employee's benefit would otherwise exceed a limit that is applicable on a uniform basis to all employees in the plan. Thus, for example, if the formula under a defined benefit plan takes into account only the first 30 years of service for accrual purposes, an employee who has completed more than 30 years of service is still treated as benefiting under the plan.

(C) *Benefits previously accrued.* The benefit previously accrued by the employee is greater than the benefit that would be determined under the plan if the benefit previously accrued were disregarded. This could happen, for example, when the plan is applying the wear-away formula of § 1.401(a)(4)–13(c)(4)(ii) and the employee's frozen accrued benefit exceeds the benefit determined under the current formula.

(D) *Benefit offset arrangements.* The plan offsets the employee's current benefit accrual under an offset arrangement described in § 1.401(a)(4)–3(f)(9) (without regard to whether the offset is attributable to pre-participation service or past service).

(E) *Target benefit plans.* In the case of a target benefit plan that satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2) by satisfying the safe harbor in § 1.401(a)(4)–8(b)(3),

the employee's theoretical reserve is greater than or equal to the actuarial present value of the fractional rule benefit.

(F) *Post-normal retirement age adjustments*. The employee has attained normal retirement age under a defined benefit plan and fails to accrue a benefit because of the provisions of section 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

(iv) *Section 412(i) plans*—(A) *General rule*. Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under an insurance contract plan within the meaning of section 412(i) for a plan year if and only if a premium is paid on behalf of the employee for the plan year.

(B) *Exceptions*. Notwithstanding paragraph (a)(2)(iv)(A) of this section, an employee is treated as benefiting under an insurance contract plan within the meaning of section 412(i) for a plan year if the sole reason that a premium is not paid on behalf of the employee is one of the reasons described in paragraph (a)(2)(iii) of this section. In addition, an employee is treated as benefiting under an insurance contract plan, within the meaning of section 412(i), that is a defined benefit plan if a premium is not paid on behalf of the employee solely because the insurance contracts that have previously been purchased on behalf of the employee guarantee to provide for the employee's projected normal retirement benefit without regard to future premium payments.

(3) *Examples*. The following examples illustrate the determination of whether an employee is benefiting under a plan for purposes of section 410(b).

Example 1. An employer has 35 employees who are eligible under a defined benefit plan. The plan requires 1,000 hours of service to accrue a benefit. Only 30 employees satisfy the 1,000-hour requirement and accrue a benefit. The five employees who do not satisfy the 1,000-hour requirement during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer maintains a section 401(k) plan. Only employees who are at least age 21 and who complete one year of service are eligible employees under the plan within the meaning of §1.401(k)–1(g)(4). Under the rule of paragraph (a)(2)(i) of this section, only employees who have satisfied these age and service conditions are treated as benefiting under the plan.

Example 3. The facts are the same as in *Example 2*, except that the employer also maintains a section 401(m) plan that provides matching contributions contingent on elective contributions under the section 401(k) plan. The matching contributions are contingent on employment on the last day of the plan year. Under §1.401(m)–1(f)(4), because matching contributions are contingent on employment on the last day of the plan year, not all employees who are eligible employees under the section 401(k) plan are eligible employees under the section 401(m) plan. Thus, employees who have satisfied the age and service conditions but who do not receive a matching contribution because they are not employed on the last day of the plan year are treated as not benefiting under the section 401(m) portion of the plan.

(b) *Former employees benefiting under a plan*—(1) *In general*. A former employee is treated as benefiting for a plan year if and only if the plan provides an allocation or benefit increase described in paragraph (a)(1) of this section to the former employee for the plan year. Thus, for example, a former employee benefits under a defined benefit plan for a plan year if the plan is amended to provide an ad hoc cost-of-living adjustment in the former employee's benefits. In contrast, because an increase in benefits payable under a plan pursuant to an automatic cost-of-living provision adopted and effective before the beginning of the plan year is previously accrued, a former employee is not treated as benefiting in a subsequent plan year merely because the former employee receives an increase pursuant to such an automatic cost-of-living provision. Any accrual or allocation for an individual during the plan year that arises from the individual's status as an employee is treated as an accrual or allocation of an employee. Similarly, any accrual or allocation for an individual during the plan year that arises from the individual's status as a former employee is treated as an accrual or allocation of a former employee. It is possible for an individual to accrue a benefit both as an employee and as a former employee in a given plan year. During the plan year in which an individual ceases performing services for the employer, the individual is treated as an employee in applying section 410(b) with respect to

employees and is treated as a former employee in applying section 410(b) with respect to former employees.

(2) *Examples*. The following examples illustrate the determination of whether a former employee benefits under a plan for purposes of section 410(b).

Example 1. Employer A amends its defined benefit plan in the 1995 plan year to provide an ad hoc cost-of-living increase of 5 percent for all retirees. Former employees who receive this increase are treated as benefiting under the plan for the 1995 plan year.

Example 2. Employer B maintains a defined benefit plan with a calendar plan year. In the 1995 plan year, Employer B amends the plan to provide that an employee who has reached early retirement age under the plan and who retires before July 31 of the 1995 plan year will receive an unreduced benefit, even though the employee has not yet reached normal retirement age. This early retirement window benefit is provided to employees based on their status as employees. Thus, although individuals who take advantage of the benefit become former employees, the window benefit is treated as provided to employees and is not treated as a benefit for former employees.

Example 3. The facts are the same as *Example 2*, except that on September 1, 1995, Employer B also amends the defined benefit plan to provide an ad hoc cost-of-living increase effective for all former employees. An individual who ceases performing services for the employer before July 31, 1995, under the early retirement window, and then receives the ad hoc cost-of-living increase, is treated as benefiting for the 1995 plan year both as an employee with respect to the early retirement window, and as a former employee with respect to the ad hoc COLA.

[T.D. 8363, 56 FR 47644, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46839, Sept. 3, 1993]

§ 1.410(b)–4 Nondiscriminatory classification test.

(a) *In general*. A plan satisfies the nondiscriminatory classification test of this section for a plan year if and only if, for the plan year, the plan benefits the employees who qualify under a classification established by the employer in accordance with paragraph (b) of this section, and the classification of employees is nondiscriminatory under paragraph (c) of this section.

(b) *Reasonable classification established by the employer*. A classification is established by the employer in accordance with this paragraph (b) if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

(c) *Nondiscriminatory classification*—(1) *General rule*. A classification is nondiscriminatory under this paragraph (c) for a plan year if and only if the group of employees included in the classification benefiting under the plan satisfies the requirements of either paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) *Safe harbor*. A plan satisfies the requirement of this paragraph (c)(2) for a plan year if and only if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage, as defined in paragraph (c)(4)(i) of this section. See §1.410(b)-9 for the definition of a plan's ratio percentage.

(3) *Facts and circumstances*—(i) *General rule*. A plan satisfies the requirements of this paragraph (c)(3) if and only if—

(A) The plan's ratio percentage is greater than or equal to the unsafe harbor percentage, as defined in paragraph (c)(4)(ii) of this section, and

(B) The classification satisfies the factual determination of paragraph (c)(3)(ii) of this section.

(ii) *Factual determination*. A classification satisfies this paragraph (c)(3)(ii) if and only if, based on all the relevant facts and circumstances, the Commissioner finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following—

(A) The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to

be nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not a relevant business reason.

(B) The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is to be nondiscriminatory.

(C) Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is to be nondiscriminatory.

(D) The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.

(E) The extent to which the plan's average benefit percentage (determined under § 1.410(b)-5) exceeds 70 percent.

(4) *Definitions*—(i) *Safe harbor percentage*. The safe harbor percentage of an employer is 50 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. See paragraph (c)(4)(iv) for a table that illustrates the safe harbor percentage and unsafe harbor percentage.

(ii) *Unsafe harbor percentage*. The unsafe harbor percentage of an employer is 40 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. However, in no case is the unsafe harbor percentage less than 20 percent.

(iii) *Nonhighly compensated employee concentration percentage*. The nonhighly compensated employee concentration percentage of an employer is the percentage of all the employees of the employer who are nonhighly compensated employees. Employees who are excludable employees for purposes of the average benefit test are not taken into account.

(iv) *Table*. The following table sets forth the safe harbor and unsafe harbor percentages at each nonhighly compensated employee concentration percentage:

Nonhighly compensated employee concentration percentage	Safe harbor percentage	Unsafe harbor percentage
0–60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

(5) *Examples*. The following examples illustrate the rules in this paragraph (c).

Example 1. Employer A has 200 nonexcludable employees, of whom 120 are nonhighly compensated employees and 80 are highly compensated employees. Employer A maintains a plan that benefits 60 nonhighly compensated employees and 72 highly compensated employees. Thus, the plan's ratio percentage is 55.56 percent ([60/120]/[72/80]=50%/90%=0.5556), which is below the percentage necessary to satisfy the ratio percentage test of § 1.410(b)–2(b)(2). The employer's nonhighly compensated employee concentration percentage is 60 percent (120/200); thus, Employer A's safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification satisfies

the safe harbor of paragraph (c)(2) of this section.

Example 2. The facts are the same as in *Example 1*, except that the plan benefits only 40 nonhighly compensated employees. The plan's ratio percentage is thus 37.03 percent ([40/120]/[72/80]=33.33%/90%=0.3703). Under these facts, the plan's classification is below the unsafe harbor percentage and is thus considered discriminatory.

Example 3. The facts are the same as in *Example 1*, except that the plan benefits 45 nonhighly compensated employees. The plan's ratio percentage is thus 41.67 percent ([45/120]/[72/80]=37.50%/90%=0.4167), above the unsafe harbor percentage (40 percent) and below the safe harbor percentage (50 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the relevant facts and circumstances.

Example 4. Employer B has 10,000 nonexcludable employees, of whom 9,600 are nonhighly compensated employees and 400 are highly compensated employees. Employer B maintains a plan that benefits 600 nonhighly compensated employees and 100 highly compensated employees. Thus, the plan's ratio percentage is 25.00 percent ([600/9,600]/[100/400]=6.25%/25%=0.2500), which is below the percentage necessary to satisfy the ratio percentage test of § 1.410(b)–2(b)(2). Employer B's nonhighly compensated employee concentration percentage is 96 percent (9,600/10,000); thus, Employer B's safe harbor percentage is 23 percent, and its unsafe harbor percentage is 20 percent. Because the plan's ratio percentage (25.00 percent) is greater than the safe harbor percentage (23.00 percent), the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 5. The facts are the same as in *Example 4*, except that the plan benefits only 400 nonhighly compensated employees. The plan's ratio percentage is thus 16.67 percent ([400/9,600]/[100/400]=4.17%/25%=0.1667). The plan's ratio percentage is below the unsafe harbor percentage and thus the classification is considered discriminatory.

Example 6. The facts are the same as in *Example 4*, except that the plan benefits 500 nonhighly compensated employees. The plan's ratio percentage is thus 20.83 percent ([500/9,600]/[100/400]=5.21%/25%=0.2083), above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the facts and circumstances.

[T.D. 8363, 56 FR 47645, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992]

§ 1.410(b)–5 Average benefit percentage test.

(a) *General rule*. A plan satisfies the average benefit percentage test of this section for a plan year if and only if the average benefit percentage of the plan for the plan year is at least 70 percent. A plan is deemed to satisfy this requirement if it satisfies paragraph (f) of this section for the plan year.

(b) *Determination of average benefit percentage*. The average benefit percentage of a plan for a plan year is the percentage determined by dividing the actual benefit percentage of the nonhighly compensated employees in plans in the testing group for the testing period that includes the plan year by the actual benefit percentage of the highly compensated employees in plans in the testing group for that testing period. See paragraph (d)(3)(ii) of this section for the definition of testing period.

(c) *Determination of actual benefit percentage*. The actual benefit percentage of a group of employees for a testing period is the average of the employee benefit percentages, calculated separately with respect to each of the employees in the group for the testing period. All nonexcludable employees of the employer are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account.

(d) *Determination of employee benefit percentages*—(1) *Overview*. This paragraph (d) provides rules for determining employee benefit percentages. See paragraph (e) of this section for alternative methods for determining employee benefit percentages.

(2) *Employee contributions and employee-provided benefits disregarded*. Only employer-provided contributions and benefits are taken into account in determining employee benefit percentages. Therefore, employee contributions (including both employee contributions allocated to separate accounts and employee contributions not allocated to separate accounts), and benefits derived from such contributions, are not taken into account in determining employee benefit percentages.

(3) *Plans and plan years taken into account*—(i) *Testing group*. All plans included in the testing group under

§ 1.410(b)–7(e)(1), and only those plans, are taken into account in determining an employee's employee benefit percentage.

(ii) *Testing period.* An employee's employee benefit percentage is determined on the basis of plan years ending with or within the same calendar year. These plan years are referred to in this section as the relevant plan years or, in the aggregate, as the testing period.

(4) *Contributions or benefits basis.* Employee benefit percentages may be determined on either a contributions or a benefits basis. Employee benefit percentages for any testing period must be determined on the same basis (contributions or benefits) for all plans in the testing group.

(5) *Determination of employee benefit percentage*—(i) *General rule.* The employee benefit percentage for an employee for a testing period is the rate that would be determined for that employee for purposes of applying the general test for nondiscrimination in §§ 1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8 or 1.401(a)(4)–9, if all the plans in the testing group were aggregated for purposes of section 410(b). Thus, if employee benefit percentages are determined on a contributions basis, each employee's employee benefit percentage is the aggregate normal allocation rate that would be determined for the employee under § 1.401(a)(4)–9(b)(2)(ii)(A) (if the plans in the testing group include both defined benefit and defined contribution plans), the allocation rate that would be determined for the employee under § 1.401(a)(4)–2(c)(2) (if the plans in the testing group include only defined contribution plans), or the equivalent normal allocation rate that would be determined for the employee under § 1.401(a)(4)–8(c)(2) (if the plans in the testing group include only defined benefit plans). Similarly, if employee benefit percentages are determined on a benefits basis, each employee's employee benefit percentage is the aggregate normal accrual rate that would be determined for the employee under § 1.401(a)(4)–9(b)(2)(ii)(B), the normal accrual rate that would be determined for the employee under § 1.401(a)(4)–3(d), or the equivalent accrual rate that would be determined for the employee under § 1.401(a)(4)–8(b)(2), depending on whether the plans in the testing group include both defined benefit and defined contribution plans, only defined benefit plans, or only defined contribution plans.

(ii) *Plans with differing plan years.* If not all the plans in the testing group share the same plan year, § 1.410(b)–7(d)(5) would ordinarily prohibit them from being aggregated for purposes of section 410(b). In such a case, employee benefit percentages are determined by applying the rules of paragraph (d)(5)(i) of this section separately to each subset of plans in the testing group that share the same plan year (or the same accrual computation period) and aggregating the results for all plans in the testing group. Thus, an employee's employee benefit percentage is determined as the sum of these separate employee benefit percentages that are determined consistently for all the plans in the testing group (except for differences attributable solely to the differences in plan years).

(iii) *Options and consistency requirements.* In determining employee benefit percentages under this paragraph (d)(5), any optional or alternative methods or rules available for determining rates in §§ 1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8, or 1.401(a)(4)–9, whichever is applicable, may be applied. Thus, for example, employee benefit percentages may generally be calculated using any of the alternative methods of determining average annual compensation or plan year compensation under § 1.401(a)(4)–12, and using any underlying definition of compensation that satisfies section 414(s). Except as otherwise specifically permitted, the determination of employee benefit percentages must be made on a consistent basis for all employees and for all plans in the testing group as required by §§ 1.401(a)(4)–2(c)(2)(vi), 1.401(a)(4)–3(d)(2)(i), 1.401(a)(4)–8(b)(2)(iv), 1.401(a)(4)–8(c)(2)(iv) or 1.401(a)(4)–9(b)(2)(iv).

(6) *Permitted disparity*—(i) *In general.* Permitted disparity may be imputed in determining employee benefit percentages as provided in §§ 1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8, or 1.401(a)(4)–9, whichever is applicable. When separate employee benefit percentages are determined for individual plans under

paragraph (e)(2) of this section (or for subsets of plans that have the same plan year as described in paragraph (d)(5)(ii) of this section), permitted disparity may be imputed for an employee only in one individual plan (or subset of plans) and may not be imputed for the same employee in another individual plan (or subset of plans). However, if the same average annual compensation or plan year compensation is used to determine employee benefit percentages in more than one plan, the employee's employee benefit percentages for those plans may be summed prior to imputing permitted disparity.

(ii) *Plans which may not use permitted disparity*. Permitted disparity may be reflected in the determination of rates only to the extent that the plans for which rates are being determined are plans for which the permitted disparity of section 401(l) is available. Thus, for example, if a section 401(k) plan is included in the testing group and permitted disparity is imputed under § 1.401(a)(4)–2(c)(iv), then employee benefit percentages are determined by first calculating an adjusted allocation rate (within the meaning of § 1.401(a)(4)–7(b)(1)) without regard to the amount of allocations under the section 401(k) plan and adding to it the allocation rate for the section 401(k) plan. See § 1.401(l)–1(a)(4) for a list of types of plans for which permitted disparity is not available.

(7) *Requirements for certain plans providing early retirement benefits*—(i) *General rule*. If any defined benefit plan in the testing group provides for early retirement benefits in addition to normal retirement benefits to any highly compensated employee, and the average actuarial reduction for any one of these benefits commencing in the five years prior to the plan's normal retirement age is less than four percent per year, then the aggregate most valuable allocation rate, equivalent most valuable allocation rate, aggregate most valuable accrual rate, or most valuable accrual rate must be substituted for the related normal rates in paragraph (d)(5) of this section.

(ii) *Exception*. Paragraph (d)(7)(i) of this section does not apply if early retirement benefits with average actuarial reductions described in that paragraph are currently available, within the meaning of § 1.401(a)(4)–4(b), under plans in the testing group to a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees to whom these benefits are currently available.

(e) *Additional optional rules*—(1) *Overview*. This paragraph (e) contains various alternative methods for determining employee benefit percentages for a testing period.

(2) *Determination of employee benefit percentages as the sum of separately determined rates*—(i) *In general*. Employee benefit percentages may be determined as the sum of separately determined employee benefit percentages for each of the plans in the testing group that are aggregated under paragraphs (d)(5)(i) or (ii) of this section, provided that these employee benefit percentages are determined on a consistent basis for all of these plans pursuant to paragraph (d)(5)(iii) of this section.

(ii) *Exception from consistency requirement*. The consistency requirement of paragraph (e)(2)(i) of this section is not violated merely because employee benefit percentages are not determined in a consistent manner for all of the plans in the testing group and the inconsistencies in determination of rates among plans are described in paragraph (e)(2)(iii) of this section. The exception in this paragraph (e)(2)(ii) applies only if it is reasonable to believe that the inconsistencies do not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined had employee benefit percentages been determined on a consistent basis pursuant to paragraph (d)(5)(iii) of this section.

(iii) *Permitted inconsistencies*. The following inconsistencies between plans are permitted under this paragraph (e)(2)—

(A) Use of different underlying definitions of section 414(s) compensation in the determination of rates;

(B) Use of different definitions of average annual compensation;

(C) Use of different testing ages;

(D) Use of different fresh-start dates;

(E) Use of different actuarial assumptions for normalization; or

(F) Disregard of actuarial increases after normal retirement age and QPSA charges without regard to any requirement for uniformity in the actuarial increases or QPSA charges.

(3) *Determination of employee benefit percentages without regard to plans of another type*—(i) *General rule*. Employee benefit percentages may be determined under plans of one type (i.e., defined benefit plans or defined contribution plans) by treating all plans of the other type (i.e., defined contribution plans or defined benefit plans, respectively) as if they were not part of the testing group, using the method provided in this paragraph (e)(3). If this method is used to determine whether a defined contribution plan satisfies the average benefit percentage test, employee benefit percentages under all defined contribution plans in the testing group must be determined on a contributions basis, and benefits under any defined benefit plans may not be included in the employee benefit percentage. Similarly, if this method is used to determine whether a defined benefit plan satisfies the average benefit percentage test, employee benefit percentages under all defined benefit plans in the testing group must be determined on a benefits basis, and allocations under any defined contribution plans may not be included in the employee benefit percentage.

(ii) *Restriction on use of separate testing group determination method*. A plan does not satisfy the average benefit percentage test using the method provided in this paragraph (e)(3) unless each of the plans in the testing group of the other type (i.e., defined benefit plan or defined contribution plan) than the plan being tested satisfies the average benefit test of §1.410(b)–2(b)(3) using the method in this paragraph (e)(3) or satisfies the ratio percentage test of §1.410(b)–2(b)(2).

(iii) *Treatment of permitted disparity*. Although under the general rule of this paragraph (e)(3) plans of another type are disregarded in determining employee benefit percentages, the permitted disparity used by those plans (including any permitted disparity that is used by those plans to satisfy §1.401(a)(4)–1(b)(2)) is nonetheless taken into account in determining the extent to which permitted disparity may be used in determining employee benefit percentages.

(iv) *Example*. The following example illustrates the rules of this paragraph (e)(3):

Example. Employer A maintains two defined benefit plans, neither of which covers a group of employees that satisfies the ratio percentage test of §1.410(b)–2(b)(2), and a profit-sharing plan and a section 401(k) plan, each of which benefits a group of employees that satisfies the ratio percentage test of §1.410(b)–2(b)(2). The defined benefit plans will satisfy the average benefit percentage test if the actual benefit percentage of all nonexcludable nonhighly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan, is at least 70 percent of the actual benefit percentage of all nonexcludable highly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan.

(4) *Simplified method for determining employee benefit percentages for certain defined benefit plans*—(i) *In general*. An employee's employee benefit percentage with respect to a plan may be determined under the simplified method of paragraph (e)(4)(ii) of this section, provided the following conditions are satisfied:

(A) The only plans included in the testing group are defined benefit plans, and employee benefit percentages under these plans are determined on a benefits basis.

(B) Employee benefit percentages under the plans in the testing group are not required to be determined by taking into account early retirement benefits under paragraph (d)(7) of this section.

(C) The plan is a safe harbor defined benefit plan described in §1.401(a)(4)–3(b).

(ii) *Simplified method*—(A) *Section 401(l) plans*. Under the simplified method of this paragraph (e)(4)(ii), an employee's employee benefit percentage with respect to a section 401(l) plan described in §1.401(a)(4)–3(b)(3) (i.e., a unit credit plan) may be deemed equal to the employee's excess benefit percentage or gross benefit percentage (as defined in §1.401(*l*)–1(c) (14) or (18), respectively), whichever is applicable under the plan's benefit formula in the

plan year. In the case of a section 401(l) plan described in §1.401(a)(4)–3(b)(4) (i.e., a fractional accrual plan), an employee's employee benefit percentage with respect to that plan may be deemed equal to the rate at which the excess or gross benefit, whichever is applicable, accrues for the employee in the plan year, taking into account the plan's benefit formula and the employee's projected service at normal retirement age. The use of this simplified method will be treated as an imputation of permitted disparity. See paragraph (d)(6) of this section for a restriction on multiple use of permitted disparity.

(B) *Other plans.* Under the simplified method of this paragraph (e)(4)(ii), an employee's employee benefit percentage with respect to a plan described in §1.401(a)(4)–3(b)(3) that is not a section 401(*l*) plan and that is not imputing permitted disparity may be deemed equal to the employee's benefit rate in the plan year under the plan's benefit formula. In the case of a plan described in §1.401(a)(4)–3(b)(4) that is not a section 401(*l*) plan and that is not imputing permitted disparity, an employee's employee benefit percentage with respect to that plan may be deemed equal to the rate at which the benefit accrues for the employee in the plan year, taking into account the plan's benefit formula and an employee's projected service at normal retirement age.

(5) *Three-year averaging period.* An employee's employee benefit percentage may be determined for a testing period as the average of the employee's employee benefit percentages determined separately for the testing period and for the immediately preceding one or two testing periods (referred to in this section as an averaging period). Employee benefit percentages of a particular employee that are averaged together within an averaging period must be determined on a consistent basis for all testing periods within the averaging period.

(6) *Alternative methods of determining compensation.* Employee benefit percentages may be determined on the basis of any definition of compensation that satisfies §1.414(s)–1(d) (without regard to whether the definition satisfies §1.414(s)–1(d)(3)), provided that the same definition is used for all employees and it is reasonable to believe that the definition does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined had employee benefit percentages been determined using a definition of compensation that also satisfies §1.414(s)–1(d)(3).

(f) *Special rule for certain collectively bargained plans.* A plan (as determined without regard to the mandatory disaggregation rule of §1.410(b)–7(c)(5)) that benefits both collectively bargained employees and noncollectively bargained employees is deemed to satisfy the average benefit percentage test of this section if—

(1) The provisions of the plan applicable to each employee in the plan are identical to the provisions of the plan applicable to every other employee in the plan, including the plan benefit or allocation formula, any optional forms of benefit, any ancillary benefit, and any other right or feature under the plan, and

(2) The plan would satisfy the ratio percentage test of §1.410(b)–2(b)(2), if §§1.410(b)–6(d) and 1.410(b)–7(c)(5) (the excludable employee and mandatory disaggregation rules for collectively bargained and noncollectively bargained employees) did not apply.

[T.D. 8363, 56 FR 47646, Sept. 19, 1991; 57 FR 10817, 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46840, Sept. 3, 1993]

§1.410(b)–6 Excludable employees.

(a) *Employees*—(1) *In general.* For purposes of applying section 410(b) with respect to employees, all employees of the employer, other than the excludable employees described in paragraphs (b) through (i) of this section, are taken into account. Excludable employees are not taken into account with respect to a plan even if they are benefiting under the plan, except as otherwise provided in paragraph (b) of this section.

(2) *Rules of application.* Except as specifically provided otherwise, excludable employees are determined separately with respect to each plan for purposes of testing that plan under section 410(b). Thus, in determining whether a

particular plan satisfies the ratio percentage test of §1.410(b)–2(b)(2), paragraphs (b) through (i) of this section are applied solely with reference to that plan. Similarly, in determining whether two or more plans that are permissively aggregated and treated as a single plan under §1.410(b)–7(d) satisfy the ratio percentage test of §1.410(b)–2(b)(2), paragraphs (b) through (i) of this section are applied solely with reference to the deemed single plan. In determining whether a plan satisfies the average benefit percentage test of §1.410(b)–5, the rules of this section are applied by treating all plans in the testing group as a single plan.

(b) *Minimum age and service exclusions*—(1) *In general.* If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, then all employees who fail to satisfy those conditions are excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date that any employee with the same age and service (including service permitted to be taken into account for purposes of nondiscrimination testing under §1.401(a)(4)–11(d)(3)) would be eligible to commence participation in the plan, as provided in section 410(b)(4)(C).

(2) *Multiple age and service conditions.* If a plan, including a plan for which an employer chooses the treatment under paragraph (b)(3) of this section, has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy all of the different sets of age and service conditions are excludable employees with respect to the plan. Except as provided in paragraph (b)(3) of this section, an employee who satisfies any one of the different sets of conditions is not an excludable employee with respect to the plan. Differences in the manner in which service is credited (e.g., hours of service calculated in accordance with 29 CFR 2530.200b–2 for hourly employees and elapsed time calculated in accordance with §1.410(a)–7 for salaried employees) for purposes of applying a service condition are not taken into account in determining whether multiple age and service eligibility conditions exist.

(3) *Plans benefiting certain otherwise excludable employees*—(i) *In general.* An employer may treat a plan benefiting otherwise excludable employees as two separate plans, one for the otherwise excludable employees and one for the other employees benefiting under the plan. See §1.410(b)–7(c)(3) regarding permissive disaggregation of plans benefiting otherwise excludable employees. The effect of this rule is that employees who would be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) but for the fact that the plan does not apply the greatest permissible minimum age and service conditions may be treated as excludable employees with respect to the plan. This treatment is available only if the plan satisfies section 410(b) and §1.410(b)–2 with respect to these otherwise excludable employees in the manner described in paragraph (b)(3)(ii) of this section.

(ii) *Testing portion of plan benefiting otherwise excludable employees.* In determining whether the plan that benefits employees who would otherwise be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) satisfies section 410(b) and §1.410(b)–2, employees who have satisfied the greatest permissible minimum age and service conditions with respect to the plan are excludable employees. In addition, if the plan being tested applies minimum age and service conditions and those conditions are less than the maximum permissible minimum age and service conditions, employees who have not satisfied the lower minimum age and service conditions actually provided for in the plan are excludable employees. Thus, for example, if the plan requires attainment of age 18 and 3 months of service, employees who have not attained age 18 or 3 months of service with the employer are excludable employees.

(4) *Examples.* The following examples illustrate the minimum age and service condition rules of this paragraph (b). In each example, the employer is not treated as operating qualified separate lines of business under section 414(r).

Example 1. An employer maintains Plan A for hourly employees and Plan B for salaried

employees. Plan A has no minimum age or service condition. Plan B has no minimum age condition and requires 1 year of service. The employer treats Plans A and B as a single plan for purposes of section 410(b). Because Plan A imposes no minimum age or service condition, all employees of the employer automatically satisfy the minimum age and service conditions of Plan A. Therefore, no employees are excludable under this paragraph (b) in testing Plans A and B for purposes of section 410(b).

Example 2. An employer maintains three plans. Plan C benefits employees in Division C who satisfy the plan's minimum age and service condition of age 21 and 1 year of service. Plan D benefits employees in Division D who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan E benefits employees in Division E who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. The employer treats Plans D and E as a single plan for purposes of section 410(b). In testing Plan C under the ratio percentage test or the nondiscriminatory classification test of section 410(b), employees who are not at least age 21 or who do not have at least 1 year of service are excludable employees under paragraph (b)(1) of this section. In testing Plans D and E, employees who do not satisfy the age and service requirements of either of the two plans are excludable employees under paragraph (b)(2) of this section. Thus, an employee is excludable with respect to Plans D and E only if the employee is not at least age 18 with at least 1 year of service or is not at least age 21 with at least 6 months of service. Thus, an employee who is 19 years old and has 11 months of service is excludable. Similarly, an employee who is 17 years old and has performed 2 years of service is also excludable.

Example 3. An employer maintains three plans. Plan F benefits all employees in Division F (the plan does not apply any minimum age or service condition). Plan G benefits employees in Division G who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan H benefits employees in Division H who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. In testing the employer's plans under the average benefit percentage test provided in §1.410(b)–5, Plans F, G, and H are treated as a single plan and, as such, use the lowest minimum age and service condition under the rule of paragraph (b)(2) of this section. Therefore, because Plan F does not apply any minimum age or service condition, no employee is excludable under this paragraph (b).

Example 4. An employer maintains Plan J, which does not apply any minimum age or service conditions. Plan J benefits all employees in Division 1 but does not benefit employees in Division 2. Although Plan J has no minimum age or service condition, the employer wants to exclude employees whose age and service is below the permissible minimums provided in section 410(b)(1)(A). The employer has 110 employees who either do not have 1 year of service or are not at least age 21. Of these 110 employees, 10 are highly compensated employees and 100 are nonhighly compensated employees. Five of these highly compensated employees, or 50 percent, work in Division 1 and thus benefit under Plan J. Thirty-five of these nonhighly compensated employees, or 35 percent, work in Division 1 and thus benefit under Plan J. Plan J satisfies the ratio percentage test of section 410(b) with respect to employees who do not satisfy the greatest permissible minimum age and service requirement because the ratio percentage of that group of employees is 70 percent. Thus, in determining whether or not Plan J satisfies section 410(b), the 110 employees may be treated as excludable employees in accordance with paragraph (b)(3)(i) of this section.

(c) *Certain nonresident aliens*—(1) *General rule.* An employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who receives no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is treated as an excludable employee.

(2) *Special treaty rule.* In addition, an employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who does receive earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is permitted to be excluded, if all of the employee's earned income from the employer from sources within the United States is exempt from United States income tax under an applicable income tax convention. This paragraph (c)(2) applies only if all employees described in the preceding sentence are so excluded.

(d) *Collectively bargained employees*—(1) *General rule.* A collectively bargained employee is an excludable employee with respect to a plan that benefits solely noncollectively bargained employees. If a plan (within the meaning of §1.410(b)–7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a

plan year, §1.410(b)–7(c)(4) provides that the portion of the plan that benefits the collectively bargained employees is treated as a separate plan from the portion of the plan that benefits the noncollectively bargained employees. Thus, a collectively bargained employee is always an excludable employee with respect to the mandatorily disaggregated portion of any plan that benefits noncollectively bargained employees.

(2) *Definition of collectively bargained employee*—(i) *In general.* A collectively bargained employee is an employee who is included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, provided that there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers. An employee is a collectively bargained employee regardless of whether the employee benefits under any plan of the employer. See section 7701(a)(46) and §301.7701–17T of this chapter for additional requirements applicable to the collective bargaining agreement. An employee who performs hours of service during the plan year as both a collectively bargained employee and a noncollectively bargained employee is treated as a collectively bargained employee with respect to the hours of service performed as a collectively bargained employee and a noncollectively bargained employee with respect to the hours of service performed as a noncollectively bargained employee. See §1.410(b)–7(c) for disaggregation rules for plans benefiting collectively bargained and noncollectively bargained employees.

(ii) *Special rules for certain employees in multiemployer plans*—(A) *In general.* For purposes of this paragraph (d), in testing the disaggregated portion of a multiemployer plan benefiting noncollectively bargained employees, a noncollectively bargained employee who benefits under the plan may be treated as a collectively bargained employee with respect to all of the employee's hours of service under the rules of paragraphs (d)(2)(ii) (B) through (E) of this section, if the employee is or was a member of a unit of employees covered by a collective bargaining agreement and that agreement or a successor agreement provides for the employee to benefit under the plan in the current plan year. For this purpose, provisions of a participation agreement or similar document are taken into account in determining whether a collective bargaining agreement provides for an employee to benefit under a multiemployer plan.

(B) *Employees who were collectively bargained employees during a portion of the current plan year.* An employee described in paragraph (d)(2)(ii)(A) of this section who performs services for one or more employers that are parties to the collective bargaining agreement, for the plan, or for the employee representative both as a collectively bargained employee and as a noncollectively bargained employee during a plan year may be treated as a collectively bargained employee for the plan year, provided that at least half of the employee's hours of service during the plan year are performed as a collectively bargained employee.

(C) *Employees who were collectively bargained employees during the collective bargaining agreement.* An employee described in paragraph (d)(2)(ii)(A) of this section who was a collectively bargained employee with respect to all of the employee's hours of service during a plan year (including employees who are treated as collectively bargained employees with respect to all of their hours of service during a plan year under paragraph (d)(2)(ii) (B) or (E) of this section) may be treated as a collectively bargained employee with respect to all of the employee's hours of service for the duration of the collective bargaining agreement applicable for such plan year or, if later, until the end of the following plan year. For this purpose, a collective bargaining agreement is applicable for a plan year if it provided for the employee to benefit in the plan and was effective for any portion of that plan year. This paragraph (d)(2)(ii)(C) does not apply unless the terms of the plan providing for benefit accruals treat the employee in a manner that is generally no more favorable

than similarly-situated employees who are collectively bargained employees.

(D) *Employees who previously were collectively bargained employees.* An employee who was treated as a collectively bargained employee pursuant to paragraph (d)(2)(ii)(C) of this section may be treated as a collectively bargained employee with respect to all of the employee's hours of service after the end of the period described in paragraph (d)(2)(ii)(C) of this section, provided that the employee is performing services for one or more employers that are parties to the collective bargaining agreement, for the plan, or for the employee representative. This paragraph (d)(2)(ii)(D) does not apply unless the terms of the plan providing for benefit accruals treat the employee in a manner that is generally no more favorable than similarly-situated employees who are collectively bargained employees, and no more than five percent of the employees covered under the multiemployer plan are noncollectively bargained employees (determined without regard to this paragraph (d)(2)(ii)(D)). In determining whether more than five percent of the employees covered under the multiemployer plan are noncollectively bargained employees, those employees who are described in paragraphs (d)(2)(ii) (B) and (C) of this section are treated as collectively bargained employees.

(E) *Transition rule.* For a plan year beginning before the applicable effective date of these regulations as set forth in §1.410(b)–10 (b) or (d), any employee described in paragraph (d)(2)(ii)(A) of this section may be treated as a collectively bargained employee with respect to all of the employee's hours of service for that plan year.

(F) *Consistency requirement.* The rules in paragraphs (d)(2) (i) and (ii) of this section must be applied to all employees on a reasonable and consistent basis for the plan year.

(iii) *Covered by a collective bargaining agreement*—(A) *General rule.* For purposes of paragraph (d)(2)(i) of this section, an employee is included in a unit of employees covered by a collective bargaining agreement if and only if the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement under which the plan is maintained. Thus, for example, an employee of either a plan or the employee representative that is a party to the collective bargaining agreement under which the plan is maintained is not included in a unit of employees covered by the collective bargaining agreement under which the plan is maintained merely because the employee is covered under the plan pursuant to an agreement entered into by the plan or employee representative on behalf of the employee (other than in the capacity of an employee representative with respect to the employee). This is the case even if all of such employees benefiting under the plan constitute only a de minimis percentage of the total employees benefiting under the plan.

(B) *Plans covering professional employees*—(*1*) *In general.* An employee is not considered included in a unit of employees covered by a collective bargaining agreement for a plan year for purposes of paragraph (d)(2)(iii)(A) of this section if, for the plan year, more than 2 percent of the employees who are covered pursuant to the agreement are professionals. This rule applies to all employees under the agreement, nonprofessionals as well as professionals. Thus, no employees covered by such an agreement are excludable employees with respect to employees who are not covered by a collective bargaining agreement.

(*2*) *Multiple collective bargaining agreements.* This paragraph (d)(2)(iii)(B) is applied separately with respect to each collective bargaining agreement. Thus, for example, if a plan benefits two groups of employees, one included in a unit of employees covered by collective bargaining agreement X, more than 2 percent of whom are professionals, and another included in a unit of employees covered by collective bargaining agreement Y, none of whom are professionals, the group covered by agreement X is not considered covered by a collective bargaining agreement and the group covered by agreement Y is considered covered by a collective bargaining agreement.

(*3*) *Application of minimum coverage tests*. If a plan covers more than 2 percent professional employees, no employees in the plan are treated as covered by a collective bargaining agreement. A plan that covers more than 2 percent professional employees must satisfy section 410(b) without regard to section 413(b) and the special rule in §1.410(b)–2(b)(7) of this section (regarding collectively bargained plans). In such cases, all nonexcludable employees must be taken into account. For this purpose, employees included in other collective bargaining units are excludable employees. However, the employees who are not covered by a collective bargaining agreement and the employees who are covered by an agreement that has more than 2 percent professionals are not excludable employees.

(iv) *Examples*. The following examples illustrate the collective bargaining unit rules of this section.

Example 1. An employer has 700 collectively bargained employees (none of whom is a professional employee) and 300 noncollectively bargained employees (200 of whom are highly compensated employees). For purposes of applying the ratio percentage test of §1.410(b)–2(b)(2) to Plan X, which benefits only the 300 noncollectively bargained employees, the 700 collectively bargained employees are treated as excludable employees pursuant to paragraph (d) of this section.

Example 2. (i) An employer has 1,500 employees in the following categories:

	Noncollectively bargained employees	Collectively bargained employees	Total
Highly compensated employees	100	100	200
Nonhighly compensated employees	900	400	1,300
Total	1,000	500	1,500

The employer maintains Plan Y, which benefits 1,100 employees, including all of the noncollectively bargained employees (except for 100 nonhighly compensated employees who are noncollectively bargained employees), and 200 of the collectively bargained employees (including the 100 highly compensated employees who are collectively bargained employees). There are no professional employees covered by the collective bargaining agreement. In accordance with §1.410(b)–7(c)(4), the employer must apply the ratio percentage test of §1.410(b)–2(b)(2) to Plan Y as if the plan were two separate plans, one benefiting the noncollectively bargained employees and the other benefiting the collectively bargained employees.

(ii) In testing the portion of Plan Y that benefits the noncollectively bargained employees, the collectively bargained employees are excludable employees. That portion's ratio percentage is 88.89 percent ([800/900] /[100/100] = 88.89%/100% =0.8889), and thus it satisfies the ratio percentage test. The portion of Plan Y that benefits collectively bargained employees automatically satisfies section 410(b) under the special rule in §1.410(b)–2(b)(7).

(e) *Employees of qualified separate lines of business*. If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1 (b), in testing a plan that benefits employees of one qualified separate line of business, the employees of the other qualified separate lines of business of the employer are treated as excludable employees. The rule in this paragraph (e) does not apply for purposes of satisfying the nondiscriminatory classification requirement of section 410(b)(5)(B). See §§1.414(r)–1(c)(2) and 1.414(r)–8 (separate application of section 410(b) to the employees of a qualified separate line of business). In addition, the rule in this paragraph (e) does not apply to a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c) (2) (ii) for a plan year.

(f) *Certain terminating employees*—(1) *In general*. An employee may be treated as an excludable employee for a plan year with respect to a particular plan if—

(i) The employee does not benefit under the plan for the plan year,

(ii) The employee is eligible to participate in the plan,

(iii) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) in order for an employee to accrue a benefit or receive an allocation for the plan year,

(iv) The employee fails to accrue a benefit or receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last-day requirement,

(v) The employee terminates employment during the plan year with no

more than 500 hours of service, and the employee is not an employee as of the last day of the plan year (for purposes of this paragraph (f)(1)(v), a plan that uses the elapsed time method of determining years of service may use either 91 consecutive calendar days or 3 consecutive calendar months instead of 500 hours of service, provided it uses the same convention for all employees during a plan year), and

(vi) If this paragraph (f) is applied with respect to any employee with respect to a plan for a plan year, it is applied with respect to all employees with respect to the plan for the plan year.

(2) *Hours of service*. For purposes of this paragraph (f), the term ''hours of service'' has the same meaning as provided for such term by 29 CFR 2530.200b–2 under the general method of crediting service for the employee. If one of the equivalencies set forth in 29 CFR 2530.200b–3 is used for crediting service under the plan, the 500-hour requirement must be adjusted accordingly.

(3) *Examples*. The following examples illustrate the provision of this paragraph (f).

Example 1. An employer has 35 employees who are eligible to participate under a defined contribution plan. The plan provides that an employee will not receive an allocation of contributions for a plan year unless the employee is employed by the employer on the last day of the plan year. Only 30 employees are employed by the employer on the last day of the plan year. Two of the five employees who terminated employment before the last day of the plan year had 500 or fewer hours of service during the plan year, and the remaining three had more than 500 hours of service during the year. Of the five employees who were no longer employed on the last day of the plan year, the two with 500 hours of service or less during the plan year are treated as excludable employees for purposes of section 410(b), and the remaining three who had over 500 hours of service during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer has 30 employees who are eligible to participate under a defined contribution plan. The plan requires 1,000 hours of service to receive an allocation of contributions or forfeitures. Ten employees do not receive an allocation because of their failure to complete 1,000 hours of service. Three of the 10 employees who failed to satisfy the minimum service requirement completed 500 or fewer hours of service and terminated their employment. Two of the employees completed more than 500, but fewer than 1,000 hours of service and terminated their employment. The remaining five employees did not terminate employment. Under the rule in paragraph (f) of this section, the three terminated employees who completed 500 or fewer hours of service are treated as excludable employees for the portion of the plan year they are employed. The other seven employees who do not receive an allocation are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 3. An employer maintains two plans, Plan A for salaried employees and Plan B for hourly employees. Of the 100 salaried employees, two do not receive an allocation under Plan A for the plan year because they terminate employment before completing 500 hours of service. Of the 300 hourly employees, 50 do not receive an allocation under Plan B for the plan year because they terminate employment before completing 500 hours. In applying section 410(b) to Plan A, the two employees who did not receive an allocation under Plan A are excludable employees, but the 50 who did not receive an allocation under Plan B are not excludable employees, because they were not eligible to participate under Plan A.

(g) *Employees of certain governmental or tax-exempt entities precluded from maintaining a section 401(k) plan*. For purposes of testing either a section 401(k) plan or a section 401(m) plan that is provided under the same general arrangement as a section 401(k) plan, an employer may treat as excludable those employees of governmental or tax-exempt entities who are precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B), if more than 95 percent of the employees of the employer who are not precluded from being eligible employees by section 401(k)(4)(B) benefit under the plan for the plan year.

(h) *Former employees*—(1) *In general*. For purposes of applying section 410(b) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described in paragraph (h)(2) or (h)(3) of this section as an excludable former employee. If either (or both) of the former employee exclusion rules under

paragraphs (h)(2) and (h)(3) of this section is applied, it must be applied to all former employees for the plan year on a consistent basis.

(2) *Employees terminated before a specified date.* The employer may treat a former employee as excludable if—

(i) The former employee became a former employee either prior to January 1, 1984, or prior to the tenth calendar year preceding the calendar year in which the current plan year begins, and

(ii) The former employee became a former employee in a calendar year that precedes the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee.

(3) *Previously excludable employees.* The employer may treat a former employee as excludable if the former employee was an excludable employee (or would have been an excludable employee if these regulations had been in effect) under the rules of paragraphs (b) through (g) of this section during the plan year in which the former employee became a former employee. If the employer treats a former employee as excludable pursuant to this paragraph (h)(3), the former employee is not taken into account with respect to a plan even if the former employee is benefiting under the plan.

(i) *Former employees treated as employees.* An employer may treat as excludable employees all formerly nonhighly compensated employees who are treated as employees of the employer under § 1.410(b)–9 solely because they have increases in accrued benefits under a defined benefit plan that are based on ongoing service or compensation credits (including imputed service or compensation) after they cease to perform services for the employer.

[T.D. 8363, 56 FR 47652, Sept. 19, 1991, as amended by T.D. 8376, 56 FR 63433, Dec. 4, 1991; T.D. 8363, 57 FR 10817, Mar. 31, 1992; T.D. 8487, 58 FR 46842, Sept. 3, 1993; T.D. 8487, 59 FR 16984, Apr. 11, 1994; T.D. 8548, 59 FR 32914, June 27, 1994]

§ 1.410(b)–7 Definition of plan and rules governing plan disaggregation and aggregation.

(a) *In general.* This section provides a definition of ''plan.'' First, this section sets forth a definition of plan within the meaning of section 401(a) or 403(a). Then certain mandatory disaggregation and permissive aggregation rules are applied. The result is the definition of plan that applies for purposes of sections 410(b) and 401(a)(4). Thus, in general, the term ''plan'' as used in this section initially refers to a plan described in section 414(l) and to an annuity plan described in section 403(a), and the term ''plan'' as used in other sections under these regulations means the plan determined after application of this section. Paragraph (b) of this section provides that each single plan under section 414(l) is treated as a single plan for purposes of section 410(b). Paragraph (c) of this section describes the rules for certain plans that must be treated as comprising two or more separate plans, each of which is a single plan subject to section 410(b). Paragraph (d) of this section provides a rule permitting an employer to aggregate certain separate plans to form a single plan for purposes of section 410(b). Paragraph (e) of this section provides rules for determining the testing group of plans taken into account in determining whether a plan satisfies the average benefit percentage test of § 1.410(b)–5.

(b) *Separate asset pools are separate plans.* Each single plan within the meaning of section 414(l) is a separate plan for purposes of section 410(b). See § 1.414(l)–1(b). For example, if only a portion of the assets under a defined benefit plan is available, on an ongoing basis, to provide the benefits of certain employees, and the remaining assets are available only in certain limited cases to provide such benefits (but are available in all cases for the benefit of other employees), there are two separate plans. Similarly, the defined contribution portion of a plan described in section 414(k) is a separate plan from the defined benefit portion of that same plan. A single plan under section

414(l) is a single plan for purposes of section 410(b), even though the plan comprises separate written documents and separate trusts, each of which receives a separate determination letter from the Internal Revenue Service. A defined contribution plan does not comprise separate plans merely because it includes more than one trust, or merely because it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Further, a plan does not comprise separate plans merely because assets are separately invested in individual insurance or annuity contracts for employees.

(c) *Mandatory disaggregation of certain plans*—(1) *Section 401(k) and 401(m) plans*. The portion of a plan that is a section 401(k) plan and the portion that is not a section 401(k) plan are treated as separate plans for purposes of section 410(b). Similarly, the portion of a plan that is a section 401(m) plan and the portion that is not a section 401(m) plan are treated as separate plans for purposes of section 410(b). Thus, a plan that consists of elective contributions under a section 401(k) plan, employee and matching contributions under a section 401(m) plan, and contributions other than elective, employee, or matching contributions is treated as three separate plans for purposes of section 410(b). In addition, the portion of a plan that consists of contributions described in §1.401(k)–1(b)(4)(iv) (i.e., contributions that fail to satisfy the allocation or compensation requirements applicable to elective contributions and are therefore required to be tested separately) and the portion of the plan that does not consist of such contributions are treated as separate plans for purposes of section 410(b). Similarly, the portion of a plan that consists of contributions described in §1.410(m)–1(b)(4)(ii) (i.e., matching contributions that fail to satisfy the allocation and other requirements applicable to matching contributions and are therefore required to be tested separately) and the portion of the plan that does not consist of such contributions are treated as separate plans for purposes of section 410(b).

(2) *ESOPs and non-ESOPs*. The portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 410(b), except as otherwise permitted under §54.4975–11(e) of this Chapter.

(3) *Plans benefiting otherwise excludable employees*. If an employer applies section 410(b) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permissible under section 410(a), the plan is treated as comprising separate plans, one benefiting the employees who have satisfied the lower minimum age and service conditions but not the greatest minimum age and service conditions permitted under section 410(a) and one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under section 410(a). See §410(b)–6(b)(3)(ii) for rules about testing otherwise excludable employees.

(4) *Plans benefiting certain disaggregation populations of employees*—(i) *In general*—(A) *Single plan must be treated as separate plans*. If a plan (*i.e.*, a single plan within the meaning of section 414(l)) benefits employees of more than one disaggregation population, the plan must be disaggregated and treated as separate plans, each separate plan consisting of the portion of the plan benefiting the employees of each disaggregation population. See paragraph (c)(4)(ii) of this section for the definition of disaggregation population.

(B) *Benefit accruals or allocations attributable to current status*. Except as otherwise provided in paragraph (c)(4)(i)(C) of this section, in applying the rule of paragraph (c)(4)(i)(A) of this section, the portion of the plan benefiting employees of a disaggregation population consists of all benefits accrued by, or all allocations made to, employees while they were members of the disaggregation population.

(C) *Exceptions for certain benefit accruals*—(*1*) *Attribution of benefits to first disaggregation population*. If employees benefiting under a plan change from one disaggregation population to a second disaggregation population, benefits

they accrue while members of the second disaggregation population that are attributable to years of service previously credited while the employees were members of the first disaggregation population may be treated as provided to them in their status as members of the first disaggregation population and thus included in the portion of the plan benefiting employees of the first disaggregation population. This special treatment is available only if it is applied on a consistent basis, if it does not result in significant discrimination in favor of highly compensated employees, and if the plan provision providing the additional benefits applies on the same terms to all similarly-situated employees. For example, if all formerly collectively bargained employees accrue additional benefits under a plan after becoming noncollectively bargained employees, then those benefit increases may be treated as included in the portion of the plan benefiting collectively bargained employees if they are attributable to years of service credited while the employees were collectively bargained (e.g., where the additional benefits result from compensation increases that occur while the employees are noncollectively bargained or from plan amendments affecting benefits earned while collectively bargained that are adopted while the employees are noncollectively bargained) and if such treatment does not result in significant discrimination in favor of highly compensated employees.

(*2*) *Attribution of benefits to current disaggregation population*. If employees benefiting under a plan change from one disaggregation population to another disaggregation population, benefits they accrue while members of the first disaggregation population may be treated as provided to them in their current status and thus included in the portion of the plan benefiting employees of the disaggregation population of which they are currently members. This special treatment is available only if it is applied on a consistent basis and if it does not result in significant discrimination in favor of highly compensated employees.

(D) *Change in disaggregation populations*—(*1*) *Reasonable treatment*. If, in previous years, the configuration of a plan's disaggregation populations differed from their configuration for the current year, for purposes of the benefits accrued by, or allocations made to, an employee for those years, the employee's status as a member of a current disaggregation population for those years must be determined on a reasonable basis. A different configuration occurs, for example, if disaggregation populations exist for the first time, such as when an employer is first treated as operating qualified separate lines of business, or if the existing disaggregation populations change, such as when an employer redesignates its qualified separate lines of business.

(*2*) *Example*. The following example illustrates the application of this paragraph (c)(4)(i)(D).

Example. (a) Employer X operates Divisions M and N, which are treated as qualified separate lines of business for the first time in 1998. Thus, the disaggregation populations of employees of Division M and employees of Division N exist for the first time. Since 1981 Employer X has maintained a defined benefit plan, Plan P, for employees of Division M. Plan P provides a normal retirement benefit of one percent of average annual compensation for each year of service up to 25. Employee A has worked for Division M since 1981 and has never worked for Division N. Employee B has worked for Division N since 1989 and worked for Division M from 1981 to 1988. Employee C has worked in the headquarters of Employer X since 1981. For the period 1981 to 1988 Employee C was credited with years of service under Plan P.

(b) For purposes of the benefits accrued by Employee A under Plan P during years 1981 through 1997, Employee A is reasonably treated as having been a member of the Division M disaggregation population for those years. For purposes of the benefits accrued by Employee B under Plan P during years 1981 through 1988, Employee B is reasonably treated as having been a member of the Division M disaggregation population for 1981 through 1988 and as having changed to the Division N disaggregation population for 1989 through 1997. For purposes of the benefits accrued by Employee C under Plan P during years 1981 through 1988, Employee C is reasonably treated as having been a member of the Division M disaggregation population for those years. Moreover, any benefit accruals for Employee B and Employee C in years after 1988, that result from increases in average annual compensation after 1988 and that are attributable to years of service credited

for 1981 through 1988, may be treated as provided to Employee B and Employee C in their status as members of the Division M disaggregation population if the requirements of paragraph (c)(4)(i)(C)(*1*) of this section are otherwise met.

(ii) *Definition of disaggregation population*—(A) *Plan benefiting employees of qualified separate lines of business*. If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b), and a plan benefits employees of more than one qualified separate line of business, the employees of each qualified separate line of business are separate disaggregation populations. In this case, the portion of the plan benefiting the employees of each qualified separate line of business is treated as a separate plan maintained by that qualified separate line of business. However, employees of different qualified separate lines of business who are benefiting under a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) for a plan year are not separate disaggregation populations merely because they are employees of different qualified separate lines of business.

(B) *Plan benefiting collectively bargained employees*. If a plan benefits both collectively bargained employees and noncollectively bargained employees, the collectively bargained employees are one disaggregation population and the noncollectively bargained employees are another disaggregation population. If the population of collectively bargained employees includes employees covered under different collective bargaining agreements, the population of employees covered under each collective bargaining agreement is also a separate disaggregation population.

(C) *Plan maintained by more than one employer*. If a plan benefits employees of more than one employer, the employees of each employer are separate disaggregation populations. In this case, the portion of the plan benefiting the employees of each employer is treated as a separate plan maintained by that employer, which must satisfy section 410(b) by reference only to that employer's employees. However, for purposes of this paragraph (c)(4)(ii)(C), if the plan of one employer (or, in the case of a plan maintained by more than one employer, the plan provisions applicable to the employees of one employer) treats compensation or service with another employer as compensation or service with the first employer, then the current accruals attributable to that compensation or service are treated as provided to an employee of the first employer under the plan of the first employer (or the portion of a plan maintained by more than one employer benefiting employees of the first employer), and the provisions of paragraph (c)(4)(i)(C) of this section do not apply to those accruals. Thus, for example, if Plan A maintained by Employer X imputes service or compensation for an employee of Employer Y, then Plan A is not treated as benefiting the employees of more than one employer merely because of this imputation.

(5) *Additional rule for plans benefiting employees of more than one qualified separate line of business*. If a plan benefiting employees of more than one qualified separate line of business satisfies the reasonable classification requirement of §1.410(b)–4(b) before the application of paragraph (c)(4) of this section, then any portion of the plan that is treated as a separate plan as a result of the application of paragraphs (c)(4)(i)(A) and (ii)(A) of this section is deemed to satisfy that requirement.

(d) *Permissive aggregation for ratio percentage and nondiscriminatory classification tests*—(1) *In general*. Except as provided in paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the ratio percentage test of §1.410(b)–2(b)(2) or the nondiscriminatory classification test of §1.410(b)–4, an employer may designate two or more separate plans (determined after application of paragraph (b) of this section) as a single plan. If an employer treats two or more separate plans as a single plan under this paragraph, the plans must be treated as a single plan for all purposes under sections 401(a)(4) and 410(b).

(2) *Rules of disaggregation*. An employer may not aggregate portions of a plan that are disaggregated under the rules of paragraph (c) of this section. Similarly, an employer may not aggregate two or more separate plans that

would be disaggregated under the rules of paragraph (c) of this section if they were portions of the same plan. In addition, an employer may not aggregate an ESOP with another ESOP, except as permitted under § 54.4975–11(e) of this Chapter.

(3) *Duplicative aggregation*. A plan may not be combined with two or more plans to form more than one single plan. Thus, for example, an employer that maintains plans A, B, and C may not aggregate plans A and B and plans A and C to form two single plans. However, the employer may apply the permissive aggregation rules of this paragraph (d) to form any one (and only one) of the following combinations: plan ABC, plans AB and C, plans AC and B, or plans A and BC.

(4) *Special rule for plans benefiting employees of a qualified separate line of business*. For purposes of paragraph (d)(1) of this section, an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b) is permitted to aggregate the portions of two or more plans that benefit employees of the same qualified separate line of business (regardless of whether the employer elects to aggregate the portions of the same plans that benefit employees of the other qualified separate lines of business of the employer), provided that none of the plans is tested under the special rule for employer-wide plans in § 1.414(r)–1 (c)(2)(ii). Thus, the employer is permitted to apply paragraph (d)(1) of this section with respect to two or more separate plans determined after the application of paragraphs (b) and (c)(4) of this section, but may not aggregate a plan that is tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) for a plan year with any portion of a plan that does not rely on that special rule for the plan year. In all other respects, the provisions of this paragraph (d) regarding permissive aggregation apply, including (but not limited to) the disaggregation rules under paragraph (d)(2) of this section (including the mandatory disaggregation rule of paragraph (c)(4) of this section), and the prohibition on duplicative aggregation under paragraph (d)(3) of this section. This paragraph (d)(4) applies only in the case of an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b). See §§ 1.414(r)–1(c)(2) and 1.414(r)–8 (separate application of section 410(b) to the employees of a qualified separate line of business).

(5) *Same plan year requirement*. Two or more plans may not be aggregated and treated as a single plan under this paragraph (d) unless they have the same plan year.

(e) *Determination of plans in testing group for average benefit percentage test*—(1) *In general*. For purposes of applying the average benefit percentage test of § 1.410(b)–5 with respect to a plan, all plans in the testing group must be taken into account. For this purpose, the plans in the testing group are the plan being tested and all other plans of the employer that could be permissively aggregated with that plan under paragraph (d) of this section. Whether two or more plans could be permissively aggregated under paragraph (d) of this section is determined (i) without regard to the rule in paragraph (d)(4) of this section that portions of two or more plans benefiting employees of the same line of business may not be aggregated if any of the plans is tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii), (ii) without regard to paragraph (d)(5) of this section, and (iii) by applying paragraph (d)(2) of this section without regard to paragraphs (c)(1) and (c)(2) of this section.

(2) *Examples*. The following example illustrates the rules of this paragraph (e).

Example 1. Employer X is treated as operating two qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), QSLOB1 and QSLOB2. Employer X must apply the rules in § 1.414(r)–8 to determine whether its plans satisfy section 410(b) on a qualified-separate-line-of-business basis. Employer X maintains the following plans:

(a) Plan A, the portion of Employer X' s employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB1,

(b) Plan B, the portion of Employer X' s employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB2,

(c) Plan C, a defined benefit plan that benefits all hourly noncollectively bargained employees of QSLOB1,

(d) Plan D, a defined benefit plan that benefits all collectively bargained employees of QSLOB1,

(e) Plan E, an ESOP that benefits all noncollectively bargained employees of QSLOB1,

(f) Plan F, a profit-sharing plan that benefits all salaried noncollectively bargained employees of QSLOB1.

Assume that Plan F does not satisfy the ratio percentage test of §1.410(b)–2(b)(2) on a qualified-separate-line-of-business basis, but does satisfy the nondiscriminatory classification test of §1.410(b)–4 on both an employer-wide and a qualified-separate-line-of-business basis. Therefore, to satisfy section 410(b), Plan F must satisfy the average benefit percentage test of §1.410(b)–5 on a qualifiedseparatelineofbu5ine55 basis. The plans in the testing group used to determine whether Plan F satisfies the average benefit percentage test of §1.4 10(b)–5 are Plans A, C, E, and F.

Example 2. The facts are the same as in *Example 1,* except that Employer X applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to its employer-wide section 401(k) plan. To satisfy section 410(b), Plan F must satisfy the average benefit percentage test of §1.4 10(b)–5. Since paragraph (c)(4) of this section no longer applies to Plans A and B, they are treated as a single plan (Plan AB). The plans in the testing group used to determine whether Plan F satisfies the average benefit percentage test of §1.4 10(b)–5 are therefore Plans A, B, C, E, and F. However, the employees of QSLOB 2 continue to be excludable employees for purposes of determining whether Plan F satisfies the average benefit percentage test. See §1.410(b)–6(e).

(f) *Section 403(b) plans*. In determining whether a plan satisfies section 410(b), a plan subject to section 403(b)(12)(A)(i) is disregarded. However, in determining whether a plan subject to section 403(b)(12)(A)(i) satisfied section 410(b), plans that are not subject to section 403(b)(12)(A)(i) may be taken into account.

[T.D. 8363, 56 FR 47655, Sept. 19, 1991, as amended by T.D. 8376, 56 FR 63433, Dec. 4, 1991; T.D. 8363, 57 FR 10819, 10954, Mar. 31, 1992; T.D. 8487, 58 FR 46843, Sept. 3, 1993; T.D. 8548, 59 FR 32914, June 27, 1994]

§1.410(b)–8 Additional rules.

(a) *Testing methods*—(1) *In general*. A plan must satisfy section 410(b) for a plan year using one of the testing options in paragraphs (a)(2) through (a)(4) of this section. Whichever testing option is used for the plan year must also be used for purposes of applying section 401(a)(4) to the plan for the plan year. The annual testing option in paragraph (a)(4) of this section must be used in applying section 410(b) to a section 401(k) plan or a section 401(m) plan, and in applying the average benefit percentage test of §1.410(b)–5. For purposes of this paragraph (a), the plan provisions and other relevant facts as of the last day of the plan year regarding which employees benefit under the plan for the plan year are applied to the employees taken into account under the testing option used for the plan year. For this purpose, amendments retroactively correcting a plan in accordance with §1.401(a)(4)–11(g) are taken into account as plan provisions in effect as of the last day of the plan year.

(2) *Daily testing option*. A plan satisfies section 410(b) for a plan year if it satisfies §1.410(b)–2 on each day of the plan year, taking into account only those employees (or former employees) who are employees (or former employees) on that day.

(3) *Quarterly testing option*. A plan is deemed to satisfy section 410(b) for a plan year if the plan satisfies §1.410(b)–2 on at least one day in each quarter of the plan year, taking into account for each of those days only those employees (or former employees) who are employees (or former employees) on that day. The preceding sentence does not apply if the plan's eligibility rules or benefit formula operate to cause the four quarterly testing days selected by the employer not to be reasonably representative of the coverage of the plan over the entire plan year.

(4) *Annual testing option*. A plan satisfies section 410(b) for a plan year if it satisfies §1.410(b)–2 as of the last day of the plan year, taking into account all employees (or former employees) who were employees (or former employees) on any day during the plan year.

(5) *Example*. The following example illustrates this paragraph (a).

Example. Plan A is a defined contribution plan that is not a section 401(k) plan or a section 401(m) plan, and that conditions allocations on an employee's employment on the last day of the plan year. Plan A is being tested for the 1995 calendar plan year using

the daily testing option in paragraph (a)(2) of this section. In testing the plan for compliance with section 410(b) on March 11, 1995, Employee X is taken into account because he was an employee on that day and was not an excludable employee with respect to Plan A on that day. Employee X was a participant in Plan A on March 11, 1995, was employed on December 31, 1995, and received an allocation under Plan A for the 1995 plan year. Under these facts, Employee X is treated as benefiting under Plan A on March 11, 1995, even though Employee X had not satisfied all of the conditions for receiving an allocation on that day, because Employee X satisfied all of those conditions as of the last day of the plan year.

(b) *Family member aggregation rule.* For purposes of section 410(b), and in accordance with section 414(q)(6), a highly compensated employee who is a 5-percent owner or one of the ten most highly compensated employees and any family member (or members) of such a highly compensated employee who is also an employee of the employer are to be treated as a single highly compensated employee. If any member of that group is benefiting under a plan, the deemed single employee is treated as benefiting under the plan. If no member of that group is benefiting under a plan, the deemed single employee is treated as not benefiting under the plan.

[T.D. 8363, 56 FR 47656, Sept. 19, 1991]

§ 1.410(b)–9 Definitions.

In applying this section and §§ 1.410(b)–2 through 1.410(b)–10, the definitions in this section govern unless otherwise provided.

Collectively bargained employee. Collectively bargained employee means a collectively bargained employee within the meaning of § 1.410(b)–6(d)(2).

Defined benefit plan. Defined benefit plan means a defined benefit plan within the meaning of section 414(j). The portion of a plan described in section 414(k) that does not consist of separate accounts is treated as a defined benefit plan.

Defined contribution plan. Defined contribution plan means a defined contribution plan within the meaning of section 414(i). The portion of a plan described in section 414(k) that consists of separate accounts is treated as a defined contribution plan.

Employee. Employee means an individual who performs services for the employer who is either a common law employee of the employer, a self-employed individual who is treated as an employee pursuant to section 401(c)(1), or a leased employee (not excluded under section 414(n)(5)) who is treated as an employee of the employer-recipient under section 414(n)(2) or 414(o)(2). Individuals that an employer treats as employees under section 414(n) pursuant to the requirements of section 414(o) are considered to be leased employees for purposes of this rule. In addition, an individual must be treated as an employee with respect to allocations under a defined contribution plan taken into account under § 1.401(a)(4)–2(c)(ii) and with respect to increases in accrued benefits (within the meaning of 411(a)(7)) under a defined benefit plan that are based on ongoing service or compensation (including imputed service or compensation) credits.

Employer. Employer means the employer maintaining the plan and those employers required to be aggregated with the employer under sections 414(b), (c), (m), or (o). An individual who owns the entire interest of an unincorporated trade or business is treated as an employer. Also, a partnership is treated as the employer of each partner and each employee of the partnership.

ESOP. ESOP or *employee stock ownership plan* means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Former employee. Former employee means an individual who was, but has ceased to be, an employee of the employer (i.e., the individual has ceased performing services as an employee for the employer). An individual is treated as a former employee beginning on the day after the day on which the individual ceases performing services as an employee for the employer. Thus, an individual who ceases performing services as an employee for an employer during a plan year is both an employee and a former employee for the plan year. Notwithstanding the foregoing, an individual is an employee (and not a former employee) to the extent that

the individual is treated as an employee with respect to the plan for the plan year under the definition of employee in this section.

Highly compensated employee. Highly compensated employee means an employee who is a highly compensated employee within the meaning of section 414(q) or a former employee treated as an employee under the definition of employee in this section who is a highly compensated former employee within the meaning of section 414(q).

Highly compensated former employee. Highly compensated former employee means a former employee who is a highly compensated former employee within the meaning of section 414(q).

Multiemployer plan. Multiemployer plan means a multiemployer plan within the meaning of section 414(f).

Noncollectively bargained employee. Noncollectively bargained employee means an employee who is not a collectively bargained employee.

Nonhighly compensated employee. Nonhighly compensated employee means an employee who is not a highly compensated employee.

Nonhighly compensated former employee. Nonhighly compensated former employee means a former employee who is not a highly compensated former employee.

Plan year. Plan year means the plan year of the plan as defined in the written plan document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Plan year compensation. Plan year compensation means plan year compensation within the meaning of §1.401(a)(4)–12.

Professional employee. Professional employee means any highly compensated employee who, on any day of the plan year, performs professional services for the employer as an actuary, architect, attorney, chiropodist, chiropractor, dentist, executive, investment banker, medical doctor, optometrist, osteopath, podiatrist, psychologist, certified or other public accountant, stockbroker, or veterinarian, or in any other professional capacity determined by the Commissioner in a notice or other document of general applicability to constitute the performance of services as a professional.

Ratio percentage. With respect to a plan for a plan year, a plan's *ratio percentage* means the percentage (rounded to the nearest hundredth of a percentage point) determined by dividing the percentage of the nonhighly compensated employees who benefit under the plan by the percentage of the highly compensated employees who benefit under the plan. The percentage of the nonhighly compensated employees who benefit under the plan is determined by dividing the number of nonhighly compensated employees benefiting under the plan by the total number of nonhighly compensated employees of the employer. The percentage of the highly compensated employees who benefit under the plan is determined by dividing the number of highly compensated employees benefiting under the plan by the total number of highly compensated employees of the employer.

Section 401(k) plan. Section 401(k) plan means a plan consisting of elective contributions described in §1.40(k)–1(g)(3) under a qualified cash or deferred arrangement described in §1.401(k)–1(a)(4)(i). Thus, a section 401(k) plan does not include a plan (or portion of a plan) that consists of contributions under a nonqualified cash or deferred arrangement, or qualified nonelective or qualified matching contributions treated as elective contributions under §1.401(k)–1(b)(5).

Section 401(l) plan. Section 401(l) plan means a plan that—

(1) Provides for a disparity in employer-provided benefits or contributions that satisfies section 401(l) in form, and

(2) Relies on one of the safe harbors of §1.401(a)(4)–2(b)(2), 1.401(a)(4)–3(b), 1.401(a)(4)–8(b)(3), or 1.401(a)(4)–8(c)(3)(iii)(B) to satisfy section 401(a)(4).

Section 401(m) plan. Section 401(m) plan means a plan consisting of employee contributions described in §1.401(m)–1(f)(6) or matching contributions described in §1.40(m)–1(f)(12), or both. Thus, a section 401(m) plan does not include a plan (or portion of a plan) that consists of elective contributions or qualified nonelective contributions

treated as matching contributions under § 1.401(m)–1(b)(5).

[T.D. 8363, 56 FR 47657, Sept. 19, 1991; 57 FR 10817, 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46843, Sept. 3, 1993]

§ 1.410(b)–10 Effective dates and transition rules.

(a) *Statutory effective dates*—(1) *In general*. Except as set forth in paragraph (a)(2) of this section, the minimum coverage rules of section 410(b) as amended by section 1112 of the Tax Reform Act of 1986 apply to plan years beginning on or after January 1, 1989.

(2) *Special statutory effective date for collective bargaining agreements*—(i) *In general*. As provided for by section 1112(e)(2) of the Tax Reform Act of 1986, in the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the minimum coverage rules of section 410(b) as amended by section 1112 of the Tax Reform Act of 1986 do not apply to employees covered by any such agreement in plan years beginning before the earlier of—

(A) January 1, 1991; or

(B) The later of January 1, 1989, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986). For purposes of this paragraph (a)(2), any extension or renegotiation of a collective bargaining agreement, which extension or renegotiation is ratified after February 28, 1986, is to be disregarded in determining the date on which the agreement terminates.

(ii) *Example*. The following example illustrates this paragraph (a)(2).

Example. Employer A maintains Plan 1 pursuant to a collective bargaining agreement. Plan 1 covers 100 of Employer A's noncollectively bargained employees and 900 of Employer A's collectively bargained employees. Employer A also maintains Plan 2, which covers Employer A's other 400 noncollectively bargained employees. The collective bargaining agreement under which Plan 1 is maintained was entered into on January 1, 1986, and expires December 31, 1992. Because Plan 1 is a plan maintained pursuant to a collective bargaining agreement, section 410(b) applies to the first plan year beginning on or after January 1, 1991. In applying section 410(b) to Plan 2, the 100 noncollectively bargained employees in Plan 1 must be taken into account. The deferred effective date for plans maintained pursuant to a collective bargaining agreement is not applicable in determining how section 410(b) is applied to a plan that is not maintained pursuant to a collective bargaining agreement.

(iii) *Plan maintained pursuant to a collective bargaining agreement*. For purposes of this paragraph (a)(2), a plan is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, if one or more of the agreements were ratified before March 1, 1986. Only plans maintained pursuant to agreements that the Secretary of Labor finds to be collective bargaining agreements and that satisfy section 7701(a)(46) are eligible for the deferred effective date under this paragraph (a)(2). A plan will not be treated as a plan maintained pursuant to one or more collective bargaining agreements eligible for the deferred effective date under this paragraph (a)(2) unless the plan would be a plan maintained pursuant to one or more collective bargaining agreements under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93rd Cong. 2d Sess. 266 (1974).

(b) *Regulatory effective dates*—(1) *In general*. Except as otherwise provided in this section, §§ 1.410(b)–2 through 1.410(b)–9 apply to plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations*. In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§ 1.410(b)–2 through 1.410(b)–9 apply to plan years beginning on or after January 1, 1996, to the extent such plans are subject to section 410(b).

(c) *Compliance during transition period*. For plan years beginning before the effective date of these regulations, as set forth in paragraph (b) of this section, and on or after the statutory effective date as set forth in paragraph (a) of this section, a plan must be operated in accordance with a reasonable, good faith interpretation of section 410(b).

Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 410(b) will generally be determined based on all of the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. If a plan's classification has been determined by the Commissioner to be nondiscriminatory and there have been no significant changes in or omissions of a material fact, the classification will be treated as nondiscriminatory for the relevant plan year. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 410(b) if it is operated in accordance with the terms of §§1.410(b)–2 through 1.410(b)–9.

(d) *Effective date for governmental plans.* In the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans) §1.410(b)–2 through §1.410(b)–10 apply to plan years beginning on or after January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. Such plans are deemed to satisfy section 410(b) (and in the case of such plans that are not subject to section 403(b)(12)(A)(i), section 401(a)(3) as in effect on September 1, 1974) for plan years before that effective date. For purposes of this section, the governing body with authority to amend the plan is the legislature, board, commission, council, or other governing body with authority to amend the plan. See §1.410(b)–2(d) and (e).

[T.D. 8487, 58 FR 46844, Sept. 3, 1993]

§1.410(d)–1 Election by church to have participation, vesting, funding, etc. provisions apply.

(a) *In general.* If a church or convention or association of churches which maintains any church plan, as defined in section 414(e), makes an election under this section, certain provisions of the Code and Title I of the Employee Retirement Income Security Act of 1974 (the ''Act'') shall apply to such church plan as if such plan were not a church plan. The provisions of the Code referred to are section 410 (relating to minimum participation standards), section 411 (relating to minimum vesting standards), section 412 (relating to minimum funding standards), section 4975 (relating to prohibited transactions), and paragraphs (11), (12), (13), (14), (15), and (19) of section 401(a) (relating to joint and survivor annuities, mergers and consolidations, assignment or alienation of benefits, time of benefit commencement, certain social security increases, and withdrawals of employee contributions, respectively).

(b) *Election is irrevocable.* An election under this section with respect to any church plan shall be binding with respect to such plan and, once made, shall be irrevocable.

(c) *Procedure for making election*—(1) *Time of election.* An election under this section may be made for plan years for which the provisions of section 410(d) of the Code apply to the church plan. By reason of section 1017(b) of the Act section 410(d) does not apply to a plan in existence on January 1, 1974, for plan years beginning before January 1, 1976. Section 1017(d) of the Act permits a plan administrator to elect to have certain provisions of the Code (including section 410(d)) apply to a plan before the otherwise applicable effective dates of such provisions. See §1.410(a)–2(d). Therefore, for a plan in existence on Janurary 1, 1974, an election under section 410(d) of the Code may be made for a plan year beginning before January 1, 1976, only if an election has been made under section 1017(d) of the Act with respect to that plan year.

(2) *By whom election is to be made.* The election provided by this section may be made only by the plan administrator of the church plan.

(3) *Manner of making election.* The plan administrator may elect to have the provisions of the Code described in paragraph (a) of this section apply to the church plan as it is were not a church plan by attaching the statement described in subparagraph (5) of this paragraph to either (i) the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective

or (ii) a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and if trusteed, the exempt status under section 501(a) of the Code of a trust constituting a part of the plan.

(4) *Conditional election.* If an election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter.

(5) *Statement.* The statement described in subparagraph (3) of this paragraph shall indicate (i) that the election is made under section 410(d) of the Code and (ii) the first plan year for which it is effective.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47198, Sept. 20, 1977]

§ 1.411(a)–1 Minimum vesting standards; general rules.

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless—

(1) The plan provides that an employee's right to his normal retirement benefit (see § 1.411(a)–7(c)) is nonforfeitable (see § 1.411(a)–4) upon and after the attainment of normal retirement age (see § 1.411(a)–7(b)),

(2) The plan provides that an employee's rights in his accrued benefit derived from his own contributions (see § 1.411(c)–1) are nonforfeitable at all times, and

(3) The plan satisfies the requirements of—

(A) Section 411(a)(2) and § 1.411(a)–3 (relating to vesting in accrued benefit derived from employer contributions), and

(B) In the case of a defined benefit plan, section 411(b)(1) and § 1.411(b)–1 (relating to accrued benefit).

(b) *Organization of regulations relating to minimum vesting standards*—(1) *General rules.* This section prescribes general rules relating to the minimum vesting standards provided by section 411.

(2) *Effective dates.* Section 1.411(a)–2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 411.

(3) *Employer contributions.* Section 1.411(a)–3 provides rules under section 411(a)(2) relating to vesting in employer-derived accrued benefits.

(4) *Certain forfeitures.* Section 1.411(a)–4 provides rules under section 411(a)(3) relating to certain permitted forfeitures, suspensions, etc. under qualified plans.

(5) *Nonforfeitable percentage.* Section 1.411(a)–5 provides rules under section 411(a)(4) relating to service included in the determination of an employee's nonforfeitable percentage under section 411(a)(2) and § 1.411(a)–3.

(6) *Years of service; break in service.* Section 1.411(a)–6 provides rules under section 411(a) (5) and (6) of the Internal Revenue Code of 1954 relating to years of service and breaks in service. Rules prescribed by the Secretary of Labor, relating to years of service and breaks in service under part 2 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 are provided under 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(7) *Definitions and special rules.* Section 1.411(a)–7 provides definitions and special rules under section 411(a) (7), (8), and (9), for purposes of section 411 and the regulations thereunder.

(8) *Changes in vesting schedule.* Section 1.411(a)–8 provides rules under section 411(a)(10) relating to changes in the vesting schedule of a plan.

(9) *Breaks in service.* Section 1.411(a)–9 provides special rules relating to breaks in service.

(10) *Accrued benefits.* See § 1.411(b)–1 for rules under section 411(b) relating to accrued benefit requirements under defined benefit plans.

(11) *Allocation of accrued benefits.* See § 1.411(c)–1 for rules under section 411(c) relating to allocation of accrued benefits between employer and employee contributions.

(12) *Discrimination, etc.* See § 1.411(d)–1 for rules relating to the coordination of section 411 with section 401(a)(4) (relating to discrimination) and other rules under section 411(d).

(c) *Application of standards to certain plans*—(1) *General rule*. Except as provided in subparagraph (2) of this paragraph, section 411 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),

(ii) A church plan (within the meaning of section 414(e) and the regulations thereunder) which has not made the election provided by section 410(d) and the regulations thereunder,

(iii) A plan which has not provided for employer contributions at any time after September 2, 1974, and

(iv) A plan established and maintained by a society, order, or association described in section 501(c) (8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

(2) *Vesting requirements*. A plan described in subparagraph (1) of this paragraph shall, for purposes of section 401(a), be treated as meeting the requirements of section 411 if such plan meets the vesting requirements resulting from the application of section 401(a)(4) and section 401(a)(7) as in effect on September 1, 1974.

(d) *Supersession*. Sections 11.411(a)–1 through 11.411(d)–3, inclusive, of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 are superseded by this section and §§1.411(a)–2 through 1.411(d)–3.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42324, Aug. 23, 1977]

§ 1.411(a)–2 Effective dates.

(a) *Plan not in existence on January 1, 1974*. Under section 1017(a) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was not in existence on January 1, 1974, section 411 and the regulations thereunder apply for plan years beginning after September 2, 1974. See paragraph (c) of this section for time plan is considered in existence.

(b) *Plans in existence on January 1, 1974*. Under section 1017(b) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was in existence on January 1, 1974, section 411 and the regulations thereunder apply for plan years beginning after December 31, 1975. See paragraph (c) of this section for time plan is considered to be in existence.

(c) *Time of plan existence*—(1) *General rule*. For purposes of this section, a plan is considered to be in existence on a particular day if—

(i) The plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed under the plan as of such day, and

(ii) The plan was not terminated on or before that day.

For example, if a plan was adopted on January 2, 1974, effective as of January 1, 1974, the plan is not considered to have been in existence on January 1, 1974, because it was not both adopted and in writing on January 1, 1974.

(2) *Collectively-bargained plan*. Notwithstanding paragraph (c) (1) of this section, a plan described in section 413 (a), relating to a plan maintained pursuant to a collective-bargaining agreement, is considered to be in existence on a particular day if—

(i) On or before that day there is a legally enforceable agreement to establish such a plan signed by the employer, and

(ii) The employer contributions to be made to the plan are set forth in the agreement.

(3) *Special rule*. If a plan is considered to be in existence under subparagraph (1) of this paragraph, any other plan with which such existing plan is merged or consolidated shall also be considered to be in existence on such date.

(d) *Existing plans under collective–bargaining agreements*. For a special effective date rule for certain plans maintained pursuant to a collective bargaining agreement, see section 1017(c)(1) of the Employee Retirement Income Security Act of 1974 (88 Stat. 932).

(e) *Certain existing plans may elect new provisions*. The plan administrator may elect to have the provisions of the Code relating to participation, vesting, funding, and form of benefit apply to a selected plan year. See §1.410(a)–2(d) for rules relating to such an election.

(f) *Application of rules.* The requirements of section 411 do not apply to employees who separate from service with the employer prior to the first plan year to which such requirements apply and who never return to service with the employer in a plan year to which section 411 applies.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42325, Aug. 23, 1977]

§ 1.411(a)–3 Vesting in employer-derived benefits.

(a) *In general*—(1) *Alternative requirements.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies the requirements of section 411(a)(2) and this section. A plan satisfies the requirements of this section if is satisfies the requirements of paragraph (b), (c), or (d) of this section.

(2) *Composite arrangements.* A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 9 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service, does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirement of one such paragraph with respect to one group of employees and another such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph. For example, if plan A provides that employees who commence participation before age 30 are subject to the ''rule of 45'' vesting schedule and employees who commence participation after age 30 are subject to the full vesting after 10 years schedule, plan A would be so structured as to evade the requirements of this paragraph.

(3) *Plan amendments.* A plan which satisfies the requirements of a particular one of such paragraphs for each of an employee's years of service and which is amended so that, as amended, it satisfies the requirements of another such paragraph for all such years of service, satisfies the requirements of this section even though, as amended, it does not satisfy the requirements of the paragraph which were satisfied prior to the amendment. See § 1.411(a)–8 for rules relating to employee election where the vesting schedule is amended.

(b) *10-year vesting.* A plan satisfies the requirements of section 411(a)(2) (A) and this paragraph if an employee who has completed 10 years of service has a nonforfeitable right to 100 percent of his accrued benefit derived from employer contributions.

(c) *5- to 15-year vesting.* A plan satisfies the requirements of section 411(a)(2) (B) and this paragraph if an employee who has completed at least 5 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contribution which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
5	25
6	30
7	35
8	40
9	45
10	50
11	60
12	70
13	80
14	90
15 or more	100

(d) *Rule of 45.* A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if an employee is entitled to the greater of the two percentages determined under paragraph (d) (1) or (2) of this section.

(1) *Age and service test.* An employee who is not separated from the service, who has completed at least 5 years of service, and with respect to whom the sum of his age and years of service equals of exceeds 45, has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions which is not less than the nonforfeitable percentage corresponding to his number of completed years of service to to the sum of his age and completed years of service

(whichever percentage is the lesser) determined under the following table:

Completed years of service	Sum of age and service	Nonforfeitable percentage
5	45 or 46	50
6	47 or 48	60
7	49 or 50	70
8	51 or 52	80
9	53 or 54	90
10 or more	55 or more	100

(2) *Service test*. An employee who has completed at least 10 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions determined under the following table:

Completed years of service	Nonforfeitable percentage
10	50
11	60
12	70
13	80
14	90
15	100

(3) *Computation of age*. For purposes of subparagraph (1) of this paragraph, the age of an employee is his age on his last birthday.

(e) *Examples*. The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
2 or less	0
3	30
4	35
5	40
6	45
7	50
8	55
9	60
10	65
11	70
12	75
13	80
14	85
15	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 5–15-year vesting) because the nonforfeitable percentage provided by the plan after completion of 14 years of service (85 percent) is less than the percentage required by paragraph (c) of this section at that time (90 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 13th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employee is at least equal to the value of the vesting rate required by that paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable after 10 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his employer-derived accrued benefit only after completion of more than 10 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0–9	0
10	50
11	60
12	70
13	80
14	90
15	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 9th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 10th year of service. It does not satisfy the requirements of paragraph (d)(1) of this section for any year of service prior to the 10th year. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the three paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 5 years of service. The plan satisfies the requirements of paragraphs (b), (c), and (d) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42325, Aug. 23, 1977]

§ 1.411(a)–3T Vesting in employer-derived benefits (temporary).

(a) *In general*—(1) [Reserved]

(2) *Composite arrangements.* A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 4 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirements of one such paragraph with respect to one group of employees and another such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph.

(b) *5-year vesting.* A plan satisfies the requirements of section 411(a)(2)(A) and this paragraph if an employee who has completed 5 years of service has a nonforfeitable right to 100 percent of his or her accrued benefits derived from employer contributions.

(c) *3- to 7-year vesting.* A plan satisfies the requirements of section 411(a)(2)(B) and this paragraph if an employee who has completed at least 3 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions, which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
3	20
4	40
5	60
6	80
7 or more	100

(d) *Multiemployer plans.* A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if—

(1) The plan is a multiemployer plan (within the meaning of section 414(f)), and

(2) Under the plan—

(i) An employee who is covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B) has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions not later than upon completion of 10 years of service, and

(ii) The requirements of paragraph (b) or (c) of this section are met with respect to employees who are not covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B).

(iii) For purposes of this provision, an employee is not covered pursuant to a collective bargaining agreement unless the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement pursuant to which the multiemployer plan is maintained. Thus, for example, an employee of either the multiemployer plan or the employee representative is not covered pursuant to the collective bargaining agreement under which the plan is maintained even if the employee is covered pursuant to an agreement entered into by the multiemployer plan or employee representative on behalf of the employee and even if all such employees covered under the plan constitute only a de minimis percentage of the total employees covered under the plan.

(e) *Effective date.* (1) The provisions of this section apply to all employees who have one hour of service in any plan year beginning after—

(i) December 31, 1988, or

(ii) In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, for employees covered by any such agreement, the earlier of—

(A) The later of—

(*1*) January 1, 1989, or

(*2*) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(B) January 1, 1991.

(2) For employees not described in paragraph (e)(1), above, the regulations in effect prior to January 1, 1989, shall be applied to determine the requirements of this section.

(f) *Examples*. The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
1	0
2	10
3	25
4	45
5	65
6	75
7	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 3- to 7-year vesting) because the nonforfeitable percentage provided by the plan after completion of 6 years of service (75 percent) is less than the percentage required by paragraph (c) of this section at that time (80 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 6th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employees is at least equal to the value of the vesting rate required by this paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefits are 100 percent nonforfeitable after 5 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his or her employer-derived accrued benefit only after completion of more than 5 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefits are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0 to 4	0
5	60
6	80
7	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 4th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 5th year of service. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the two paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 3 years of service. The plan satisfies the requirements of paragraphs (b) and (c) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

[T.D. 8170, 53 FR 240, Jan. 6, 1988]

§ 1.411(a)–4 Forfeitures, suspensions, etc.

(a) *Nonforfeitability*. Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term ''nonforfeitable'' for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets or the Pension Benefit Guaranty Corporation. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced to take into account benefits which are provided under the Social Security Act or under any other Federal or State law and which are taken

into account in determining plan benefits. To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in Division A of Corporation X under a plan utilizing a 10-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 10 years of service even though employees are not vested at that time.

(b) *Special rules.* For purposes of paragraph (a) of this section a right is not treated as forfeitable—

(1) *Death*—(i) *General rule.* In the case of a participant's right to his employer-derived accrued benefit, merely because such accrued benefit is forfeitable by the participant to the extent it has not been paid or distributed to him prior to his death. This subparagraph shall not apply to a benefit which must be paid to a survivor in order to satisfy the requirements of section 401(a)(11).

(ii) *Employee contributions.* A participant's right in his accrued benefit derived from his own contributions must be nonforfeitable at all times. Such a right is not treated as forfeitable merely because, after commencement of annuity or pension payments in a benefit form provided under the plan, the participant dies without receiving payments equal in amount to his nonforfeitable accrued benefit derived from his contributions determined at the time of commencement.

(2) *Suspension of benefits upon reemployment of retiree.* In the case of certain suspensions of benefits under section 411(a)(3)(B), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(3) *Retroactive plan amendment.* In the case of a participant's right to his employer-derived accrued benefit, merely because such benefit is subject to reduction to the extent provided by a plan amendment described in section 412(c)(8) and the regulations thereunder, which amendment is given retroactive effect in accordance with such section.

(4) *Other forfeiture rules*—(i) *Withdrawal of mandatory contributions.* For rules allowing forfeitures on account of the withdrawal of mandatory contributions, see § 1.411(a)–7(d) (2) and (3).

(ii) *Class year plans.* For forfeiture rules pertaining to class year plans, see § 1.411(d)–3(b).

(iii) *Additional requirements.* For additional requirements relating to nonforfeitability of benefits in the event of a withdrawal by the employee, see section 401(a)(19) and § 1.401(a)–19.

(5) *Multiemployer plan.* In the case of a multiemployer plan described in section 414(f), merely because an employee's accrued benefit which results from service with an employer before such employer was required to contribute to the plan is forfeitable on account of the cessation of contributions by the employer of the employee. This subparagraph shall not apply to an employee's accrued benefit with respect to an employer which accrued under a plan maintained by that employer prior to the adoption by that employer of the multiemployer plan.

(6) *Lost beneficiary; escheat.* In the case of a benefit which is payable, merely because the benefit is forfeitable on account of the inability to find the participant or beneficiary to whom payment is due, provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. In addition, a benefit which is

lost by reason of escheat under applicable state law is not treated as a forfeiture.

(7) *Certain matching contributions.* A matching contribution (within the meaning of section 401(m)(4)(A) and §1.401(m)–1(f)(12)) is not treated as forfeitable even if under the plan it may be forfeited under §1.401(m)–1(e)(1) because the contribution to which it relates is treated as an excess contribution (within the meaning of §1.402(k)–1(f)(2) and (g)(7)), excess deferral (within the meaning of §1.402(g)–1(e)(1)(iii)), or excess aggregate contribution (within the meaning of §1.401(m)–1(f)(8)).

(c) *Examples.* The rules of this section are illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 5 years of service. The plan also provides that, if an employee works for a competitor he forfeits his rights in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 10 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

Example (2). Plan B provides that if an employee does not apply for benefits within 5 years after the attainment of normal retirement age, the employee loses his plan benefits. Such a plan provision could result in forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and, therefore, the plan would not satisfy the requirements of section 411.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42326, Aug. 23, 1977, as amended by T.D. 8357, 56 FR 40549, Aug. 15, 1991]

§1.411(a)–4T Forfeitures, suspensions, etc. (temporary).

(a) *Nonforfeitability.* Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term ''nonforfeitable'' for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits, such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets, the Pension Benefit Guaranty Corporation, or a trust established and maintained pursuant to sections 4041(c)(3)(B) (ii) or (iii) and section 4049 of ERISA with respect to the plan. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced as allowed under sections 401(a)(5) and 401(l). To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in

Division A of Corporation X under a plan utilizing a 5-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 5 years of service even though employees are not vested at that time.

(b) [Reserved]

(c) *Examples*. The rules of this section ae illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 3 years of service. The plan also provides that if the employee works for a competitor he forfeits his rights in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 5 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

[T.D. 8170, 53 FR 241, Jan. 6, 1988]

§ 1.411(a)–5 Service included in determination of nonforfeitable percentage.

(a) *In general*. Under section 411(a)(4), for purposes of determining the nonforfeitable percentage of an employee's right to his employer-derived accrued benefit under section 411(a)(2) and § 1.411(a)–3, all of an employee's years of service with an employer or employers maintaining the plan shall be taken into account except that years of service described in paragraph (b) of this section may be disregarded.

(b) *Certain service*. For purposes of paragraph (a) of this section, the following years of service may be disregarded:

(1) *Service before age 22*. (i) In the case of a plan which satisfies the requirements of section 411(a)(2) (A) or (B) (relating to 10-year vesting and 5–15-year vesting, respectively), a year of service completed by an employee before he attains age 22.

(ii) In the case of a plan which does not satisfy the requirements of section 411(a)(2) (A) or (B), a year of service completed by an employee before he attains age 22 if the employee is not a participant (for purposes of section 410) in the plan at any time during such year.

(iii) For purposes of this subparagraph in the case of a plan utilizing computation periods, service during a computation period described in section 411(a)(5)(A) within which the employee attains age 22 may not be disregarded. In the case of a plan utilizing the elapsed time method described in § 1.410(a)–7, service on or after the date on which the employee attains age 22 may not be disregarded.

(2) *Contributory plans*. In the case of a plan utilizing computation periods, a year of service completed by an employee under a plan which requires mandatory contributions (within the meaning of section 411(c)(2)(C) and § 1.411(c)–1(c)(4)) to be made by the employee for such year, if the employee does not participate for such year solely because of his failure to make all mandatory contributions to the plan for such year. If the employee contributes any part of the mandatory contributions for the year, such year may not be excluded by reason of this subparagraph. In the case of a plan utilizing the elapsed time method described in § 1.410(a)–7, the service which may be disregarded is the period with respect to which the mandatory contribution is not made.

(3) *Plan not maintained*—(i) *In general*. An employee's years of service with an employer during any period for which the employer did not maintain the plan or a predecessor plan may be disregarded for purposes of section 411(a)(2). Paragraph (b)(3)(ii) of this section provides rules regarding the period prior to the adoption of a plan. Paragraph (b)(3)(iii) of this section provides rules regarding the period after the termination of a plan. Paragraph (b)(3)(iv) of this section provides rules regarding employers who have certain relationships with other employers maintaining the plan.

(ii) *Period prior to adoption*. The period for which a plan is not maintained by an employer includes the period before the plan was established. For purposes of this subdivision, a plan is established on the first day of the plan

year in which the plan is adopted even though the plan is adopted after such first day. Except as provided in paragraph (b)(3)(iv) of this section if an employer adopts a plan which has previously been established by another employer or group of employers, the plan is not maintained by the adopting employer prior to the first day of the plan year in which the plan is adopted by the adopting employer. In the case of a transfer of assets or liabilities (including a merger or consolidation) involving two plans maintained by a single employer, the successor (or transferee) plan is treated as if it was established at the same time as the date of the establishment of the earliest component plan. In the case of a plan merger, consolidation, or transfer of plan assets or liabilities involving plans of two or more employers, the successor plan is treated as if it were established on each of the separate dates on which such component plan was established for the employees of each employer. Thus, for example, if employer A establishes a plan January 1, 1970, and employer B establishes a plan January 1, 1980, and the plans were subsequently merged, then the merged plan would be treated as if it were in existence on January 1, 1970, with respect to A's employees and as if it were in existence on January 1, 1980, with respect to B's employees.

(iii) *Period after termination or withdrawal.* The period for which a plan is not maintained by an employer includes the period after the plan is terminated. For purposes of this section, a plan is terminated at the date there is a termination of the plan within the meaning of section 411(d)(3)(A) and the regulations thereunder. Notwithstanding the preceding sentence, if contributions to or under a plan are made after termination, the plan is treated as being maintained until such contributions cease, whether or not accruals are made after such termination. If, after termination of a plan in circumstances under which the employer may be liable to the Pension Benefit Guaranty Corporation under section 4062 of the Act, employer contributions are made to or under the plan to fund benefits accrued at the time of termination, such contributions shall, for purposes of this paragraph, be deemed to be payments in satisfaction of employer liability to such Corporation rather than contributions to or under the plan. In the case of a plan maintained by more than one employer, the period for which the plan is not maintained by the withdrawing employer includes the period after the withdrawal from the plan.

(iv) *Certain employers.* For purposes of this subparagraph—

(A) *Predecessor employers.* Service with a predecessor employer who maintained the plan of the current employer is treated as service with such current employer (see section 414(a)(1) and the regulations thereunder), and certain service with a predecessor employer who did not maintain the plan of the current employer is treated as service with the current employer (see section 414(a)(2) and the regulations thereunder).

(B) *Related employers.* Service with an employer is treated as service for certain related employers for the period during which the employers are related. These related employers include members of a controlled group of corporations (within the meaning of section 1563(a), determined without regard to subsections (a)(4) and (e)(3) (C) thereof) and trades or businesses (whether or not incorporated) which are under common control (see section 414 (b) and (c) and 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefits plans).

(C) *Plan maintained by more than one employer.* Service with an employer who maintains a plan is treated as service for each other employer who maintains that plan for the period during which the employers are maintaining the plan (see section 413 (b)(4) and (c)(3) and 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(v) *Predecessor plan*—(A) *General rule.* In the case of an employee who was covered by a predecessor plan, the time the successor of such plan is maintained for such employee includes the time the predecessor plan was maintained if, as of the later of the time the predecessor plan is terminated or the

successor plan is established, the employee's years of service under the predecessor plan are not equalled or exceeded by the aggregate number of consecutive 1-year breaks in service occuring after such years of service. Years of service and breaks in service, without regard to whether the employee has nonforfeitable rights under the predecessor plan, are determined under section 411(a) (5) and (6) except that years between the termination date of the predecessor plan and the date of establishment of the successor plan do not count as years of service.

(B) *Definition of predecessor plan.* For purposes of this section, if—

(1) An employer establishes a retirement plan (within the meaning of section 7476(d)) qualified under subchapter D of chapter 1 of the Code within the 5-year period immediately preceding or following the date another such plan terminates, and

(*2*) The other plan is terminated during a plan year to which this section applies.

The terminated plan is a predecessor plan with respect to such other plan.

(C) *Example.* The rules provided by this subparagraph are illustrated by the following example:

Example. (1) Employer X's qualified plan A terminated on January 1, 1977, Employer X established qualified plan B on January 1, 1981. Under paragraph (b)(3)(v)(B) of this section, plan A is a predecessor plan with respect to plan B because plan B is established within the 5-year period immediately following the date plan A terminated.

(2) Employee C was not covered by the A plan. Under the general rule in subdivision (v)(A) of this subparagraph, plan B is not maintained until January 1, 1981, with respect to Employee C.

(3) Employee D was covered by the A plan. On December 31, 1976, D had 4 years of service. D had 4 consecutive 1-year breaks in service because, during the years between the termination of plan A and the establishment of plan B, he did not have more than 500 hours of service in any applicable computation period. Because D's consecutive 1-year breaks (4) equal his years of service prior to his breaks (4), plan B is not maintained until January 1, 1981, with respect to employee D.

(4) Employee E was covered by the A plan. On December 31, 1975, E had 6 years of service. E had a 1-year break in service in 1976. E also had 4 consecutive 1-year breaks in service for the period between plan A's termination and plan B's establishment. Because E's years of service (6) are not less than his consecutive 1-year breaks (5), plan B is maintained for E as of the establishment date of plan A.

(4) *Break in service.* A year of service which is not required to be taken into account by reason of a break in service (within the meaning of section 411(a)(6) and § 1.411(a)–6)).

(5) *Service before January 1, 1971.* A year of service completed by an employee prior to January 1, 1971, unless the employee completes at least 3 years of service at any time after December 31, 1970. For purposes of determining if an employee completes 3 years of service, whether or not consecutive, the exceptions of section 411(a)(4) are not applicable. For the meaning of the term ''year of service'', see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(6) *Service before effective date.* A year of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service (whether or not such rules are so designated in the plan) as such rules were in effect from time to time under the plan. For this purpose, plan rules which result in the loss of prior vesting or benefit accruals of an employee, or which deny an employee eligibility to participate, by reason of separation or failure to complete a required period of service within a specified priod of time (*e.g.*, 300 hours in one year) will be considered break in service rules See § 1.411(a)–9 for requirements relating to certain amendments to the break in service rules of a plan.

(i) [Reserved]

(ii) *Examples.* The rules of this subparagraph are illustrated by the following examples:

Example 1. The A plan in 1971 provides for immediate participation and vesting at normal retirement age. Employees accrue a unit benefit based on their compensation in each year. The plan provides that if an employee is not employed on the last day of the calendar year, he loses all accrued benefits. The requirement of employment on the last day of the year is a break in service rule because employees can lose benefits by reason of

their separation. Accordingly, in the case of employees who separate and do not return by the close of the year, service which is completed prior to separation may be disregarded.

Example 2. The B plan in 1971 excludes from plan participation employees who work less than 1,200 hours per year. Because years of less than 1,200 hours are not taken into account under the B plan for eligibility to participate, such years are excluded under rules relating to breaks in service. Therefore, the years can be disregarded under this subparagraph.

Example 3. The C plan in 1971 provides for immediate participation and provides accruals and vesting credit for 1,200 hours or more in a given year. The plan provides that if a participant works less than 300 hours in a given year, he loses all prior vesting and benefit credits. The 300 hour rule is a break in service rule because the failure to complete 300 hours results in the loss of vesting and prior service credit. The 1,200 hour requirement is not a break in service rule because even though employees do not increase vesting or accrue benefits for service between 300 and 1,200 hours, they cannot lose prior vesting or benefits for such service. Accordingly, the C plan can disregard completed years only on account of less than 300 hours of service by an employee.

(c) *Special continuity rule for certain plans.* For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(Sec. 411 (88 Stat. 901, 26 U.S.C. 411))

[T.D. 7501, 42 FR 42327, Aug. 23, 1977, as amended by T.D. 7703, 45 FR 40985, June 17, 1980]

§ 1.411(a)–6 Year of service; hours of service; breaks in service.

(a) *Year of service.* Under section 411 (a)(5)(A), for purposes of the regulations thereunder, the term ''year of service'' is defined in regulations prescribed by the Secretary of Labor under section 203(b)(2)(A) of the Employee Retirement Income Security Act of 1974. For special rules applicable to seasonal industries and maritime industries, see regulations prescribed by the Secretary of Labor under subparagraphs (C) and (D) of section 203(b)(2) of the Employee Retirement Income Security Act of 1974.

(b) *Hours of service.* Under section 411(a)(5)(B), for purposes of the regulations thereunder, the term ''hours of service'' has the meaning provided by section 410(a)(3)(C). See regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(c) *Breaks in service.* Under section 411(a)(6), for purposes of § 1.411(a)–5(b)(4) and of this paragraph—

(1) *In general*—(i) *Year of service after 1-year break in service.* In the case of any employee who has incurred a 1-year break in service, years of service completed before such break are not required to be taken into account until the employee has completed one year of service after his return to service.

(ii) *Defined contribution plan.* In the case of a participant in a defined contribution plan or in an insured defined benefit plan (which plan satisfies the requirements of section 411 (b)(1)(F) and § 1.411(b)–1) who has incurred a 1-year break in service, years of service completed after such break are not required to be taken into account for purposes of determining the nonforfeitable percentage of the participant's right to employer-derived benefits which accrued before such break. This subdivision does not permit years of service completed before a 1-year break in service to be disregarded in determining the nonforfeitable percentage of a participant's right to employer-derived benefits which accrue after such break.

(iii) *Nonvested participants.* In the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year break in service, years of service completed by such participant before such break are not required to be taken into account for purposes of determining the nonforfeitable percentage of his right to employer-derived benefits if at such time the number of consecutive 1-year breaks in service included in his most recent break in service equals or exceeds the aggregate number of his years of service, whether or not consecutive, completed before such break. In the case of a plan utilizing the elapsed time method described in

§ 1.410(a)–7, the condition in the preceding sentence shall be satisfied if the period of severance is at least one year and the consecutive period of severance equals or exceeds his prior period of service, whether or not consecutive, completed before such period of severance. In computing the aggregate number of years of service prior to such break, years of service which could have been disregarded under this subdivision by reason of any prior break in service may be disregarded.

(2) *One-year break in service defined.* The term ''1-year break in service'' means a calendar year, plan year, or other 12-consecutive month period designated by a plan (and not prohibited under regulations prescribed by the Secretary of Labor) during which the participant has not completed more than 500 hours of service. In the case of a plan utilizing the elapsed time method, the term ''1-year break in service'' means a 12-consecutive month period beginning on the severance from service date or any anniversary thereof and ending on the next succeeding anniversary of such date; provided, however, that the employee during such 12-consecutive-month period does not complete any hours of service within the meaning of 29 CFR Part 2530.200b–2(a) for the employer or employers maintaining the plan. See regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(d) *Examples.* The rules provided by this section are illustrated by the following examples:

Example (1). (i) X Corporation maintains a defined contribution plan to which section 411 applies. The plan uses the calendar year as the vesting computation period. In 1980, Employee A, who was hired at age 35, separates from the service of X Corporation after completing 4 years of service. At the time of his separation, Employee A had a nonforfeitable right to 25 percent of his employer-derived accrued benefit which was not distributed. In 1985, after incurring 5 consecutive one-year breaks in service. Employee A is reemployed by X Corporation and becomes an active participant in the plan. The plan provides that, for 1985 and all subsequent years, Employee A's previous years of service will not be taken into account for purposes of computing the nonforfeitable percentage of his employer-derived accrued benefit, solely because of his break in service.

(ii) The plan fails to satisfy section 411. Section 411(a)(6)(B) would permit the plan to disregard Employee A's prior service for purposes of computing his nonforfeitable percentage in 1985 only, but such service must be taken into account in subsequent years unless there is another break in service. Under section 411(a)(6)(C), the plan is not required to take Employee A's post-break service into account for purposes of computing his nonforfeitable right to his prebreak employer-derived accrued benefits. This provision, however, would not permit the plan to disregard pre-break service in determining his nonforfeitable right to his benefit accrued after the break. The exception provided by section 411(a)(6)(D) does not apply in the case of a participant who has any nonforfeitable right to his accrued benefit derived from employer contributions.

Example (2). (i) X Corporation maintains a qualified plan to which sections 410 and 411 (relating to minimum participation standards and minimum vesting standards, respectively) apply. The plan permits participation upon completion of a year of service and provides that 100% of an employee's employer-derived accrued benefit vests after 10 years of service. The plan uses the calendar year as the vesting computation period. The plan provides that an employee who completes at least 1,000 hours of service in a 12-month period is credited with a year of service for participation and vesting purposes. The plan also provides that an employee who does not complete more than 500 hours of service in that 12-month period incurs a one-year break in service. The plan includes the rule described in section 411 (a)(6)(D) for participation and vesting purposes. Under this rule, an employee's years of service prior to a break in service may be disregarded under certain circumstances if he has no vested right to any employer-derived benefit under the plan. The plan does not contain the rule described in section 411(a)(6)(B) (relating to the requirement of one year of service after a one-year break in service).

(ii) Employee A commences employment with the X Corporation on January 1, 1977. Employee A's employment history for 1977 through 1989 is as follows:

Year ending December 31	Hours of service completed
1977	1,000
1978	800
1979	1,000
1980	400
1981	1,000
1982	0
1983	400
1984	1,000
1985	0
1986	0

Year ending December 31	Hours of service completed
1987	500
1988	200
1989	1,000

Employee A's status as a participant during this period is determined as follows:

1978: Employee A was a plan participant on January 1, 1978, because he completed a year of service (1,000 hours) in 1977. He did not complete a year of service in 1978 because he completed fewer than 1,000 hours in that year. Because he completed more than 500 hours of service in 1978, however, Employee A did not incur a one-year break in service that year.

1979: Employee A completes a year of service in 1979. Because he did not incur a one-year break in service in 1978, the plan may not disregard his 1977 service for purposes of determining his years of service as of January 1, 1979.

1980: Employee A incurs a one-year break in service in 1980.

1981: Because Employee A had completed 2 years of service prior to 1981 and had incurred one 1-year break in service prior to 1981, under section 411(a)(6)(D), the plan may not disregard his pre-1980 service in 1981. Employee A completes a year of service in 1981.

1982: Employee A incurs a one-year break in service in 1982.

1983: Employee A incurs a one-year break in service in 1983. As of the end of 1983, he has completed 3 years of service and has incurred 2 consecutive one-year breaks in service.

1984: Employee A completes a year of service in 1984. Under section 411(a)(6)(D), his pre-1982 service may not be disregarded in 1984 because, as of the beginning of 1984, his pre-1984 years of service (3) exceed his consecutive one-year breaks in service (2).

1984–1988: Employee A incurs 4 consecutive one-year breaks in service during the years 1985 through 1988.

1989: Employee A's pre-1989 service is disregarded in 1989 and all subsequent plan years because his years of service as of January 1, 1989, equal the number of consecutive one-year breaks he has incurred as of that date. Therefore, as of the beginning of 1989, Employee A is not a plan participant. Employee A completes a year of service in 1989. (Although section 411(a)(6)(D) does not prohibit the plan provision under which Employee A's pre-1989 service is disregarded, that section does not require such a provision in a qualified plan.)

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42329, Aug. 23, 1977, as amended by T.D. 7703, 45 FR 40985, June 17, 1980]

§ 1.411(a)–7 Definitions and special rules.

(a) *Accrued benefit.* For purposes of section 411 and the regulations thereunder, the term ''accrued benefit'' means—

(1) *Defined benefit plan.* In the case of a defined benefit plan—

(i) If the plan provides an accrued benefit in the form of an annual benefit commencing at normal retirement age, such accrued benefit, or

(ii) If the plan does not provide an accured benefit in the form described in subdivision (i) of this subparagraph, an annual benefit commencing at normal retirement age which is the actuarial equivalent (determined under section 411(c)(3) and § 1.411(c)–(5) of the accrued benefit determined under the plan. In general, the term ''accrued benefits'' refers only to pension or retirement benefits. Consequently, accrued benefits do not include ancillary benefits not directly related to retirement benefits such as payment of medical expenses (or insurance premiums for such expenses), disability benefits not in excess of the qualified disability benefit (see section 411(a)(9) and paragraph (c)(3) of this section), life insurance benefits payable as a lump sum, incidental death benefits, current life insurance protection, or medical benefits described in section 401(h). For purposes of this paragraph a subsidized early retirement benefit which is provided by a plan is not taken into account, except to the extent of determining the normal retirement benefit under the plan (see section 411(a)(9) and paragraph (c) of this section). The accrued benefit includes any optional settlement at normal retirement age under actuarial assumptions no less favorable than those which would be applied if the employee were terminating his employment at normal retirement age. The accrued benefit does not include any subsidized value in a joint and survivor annuity to the extent that the annual benefit of the joint and survivor annuity does not exceed the annual benefit of a single life annuity.

(2) *Defined contribution plan.* In the case of a defined contribution plan, the balance of the employee's account held under the plan.

(b) *Normal retirement age*—(1) *General rule*. For the purposes of section 411 and the regulations thereunder, the term ''normal retirement age'' means the earlier of—

(i) The time specified by a plan at which a plan participant attains normal retirement age, or

(ii) The later of—

(A) The time the plan participant attains age 65, or

(B) The 10th anniversary of the date the plan participant commences participation in the plan.

If a plan, or the employer sponsoring the plan, imposes a requirement that an employee retire upon reaching a certain age, the normal retirement age may not exceed that mandatory retirement age. The preceding sentence will apply if the employer consistently enforces a mandatory retirement age rule, whether or not set forth in the plan or any related document. For purposes of subdivision (i) of this subparagraph, if an age is not specified by a plan as the normal retirement age then the normal retirement age under the plan is the earliest age beyond which the participant's benefits under the plan are not greater solely on account of his age or service. For purposes of paragraph (b)(1)(ii)(B) of this section, participation commences on the first day of the first year in which the participant commenced his participation in the plan, except that years which may be disregarded under section 410(a)(5)(D) may be disregarded in determining when participation commenced.

(2) *Examples*. The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A defines normal retirement age as age 65. Under the plan, benefits payable to participants who retire at or after age 60 are not reduced on account of early retirement. For purposes of section 411 and the vesting regulations, normal retirement age under Plan A is age 65 (determined under subparagraph (1)(i) of this paragraph). This is true even if in operation all participants retire at age 60.

Example (2). Plan B does not specify any age as the normal retirement age. Under the plan, participants who have attained age 55 are entitled to benefits commencing upon retirement but the benefits of participants who retire before attaining age 70 are subject to reduction on account of early retirement. For purposes of section 411 and the vesting regulations the normal retirement age under Plan B is the later of (i) age 65, or (ii) the 10th anniversary of the date a plan participant commences participation in the plan (assuming such date is prior to age 70).

Example (3). The facts are the same as in example (2). Employee X first became a participant in Plan B on January 1, 1980 at age 53. His participation continued until December 31, 1980, when he separated from the service with no vested benefits. After incurring 5 consecutive 1-year breaks in service, Employee X again becomes an employee and a plan participant on January 1, 1986, at age 59. For purposes of section 411, Employee X's normal retirement age under Plan B is age 69, the 10th anniversary of the date on which his year of plan participation commenced. His participation in 1980 may be disregarded under the last sentence of paragraph (b)(1) of this section.

(c) *Normal retirement benefit*—(1) *In general*. For purposes of section 411 and the regulations thereunder, the term ''normal retirement benefit'' means the periodic benefit under the plan commencing upon early retirement (if any) or at normal retirement age, whichever benefit is greater.

(2) *Periodic benefit*. For purposes of subparagraph (1) of this paragraph—

(i) In the case of a plan under which a benefit is payable as an annuity in the same form upon early retirement and at normal retirement age, the greater benefit is determined by comparing the amount of such annuity payments.

(ii) In the case of a plan under which an annuity benefit payable upon early retirement is not in the same form as an annuity benefit payable at normal retirement age, the greater benefit is determined by converting the annuity benefit payable upon early retirement age into the same form of annuity benefit as is payable at normal retirement age and by comparing the amount of the converted early retirement benefit payment with the amount of the normal retirement benefit payment.

(iii) In the case of a plan which is integrated with the Social Security Act or any other Federal or State law, the periodic benefit payable upon and after early retirement age is adjusted for any increases in such benefits occurring on or after early retirement age which are taken into account under the

plan. See however, section 401(a)(15) and the regulations thereunder.

(3) *Benefits included.* For purposes of this paragraph, the normal retirement benefit under a plan shall be determined without regard to ancillary benefits not directly related to retirement benefits such as medical benefits or disability benefits not in excess of the qualified disability benefit; see section 411(a)(7) and paragraph (a)(1) of this section. For this purpose, a qualified disability benefit is a disability benefit which is not in excess of the amount of the benefit which would be payable to the participant if he separated from service at normal retirement age.

(4) *Early retirement benefit; social security supplement.* (i) For purposes of this paragraph, the early retirement benefit under a plan shall be determined without regard to any social security supplement.

(ii) For purposes of this subparagraph, a social security supplement is a benefit for plan participants which—

(A) Commences before the age and terminates before the age when participants are entitled to old-age insurance benefits, unreduced on account of age, under title II of the Social Security Act, as amended (see section 202 (a) and (g) of such Act), and

(B) Does not exceed such old-age insurance benefit.

(5) *Special limitation.* If a defined benefit plan bases its normal retirement benefits on employee compensation, the compensation must reflect the compensation which would have been paid for a full year of participation within the meaning of section 411(b)(3). If an employee works less than a full year of participation, the compensation used to determine benefits under the plan for such year of participation must be multiplied by the ratio of the number of hours for a complete year of participation to the number of hours worked in such year. A plan whose benefit formula is computed on a computation base which cannot decrease is not required to adjust employee compensation in the manner described in the previous sentence. Thus, for example, if a plan provided a benefit based on an employee's compensation for his highest five consecutive years or a separate benefit for each year of participation based on the employee's compensation for such year the plan would not have to so adjust compensation. However, if a plan provided a benefit based on an employee's compensation for the employee's last five years or the five highest consecutive years out of the last 10 years, the compensation, would have to be so adjusted. For special rules for applying the limitations on proration of a year of participation for benefit accrual, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A provides for a benefit equal to 1% of high 5 years compensation for each year of service and a normal retirement age of 65. The plan also provides for a full unreduced accrued benefit without any actuarial reduction for any employee at age 55 with 30 years of service. Even though the actuarial value of the early retirement benefit could exceed the value of the benefit at the normal retirement age, the normal retirement benefit would not include the greater value of the early retirement benefit because actuarial subsidies are ignored.

Example (2). Plan B provides the following benefits: (1) at normal retirement age 65, $300/mo. for life and (2) at early retirement age 60, $400/mo. for life. The normal retirement benefit is $400/mo., the greater of the benefit payable at normal retirement age ($300) or early retirement ($400).

Example (3). Assume the same facts as example (2) except that the early retirement benefit of $400 is reduced to $300 upon attainment of age 65. If each employee's social security benefit at age 65 is not less than $100, the $100 would be considered to be a social security supplement and would therefore be ignored. Consequently, the normal retirement benefit would be $300.

Example (4). Plan C provides a benefit at normal retirement age equal to 1% per year of service, multiplied by the participant's compensation averaged over the 5 years immediately prior to retirement. An early retirement benefit is provided upon attainment of age 60 equal to the benefit accrued to date of early retirement reduced by 4 percent for each year by which the early retirement date precedes the normal retirement age of 65. Employee A was hired at age 30, participated immediately, and retired at age 65. Employee A's annual compensation was $50,000 between ages 55–60 and was reduced to $33,000 after age 60. The following table indicates the amount of annual benefit that

would have been provided by the plan formula if the employee retired at or after age 60:

Age	Final average computated (1)—	Percent accrued benefit (2)—	Reduction (3)—	Annual benefit (4)—
60	$50,000	30	0.80	*$12,000
61	46,600	31	.84	12,135
62	43,200	32	.88	12,165
63	39,800	33	.92	12,083
64	36,400	34	.96	11,881
65	33,000	35	1.00	11,550

NOTE.— Col. (1) times col. (2) times col. (3) equals col. (4).

The normal retirement benefit is the greater of the benefit payable at normal retirement age or the early retirment benefit. Employee A's normal retirement benefit is $12,165, the greatest annual benefit Employee A would be entitled to.

(d) *Rules relating to certain distributions and cash-outs of accrued benefits*—(1) *In general*. This paragraph sets forth vesting rules applicable to certain distributions from qualified plans and their related trusts (other than class year plans). Subparagraphs (2) and (3) set forth the exceptions to nonforfeitability on account of withdrawal of mandatory contributions provided by section 411(a)(3)(D). When a plan utilizes these exceptions with respect to a given participant's accrued benefit, such accrued benefit is not subject to the cash-out rules or vesting rules of subparagraphs (4) or (5), respectively. Section 411 prescribes certain requirements with respect to accrued benefits under a qualified plan. These requirements would generally not be satisfied if the plan disregarded service in computing accrued benefits even though amounts were distributed on account of such service. Subparagraph (4) of this paragraph sets forth rules under section 411(a)(7)(B) which allow a plan to make distributions and compute accrued benefits without regard to the accrued benefit attributable to the distribution. When a defined contribution plan utilizes this exception with respect to an accrued benefit, the plan is not required to satisfy the rules of subparagraph (5) of this paragraph. Subparagraph (5) of this paragraph sets forth a vesting requirement applicable to certain distributions from defined contribution plans. Subparagraph (6) sets forth other rules which pertain to the distribution rules of this paragraph.

(2) *Withdrawal of mandatory contribution*—(i) *General rule*. In the case of a participant's right to his employer-derived accrued benefit, a right is not treated as forfeitable merely because all or a portion of such benefit may be forfeited on account of the withdrawal by the participant of any amount attributable to his accrued benefit derived from his mandatory contributions (within the meaning of section 411(c)(2)(C) and §1.411(c)–1) before he has become a 50 percent vested participant (within the meaning of §1.401(a)–19(b)(2)). For purposes of determining the vested percentage, the plan may disregard service after the withdrawal. For example, assume that a plan utilizes 1000 hours for computing years of service and that for the computation period employee A had 1000 hours of service. If A was 40 percent vested at the beginning of the period but only had 800 hours at the time of the withdrawal, the plan could treat A as only 40 percent vested because service after the withdrawal can be disregarded. On the other hand, if A had 1000 hours at the time of the withdrawal, he must receive a year of service for the computation period, even though service is not taken into account until the end of such period.

(ii) *Plan repayment provision*. (A) Subdivision (i) of this subparagraph shall not apply unless, at the time the amount described in such subdivision is withdrawn by the participant, the plan provides the employee with a right to restoration of his employer-derived accrued benefit to the extent forfeited in accordance with such subdivision upon repayment to the plan of the full amount of the withdrawal.

(B) In the case of a defined benefit plan (as defined in section 414(j)) the restoration of the employee's employer-derived accrued benefit may be conditioned upon repayment of interest on the full amount of the distribution. Such interest shall be computed on the amount of the distribution from the date of such distribution to the date of repayment, compounded annually from the date of distribution, at the rate determined under section 411(c)(2)(C) in

effect on the date of repayment. A plan may provide for repayment of interest which is less than the amount determined under the preceding sentence.

(C) In the case of both defined benefit plans and defined contribution plans, the plan repayment provision described in this subparagraph may provide that the employee must repay the full amount of the distribution in order to have the forfeited benefit restored. The plan provision may not require that such repayment be made sooner than the time described in paragraph (d)(2)(ii)(D) of this section.

(D)(*1*) If a distribution is on account of separation from service, the time for repayment may not end before the earlier of—

(*i*) 5 years after the first day the employee is subsequently employed, or

(*ii*) The close of the first period of consecutive 1-year breaks in service commencing after the distribution.

If the distribution occurs for any other reason, the time for repayment may not end earlier than 5 years after the date of distribution. Nevertheless, a plan provision may provide for a longer period in which the employee may repay. For example, a plan could allow repayments to be made at any time before normal retirement age.

(*2*) In the case of a plan utilizing the elapsed time method, described in §1.410(a)–7, the minimum time for repayment shall be determined as in paragraph (d)(2)(ii)(D)(*1*) of this section except as provided in this subdivision. The 5 consecutive 1-year break periods shall be determined by substituting the term ''1-year period of severance'' for the term ''1-year break in service''. Also, the repayment period both commences and closes in a manner determined by the Commissioner that is consistent with the rules in §1.410(a)–7 and the substitution in section 411(a)(6)(C) and (D) of a 5-year break–in–service rule for the former 1-year break–in–service rule.

(E) A defined benefit plan using the break–in–service rule described in section 410(a)(5)(D) or a defined contribution plan using the break–in–service rule described in section 411(a)(6)(C) for determining employees' accrued benefits is not required to provide for repayment by an employee whose accrued benefit is disregarded by reason of a plan provision using these rules.

(iii) *Computation of benefit.* In the case of a defined contribution plan, the employer-derived accrued benefit required to be restored by this subparagraph shall not be less than the amount in the account balance of the employee which was forfeited, unadjusted by any subsequent gains or losses.

(iv) *Delayed forfeiture.* A defined contribution plan may, in lieu of the forfeiture and restoration described in this subparagraph, provide that the forfeiture does not occur until the expiration of the time for repayment described in subdivision (ii) of this subparagraph provided that the conditions of this subparagraph are satisfied.

(3) *Withdrawal of mandatory contributions; accruals before September 2, 1974*—(i) *General rule.* In the case of a participant's right to the portion of the employer-derived benefit which accrued prior to September 2, 1974, a right is not treated as forfeitable merely because all or part of such portion may be forfeited on account of the withdrawal by the participant of an amount attributable to his benefit derived from mandatory contributions (within the meaning of section 411(c)(2)(C) and §1.411(c)–1(c)(4)) made by the participant before September 2, 1974, if the amount so subject to forfeiture is no more than proportional to such amounts withdrawn. This subparagraph shall not apply to any plan to which any mandatory contribution (within the meaning of section 411(c)(2)(C) and §1.411(c)–1(c)(4)) is made after September 2, 1974.

(ii) *Defined contribution plan.* In the case of a defined contribution plan, the portion of a participant's employer-derived benefit which accrued prior to September 2, 1974, shall be determined on the basis of a separate accounting between benefits accruing before and after such date. Gains, losses, withdrawals, forfeitures, and other credits or charges must be separately allocated to such benefits. Any allocation made on a reasonable and consistent basis prior to September 1, 1977, shall satisfy the requirements of this subdivision.

(iii) *Defined benefit plan.* In the case of a defined benefit plan, the portion of a participant's employer-derived benefit which accrued prior to September 2, 1974, shall be determined in a manner consistent with the determination of an accrued benefit under section 411(b)(1)(D) (see §1.411(b)–1(c)). Any method of determining such accrued benefit which the Commissioner finds to be reasonable shall satisfy the requirements of this subdivision.

(4) *Certain cash-outs of accrued benefits*—(i) *Involuntary cash-outs.* For purposes of determining an employee's right to an accrued benefit derived from employer contributions under a plan, the plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his entire nonforfeitable benefit at the time of the distribution;

(B) The requirements of section 411(a)(11) are satisfied at the time of the distribution;

(C) The distribution is made due to the termination of the employee's participation in the plan; and

(D) The plan has a repayment provision which satisfies the requirements of paragraph (d)(4)(iv) of this section in effect at the time of the distribution.

(ii) *Voluntary cash-outs.* For purposes of determining an employee's accrued benefit derived from employer contributions under a plan, the plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his nonforfeitable benefit attributable to such service at the time of such distribution,

(B) The employee voluntarily elects to receive such distribution,

(C) The distribution is made on termination of the employee's participation in the plan, and

(D) The plan has a repayment provision in effect at the time of the distribution which satisfies the requirements of subdivision (iv) of this subparagraph.

A distribution shall be deemed to be made on termination of participation in the plan if it is made not later than the close of the second plan year following the plan year in which such termination occurs. For purposes of determining the nonforfeitable benefit, the plan may disregard service after the distribution as illustrated in subparagraph (2)(i) of this subparagraph.

(iii) *Disregard of service.* Service of an employee permitted to be disregarded under subdivision (i) or (ii) of the subparagraph is not required to be taken into account in computing the employee's accrued benefit under the plan. In the case of a voluntary distribution described in subdivision (ii) of this subparagraph which is less than the present value of the employee's total nonforfeitable benefit immediately prior to the distribution, the accrued benefit not required to be taken into account is such total accrued benefit multiplied by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the present value of his total nonforfeitable benefit immediately prior to such distribution. For example, A who is 50 percent vested in an account balance of $1,000 receives a voluntary distribution of $250. The accrued benefit which can be disregarded equals $1,000 times $250/$500, or $500. However, such service may not by reason of this paragraph be disregarded for purposes of determining an employee's years of service under sections 410(a)(3) and 411(a)(4).

(iv) *Plan repayment provision.* (A) A plan repayment provision satisfies the requirements of this subdivision if, under the provision, the accrued benefit of an employee that is disregarded by a plan under this subparagraph is restored upon repayment to the plan by the employee of the full amount of the distribution. An accrued benefit is not restored unless all of the optional forms of benefit and subsidies relating to such benefit are also restored. A plan is not required to provide for repayment of an accrued benefit unless the employee—

(*1*) Received a distribution that is in a plan year to which section 411 applies (see §1.411(a)–2), which distribution is less than the amount of his accrued benefit determined under the same optional form of benefit as the distribution was made, and

(*2*) Resumes employment covered under the plan.

(B) *Example.* Plan A provides a single sum distribution equal to the present value of the normal form of the accrued benefit payable at normal retirement age which is a single life annuity. Plan A also provides a subsidized joint and survivor annuity and a subsidized early retirement annuity benefit. A participant who is fully vested and receives a single sum distribution equal to the present value of the single life annuity normal retirement benefit is not required to be provided the right under the plan to repay the distribution upon subsequent reemployment even though the participant received a distribution that did not reflect the value of the subsidy in the joint and survivor annuity or the value of the early retirement annuity subsidy. This is true whether or not the participant had satisfied at the time of the distribution all of the conditions necessary to receive the subsidies. However, if a participant does not receive his total accrued benefit in the optional form of benefit under which his benefit was distributed, the plan must provide for repayment. If the employee repays the distribution in accordance with section 411(a)(7), the plan must restore the employee's accrued benefit which would include the right to receive the subsidized joint and survivor annuity and the subsidized early retirement annuity benefit.

(C) A plan may impose the same conditions on repayments for the restoration of employer-derived accrued benefits that are allowed as conditions for restoration of employer-derived accrued benefits upon repayment of mandatory contributions under paragraphs (d)(2)(ii) (B), (C), (D) and (E) of this section.

(v) In the case of a defined contribution plan, the employer-derived accrued benefit required to be restored by this subparagraph shall not be less than the amount in the account balance of the employee, both the amount distributed and the amount forfeited, unadjusted by any subsequent gains or losses. Thus, for example, if an employee received a distribution of $250 when he was 25 percent vested in an account balance of $1,000, upon repayment of $250 the account balance may not be less than $1,000 even if, because of plan losses, the account balance, if not distributed, would have been reduced to $500.

(vi) For purposes of paragraph (d)(4)(i) of this section, a distribution shall be deemed to be made due to the termination of an employee's participation in the plan if it is made no later than the close of the second plan year following the plan year in which such termination occurs, or if such distribution would have been made under the plan by the close of such second plan year but for the fact that the present value of the nonforfeitable accrued benefit then exceeded the cash-out limit in effect under §1.411(a)–11(c)(3)(ii). For purposes of determining the entire nonforfeitable benefit, the plan may disregard service after the distribution, as illustrated in paragraph (d)(2)(i) of this section.

(vii) *Effective date.* Paragraphs (d)(4)(i) and (vi) of this section apply to distributions made on or after March 22, 1999. However, an employer is permitted to apply paragraphs (d)(4)(i) and (vi) of this section to plan years beginning on or after August 6, 1997. Otherwise, for distributions prior to March 22, 1999, §§1.411(a)–7 and 1.411(a)–7T, in effect prior to October 17, 2000 (as contained in 26 CFR part 1, revised as of April 1, 2000) apply.

(5) *Vesting requirement for defined contribution plans*—(i) *Application.* The requirements of this subparagraph apply to a defined contribution plan which makes distributions to employees from their accounts attributable to employer contributions at a time when—

(A) Employees are less than 100 percent vested in such accounts, and

(B) Under the plan, employees can increase their percentage of vesting in such accounts after the distributions.

(ii) *Requirements.* In order for a plan, to which this subparagraph applies, to satisfy the vesting requirements of section 411, account balances under the plan (with respect to which percentage vesting can increase) must be computed in a manner which satisfies either subdivision (iii) (A) or (B) of this subparagraph.

(iii) *Permissible methods.* A plan many provide for either of the following methods, but not both, for computing account balances with respect to which percentage vesting can increase and from which distributions are made:

(A)*(1)* A separate account is established for the employee's interest in the plan as of the time of the distribution, and

(*2*) At any relevant time the employee's vested portion of the separate account is not less than an amount (''X'') determined by the formula: X=P(AB+(R×D))−(R×D). For purposes of applying the formula: P is the vested percentage at the relevant time; AB is the account balance at the relevant time; D is the amount of the distribution; R is the ratio of the account balance at the relevant time to the account balance after distribution; and the relevant time is the time at which, under the plan, the vested percentage in the account cannot increase.

A plan is not required to provide for separate accounts provided that account balances are maintained under a method that has the same effect as under this subdivision.

(B) At any relevant time the employee's vested portion is not less than an amount (''X'') determined by the formula: X=P(AB+D)−D. For purposes of applying the formula, the terms have the same meaning as under subdivision (iii)(A)(*2*) of this subparagraph.

(C) An application of the methods described in subdivisions (iii) (A) and (B) of this subparagraph is illustrated by the following examples:

Example (1). The X defined contribution plan uses the method described in subdivision (iii)(A) of this subparagraph for computing account balances and the break in service rule described in section 411(a)(6)(C) (service after a 1-year break does not increase the vesting percentage in account balances accrued prior to the break). The plan distributes $250 to A when A's account balance prior to the distribution equals $1,000 and he is 25 percent vested. At the time of the distribution, A has not incurred a 1-year break so that his vesting percentage can increase. Six years later, when A is 60 percent vested, he incurs a 1-year break so that his vesting percentage cannot increase. At this time his separate account balance equals $1,500. R=$1,500/$750 or 2. A's separate account must equal 60 percent ($1,500+(2×$250))−(2×$250) or 60 percent ($1,500+$500)−$500, or $1,200−$500 equals $700.

Example (2). The Y defined contribution plan uses the method descirbed in subdivision (iii)(B) of this subparagraph for computing account balances and the break in service rule described in section 411(a)(6)(C). The plan distributes $250 to B when B's account balance prior to the distribution equals $1,000 and he is 25 percent vested. At the time of the distribution, B has not incurred a 1-year break so that his vesting percentage can increase. Six years later, when A is 60 percent vested, he incurs a 1-year break so that his vesting percentage cannot increase. At this time his account balance equals $1,500. B's separate account must equal 60 percent ($1,500+$250)−$250, 60% of $1,750−$250 equals $800.

(6) *Other rules*—(i) *Distributions on separation or other event.* None of the rules of this paragraph preclude distributions to employees upon separation from service or any other event recognized by the plan for commencing distributions. Such a distribution must, of course, satisfy the applicable qualification requirements pertaining to such distributions. For example, a profitsharing plan could pay the vested portion of an account balance to an employee when he separated from service, but in order to satisfy section 411 the plan might not be able to forfeit the nonvested account balance until the employee has a 1-year break in service. Similarly, the fact that a plan cannot disregard an accrued benefit attributable to service for which an employee has received a distribution because the plan does not satisfy the cash-out requirements of subparagraph (4) of this paragraph does not mean that the employee's accrued benefit (computed by taking into account such service) cannot be offset by the accrued benefit attributable to the distribution.

(ii) *Joint and survivor requirements.* See §1.401(a)–11(a)(2) (relating to joint and survivor annuities) for special rules applicable to certain distributions described in this paragraph.

(iii) *Plan repayments.* (A) Under subparagraphs (2) and (4) of this paragraph, a plan may be required to restore accrued benefits in the event of repayment by an employee.

(B) For purposes of applying the limitations of section 415 (c) and (e), in the case of a defined contribution plan, the repayment by the employee and the restoration by the employer shall not be treated as annual additions.

(C) In the case of a defined contribution plan, the permissible sources for restoration of the accrued benefit are: income or gain to the plan, forfeitures, or employer contributions. Notwithstanding the provisions of §1.401–1(b)(1)(ii), contributions may be made for such an accrued benefit by a profit-

sharing plan even though there are no profits. In order for such a plan to be qualified, account balances (accrued benefits) generally must correspond to assets in the plan. Accordingly, there cannot be an unfunded account balance. However, an account balance will not be deemed to be unfunded in the case of a restoration if assets for the restored benefit are provided by the end of the plan year following the plan year in which the repayment occurs.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42329, Aug. 23, 1977, as amended by T.D. 8038, 50 FR 29374, July 19, 1985; T.D. 8219, 53 FR 31852, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988; T.D. 8794, 63 FR 70337, Dec. 21, 1998; T.D. 8891, 65 FR 44681, July 19, 2000]

§ 1.411(a)–8 Changes in vesting schedule.

(a) *Requirement of prior schedule.* Under section 411(a)(10)(A), for plan years for which section 411 applies, a plan will be treated as not meeting the minimum vesting standards of section 411(a)(2) if the plan does not satisfy the requirements of this paragraph. If the vesting schedule of a plan is amended, then as of the date such amendment is adopted, the plan satisfies the requirements of this paragraph if, under the plan as amended, in the case of an employee who is a participant on—

(1) The date the amendment is adopted, or

(2) The date the amendment is effective, if later.

The nonforfeitable percentage (determined as of such date) of such employee's right to his employer-derived accrued benefit is not less than his percentage computed under the plan without regard to such amendment.

(b) *Election of former schedule*—(1) *In general.* Under section 411 (a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411 (a)(2) unless the plan as amended, provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 5 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment.

(2) *Election period.* For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) *Service requirement.* For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 5 years of service if such participant has completed 5 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term ''year of service'', see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(4) *Election only by participant.* The election described in subparagraph (1) of this paragraph is available only to an individual who is a participant in the plan at the time such election is made.

(5) *Election may be irrevocable.* A plan, as amended, shall not fail to meet the minimum vesting standards of section 411(a)(2) by reason of section 411(a)(10)(B) merely because such plan provides that the election described in subparagraph (1) of this paragraph is irrevocable.

(6) *Relationship with section 411(a)(2).* The election described in subparagraph

(1) of this paragraph is available for a vesting schedule which does not satisfy the requirements of section 411(a)(2) only if under such schedule all participants have a 50 percent nonforfeitable right after 10 years of service, and a 100 percent nonforfeitable right after 15 years of service, in their employer-derived accrued benefit. If the vesting schedule provides less vesting than the percentages required by the preceding sentence, the plan can be amended to provide for such vesting.

(c) *Special rules*—(1) *Amendment of vesting schedule*. For purposes of this section, an amendment of a vesting schedule is each plan amendment which directly or indirectly affects the computation of the nonforfeitable percentage of employees' rights to employer-derived accrued benefits. Consequently, such an amendment, for example, includes each change in the plan which affects either the plan's computation of years of service or of vesting percentages for years of service.

(2) *Aggregation of amendments*. All plan amendments which are: (i) amendments of a vesting schedule within the meaning of subparagraph (1) of this paragraph and (ii) adopted and effective at the same time, shall be deemed to be a single amendment for purposes of applying the rules in paragraphs (a) and (b) of this section.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42333, Aug. 23, 1977]

§ 1.411(a)–8T Changes in vesting schedule (temporary).

(a) [Reserved]

(b) *Election of former schedule*—(1) *In general*. Under section 411(a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411(a)(2) unless the plan as amended provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 3 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment. For employees not described in § 1.411(a)–3T(e)(1), this section shall be applied by substituting ''5 years of service'' for ''3 years of service'' where such language appears.

(2) *Election period*. For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) *Service requirement*. For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 3 years of service if such participant has completed 3 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term ''year of service'', see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

[T.D. 8170, 53 FR 241, Jan. 6, 1988]

§ 1.411(a)–9 Amendment of break in service rules; transitional period.

(a) *In general*. Under section 1017(f)(2) of the Employee Retirement Income Security Act of 1974, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the rules of the plan relating to breaks in service are amended, and—

(1) Such amendment is effective after January 1, 1974, and before the effective date of section 411, and

(2) Under such amendment, the nonforfeitable percentage of any employee's right to his employer-derived accrued benefit is less than the lesser of the nonforfeitable percentage of such employee's right to such benefit—

(i) Under the break in service rules provided by section 411(a)(6) and § 1.411(a)–6(c), or

(ii) The greatest such percentage under the plan as in effect on or after January 1, 1974 (provided the break in service rules of the plan were not in violation of any law or rule of law on January 1, 1974).

(b) *Break in service rules.* For purposes of paragraph (a), the term ''break in service rules'' means the rules provided by a plan relating to circumstances under which a period of an employee's service or plan participation is disregarded, for purposes of determining the extent to which his rights to his accrued benefit under the plan are unconditional, if under such rules such service is disregarded by reason of the employee's failure to complete a required period of service within a specified period of time. For this purpose, plan rules which result in the loss of prior vesting or benefit accruals of an employee, or which deny an employee eligibility to participate, by reason of separation or failure to complete a required period of service within a specified period of time (e.g., 300 hours in one year) will be considered break in service rules. For purposes of section 411(b)(3), service described under the plan's break in service rules, as in effect before the effective date of section 411, need not be counted.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42333, Aug. 23, 1977]

§ 1.411(a)–11 Restriction and valuation of distributions.

(a) *Scope*—(1) *In general.* Section 411(a)(11) restricts the ability of a plan to distribute any portion of a participant's accrued benefit without the participant's consent. Section 411(a)(11) also restricts the ability of defined benefit plans to distribute any portion of a participant's accrued benefit in optional forms of benefit without complying with specified valuation rules for determining the amount of the distribution. If the consent requirements or the valuation rules of this section are not satisfied, the plan fails to satisfy the requirements of section 411(a).

(2) *Accrued benefit.* For purposes of this section, an accrued benefit is valued taking into consideration the particular optional form in which the benefit is to be distributed. The value of an accrued benefit is the present value of the benefit in the distribution form determined under the plan. For example, a plan that provides a subsidized early retirement annuity benefit may specify that the optional single sum distribution form of benefit available at early retirement age is the present value of the subsidized early retirement annuity benefit. In this case, the subsidized early retirement annuity benefit must be used to apply the valuation requirements of this section and the resulting amount of the single sum distribution. However, if a plan that provides a subsidized early retirement annuity benefit specifies that the single sum distribution benefit available at early retirement age is the present value of the normal retirement annuity benefit, then the normal retirement annuity benefit is used to apply the valuation requirements of this section and the resulting amount of the single sum distribution available at early retirement age.

(b) *General consent rules.* A plan must satisfy the participant consent requirement with respect to the distribution of a participant's nonforfeitable accrued benefit with a present value in excess of the cash-out limit in effect under paragraph (c)(3)(ii) of this section. See paragraphs (c) (3) and (4) for situations where no consent is required.

(c) *Consent, etc. requirements*—(1) *General rule.* If an accrued benefit is immediately distributable, section 411(a)(11) permits plans to provide for the distribution of any portion of a participant's nonforfeitable accrued benefits only if the applicable consent requirements are satisfied.

(2) *Consent.* (i) No consent is valid unless the participant has received a general description of the material features of the optional forms of benefit available under the plan. In addition,

so long as a benefit is immediately distributable, a participant must be informed of the right, if any, to defer receipt of the distribution. Furthermore, consent is not valid if a significant detriment is imposed under the plan on any participant who does not consent to a distribution. Whether or not a significant detriment is imposed shall be determined by the Commissioner by examining the particular facts and circumstances.

(ii) Consent of the participant to the distribution must not be made before the participant receives the notice of his or her rights specified in this paragraph (c)(2) and must not be made more than 90 days before the date the distribution commences.

(iii) A plan must provide a participant with notice of the rights specified in this paragraph (c)(2) at a time that satisfies either paragraph (c)(2)(iii)(A) or (B) of this section:

(A) This paragraph (c)(2)(iii)(A) is satisfied if the plan provides a participant with notice of the rights specified in this paragraph (c)(2) no less than 30 days and no more than 90 days before the date the distribution commences. However, if the participant, after having received this notice, affirmatively elects a distribution, a plan will not fail to satisfy the consent requirement of section 411(a)(11) merely because the distribution commences less than 30 days after the notice was provided to the participant, provided the plan administrator clearly indicates to the participant that the participant has a right to at least 30 days to consider whether to consent to the distribution.

(B) This paragraph (c)(2)(iii)(B) is satisfied if the plan—

(*1*) Provides the participant with notice of the rights specified in this paragraph (c)(2);

(*2*) Provides the participant with a summary of the notice within the time period described in paragraph (c)(2)(iii)(A) of this section; and

(*3*) If the participant so requests after receiving the summary described in paragraph (c)(2)(iii)(B)(*2*) of this section, provides the notice to the participant without charge and no less than 30 days before the date the distribution commences, subject to the rules for the participant's waiver of that 30-day period. The summary described in paragraph (c)(2)(iii)(B)(*2*) of this section must advise the participant of the right, if any, to defer receipt of the distribution, must set forth a summary of the distribution options under the plan, must refer the participant to the most recent version of the notice (and, in the case of a notice provided in any document containing information in addition to the notice, must identify that document and must provide a reasonable indication of where the notice may be found in that document, such as by index reference or by section heading), and must advise the participant that, upon request, a copy of the notice will be provided without charge.

(iv) For purposes of satisfying the requirements of this paragraph (c)(2), the plan administrator may substitute the annuity starting date, within the meaning of § 1.401(a)–20, Q&A–10, for the date the distribution commences.

(v) See § 1.401(a)–20, Q&A–24 for a special rule applicable to consents to plan loans.

(3) *Cash-out limit*. (i) Written consent of the participant is required before the commencement of the distribution of any portion of an accrued benefit if the present value of the nonforfeitable total accrued benefit is greater than the cash-out limit in effect under paragraph (c)(3)(ii) of this section on the date the distribution commences. The consent requirements are deemed satisfied if such value does not exceed the cash-out limit, and the plan may distribute such portion to the participant as a single sum. Present value for this purpose must be determined in the same manner as under section 417(e); see § 1.417(e)–1(d).

(ii) The cash-out limit in effect for a date is the amount described in section 411(a)(11)(A) for the plan year that includes that date. The cash-out limit in effect for dates in plan years beginning on or after August 6, 1997, is $5,000. The cash-out limit in effect for dates in plan years beginning before August 6, 1997, is $3,500.

(iii) *Effective date*. Paragraphs (c)(3)(i) and (ii) of this section apply to distributions made on or after October 17, 2000. However, an employer is permitted to apply the $5,000 cash-out limit described in paragraph (c)(3)(ii) of

this section to plan years beginning on or after August 6, 1997. Otherwise, for distributions prior to October 17, 2000, §§ 1.411(a)–11 and 1.411(a)–11T in effect prior to October 17, 2000 (as contained in 26 CFR Part 1 revised as of April 1, 2000) apply.

(4) *Immediately distributable.* Participant consent is required for any distribution while it is immediately distributable, *i.e.*, prior to the later of the time a participant has attained normal retirement age (as defined in section 411(a)(8)) or age 62. Once a distribution is no longer immediately distributable, a plan may distribute the benefit in the form of a QJSA in the case of a benefit subject to section 417 or in the normal form in other cases without consent.

(5) *Death of participant.* The consent requirements of section 411(a)(11) do not apply after the death of the participant.

(6) *QDROs.* The consent requirements of section 411(a)(11) do not apply to payments to an alternate payee, defined in section 414(p)(8), except as provided in a qualified domestic relations order pursuant to section 414(p).

(7) *Section 401(a)(9), etc.* The consent requirements of section 411(a)(11) do not apply to the extent that a distribution is required to satisfy the requirements of section 401(a)(9) or 415. See section 401(a)(9) and the regulations thereunder and § 1.401(a)–20 Q&A 23 for guidance on these requirements. Notwithstanding any provision to the contrary in section 401(a)(14) or § 1.401(a)–14, a plan may not distribute a participant's nonforfeitable accrued benefit with a present value in excess of the cash-out limit in effect under paragraph (c)(3)(ii) of this section while the benefit is immediately distributable unless the participant consents to such distribution. The failure of a participant to consent is deemed to be an election to defer commencement of payment of the benefit for purposes of section 401(a)(14) and § 1.401(a)–14.

(8) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may modify, or provide additional guidance with respect to, the notice and consent requirements of this section. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(d) *Distribution valuation requirements.* In determining the present value of any distribution of any accrued benefit from a defined benefit plan, the plan must take into account specified valuation rules. For this purpose, the valuation rules are the same valuation rules for valuing distributions as set forth in section 417(e); see § 1.417(e)–1(d). This paragraph (d) applies both before and after the participant's death regardless of whether the accrued benefit is immediately distributable. This paragraph also applies whether or not the participant's consent is required under paragraphs (b) and (c) of this section.

(e) *Special rules*—(1) *Plan termination.* The requirements of this section apply before, on and after a plan termination. If a defined contribution plan terminates and the plan does not offer an annuity option (purchased from a commercial provider), then the plan may distribute a participant's accrued benefit without the participant's consent. The preceding sentence does not apply if the employer, or any entity within the same controlled group as the employer, maintains another defined contribution plan, other than an employee stock ownership plan (as defined in section 4975(e)(7)). In such a case, the participant's accrued benefit may be transferred without the participant's consent to the other plan if the participant does not consent to an immediate distribution from the terminating plan. See section 411(d)(6) and the regulations thereunder for other rules applicable to transferee plans and plan terminations.

(2) *ESOP dividends.* The requirements of this section do not apply to any distribution of dividends to which section 404(k) applies.

(3) *Other rules.* See § 1.401(a)–20 Q&As 14, 17 and 24 for other rules that apply to the section 411(a)(11) requirements.

(f) *Medium for notice and consent*—(1) *Notice.* The notice of a participant's rights described in paragraph (c)(2) of this section or the summary of that notice described in paragraph (c)(2)(iii)(B)(*2*) of this section may be provided either on a written paper document or through an electronic medium reasonably accessible to the participant. A notice or summary provided

through an electronic medium must be provided under a system that satisfies the following requirements:

(i) The system must be reasonably designed to provide the notice or summary in a manner no less understandable to the participant than a written paper document.

(ii) At the time the notice or summary is provided, the participant must be advised that he or she may request and receive the notice on a written paper document at no charge, and, upon request, that document must be provided to the participant at no charge.

(2) *Consent*. The consent described in paragraphs (c)(2) and (3) of this section may be given either on a written paper document or through an electronic medium reasonably accessible to the participant. A consent given through an electronic medium must be given under a system that satisfies the following requirements:

(i) The system must be reasonably designed to preclude any individual other than the participant from giving the consent.

(ii) The system must provide the participant with a reasonable opportunity to review and to confirm, modify, or rescind the terms of the distribution before the consent to the distribution becomes effective.

(iii) The system must provide the participant, within a reasonable time after the consent is given, a confirmation of the terms (including the form) of the distribution either on a written paper document or through an electronic medium under a system that satisfies the requirements of paragraph (f)(1) of this section.

(g) *Examples*. The provisions of paragraph (f) of this section are illustrated by the following examples:

Example 1. (i) A qualified plan (Plan A) permits participants to request distributions by e-mail. Under Plan A's system for such transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match that in Plan A's records in order for the transaction to proceed. If a participant requests a distribution from Plan A by e-mail, the plan administrator provides the participant with a section 411(a)(11) notice by e-mail. The plan administrator also advises the participant by e-mail that he or she may request the section 411(a)(11) notice on a written paper document and that, if the participant requests the notice on a written paper document, it will be provided at no charge. To proceed with the distribution by e-mail, the participant must acknowledge receipt, review, and comprehension of the section 411(a)(11) notice and must consent to the distribution within the time required under section 411(a)(11). Within a reasonable time after the participant's consent by e-mail, the plan administrator, by e-mail, sends confirmation of the terms (including the form) of the distribution to the participant and advises the participant that he or she may request the confirmation on a written paper document that will be provided at no charge.

(ii) In this *Example 1*, Plan A does not fail to satisfy the notice or consent requirement of section 411(a)(11) merely because the notice and consent are provided other than through written paper documents.

Example 2. (i) Same facts as *Example 1*, except that, instead of sending a confirmation of the distribution by e-mail, the plan administrator, within a reasonable time after the participant's consent, sends the participant an account statement for the period that includes information reflecting the terms of the distribution.

(ii) In this *Example 2*, Plan A does not fail to satisfy the consent requirement of section 411(a)(11) merely because the consent is provided other than through a written paper document.

Example 3. (i) A qualified plan (Plan B) permits participants to request distributions through the Plan B web site (Internet or intranet). Under Plan B's system for such transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match that in Plan B's records in order for the transaction to proceed. A participant may request a distribution from Plan B by following the applicable instructions on the Plan B web site. After the participant has requested a distribution, the participant is automatically shown a page on the web site containing a section 411(a)(11) notice. Although this page of the web site may be printed, the page also advises the participant that he or she may request the section 411(a)(11) notice on a written paper document by calling a telephone number indicated on the web page and that, if the participant requests the notice on a written paper document, it will be provided at no charge. To proceed with the distribution by e-mail, the participant must acknowledge receipt, review, and comprehension of the section 411(a)(11) notice and must consent to the distribution within the time required under section 411(a)(11). The web site requires the participant to review and confirm the terms (including the form) of the distribution before

the transaction is completed. After the participant has given consent via e-mail, the Plan B web site confirms the distribution to the participant and advises the participant that he or she may request the confirmation on a written paper document that will be provided at no charge.

(ii) In this *Example 3*, Plan B does not fail to satisfy the notice or consent requirement of section 411(a)(11) merely because the notice and consent are provided other than through written paper documents.

Example 4. (i) A qualified plan (Plan C) permits participants to request distributions through Plan C's automated telephone system. Under Plan C's system for such transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match that in Plan C's records in order for the transaction to proceed. Plan C provides only the following distribution options: a lump sum and annual installments over 5, 10, or 20 years. A participant may request a distribution from Plan C by following the applicable instructions on the automated telephone system. After the participant has requested a distribution, the automated telephone system reads the section 411(a)(11) notice to the participant. The automated telephone system also advises the participant that he or she may request the notice on a written paper document and that, if the participant requests the notice on a written paper document, it will be provided at no charge. Before proceeding with the distribution transaction, the participant must acknowledge receipt, review, and comprehension of the section 411(a)(11) notice and must consent to the distribution within the time required under section 411(a)(11). The automated telephone system requires the participant to review and confirm the terms (including the form) of the distribution before the transaction is completed. After the participant has given consent, the automated telephone system confirms the distribution to the participant and advises the participant that he or she may request the confirmation on a written paper document that will be provided at no charge. Because Plan C has relatively few and simple distribution options, the provision of the section 411(a)(11) notice over the automated telephone system is no less understandable to the participant than a written paper notice.

(ii) In this Example 4, Plan C does not fail to satisfy the notice or consent requirement of section 411(a)(11) merely because the notice and consent are provided other than through written paper documents.

Example 5. (i) Same facts as *Example 4*, except that, pursuant to Plan C's system for processing such transactions, a participant who so requests is transferred to a customer service representative whose conversation with the participant is recorded. The customer service representative provides the section 411(a)(11) notice from a prepared text and processes the participant's distribution in accordance with predetermined instructions of the plan administrator.

(ii) In this *Example 5*, Plan C does not fail to satisfy the notice or consent requirement of section 411(a)(11) merely because the notice and consent are provided other than through written paper documents.

Example 6. (i) Same facts as *Example 1*, except that Participant D requested a distribution by e-mail, then terminated employment and, following the termination, no longer has access to e-mail.

(ii) In this *Example 6*, Plan A does not satisfy the notice or consent requirement of section 411(a)(11) because the electronic medium through which the notice is provided is not reasonably accessible to Participant D. Plan A must provide Participant D the section 411(a)(11) notice in a written paper document or by an electronic means that is reasonably accessible to Participant D.

[T.D. 8219, 53 FR 31853, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988, as amended by T.D. 8620, 60 FR 49221, Sept. 22, 1995; T.D. 8796, 63 FR 70011, Dec. 18, 1998; T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8873, 65 FR 6006, Feb. 8, 2000; T.D. 8891, 65 FR 44681, 44682, July 19, 2000]

§ 1.411(b)–1 Accrued benefit requirements.

(a) *Accrued benefit requirements*—(1) *In general*. Under section 411(b), for plan years beginning after the applicable effective date of section 411, rules are provided for the determination of the accrued benefit to which a participant is entitled under a plan. Under a defined contribution plan, a participant's accrued benefit is the balance to the credit of the participant's account. Under a defined benefit plan, a participant's accrued benefit is his accrued benefit determined under the plan. A defined benefit plan is not a qualified plan unless the method provided by the plan for determining accrued benefits satisfies at least one of the alternative methods (described in paragraph (b) of this section) for determining accrued benefits with respect to all active participants under the plan. A defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for

participants satisfy one of the alternative methods. A plan may satisfy different methods with respect to different classifications of employees, or separately satisfy one method with respect to the accrued benefits for each such classification, provided that such classifications are not so structured as to evade the accrued benefit requirements of section 411(b) and this section. (For example, if a plan provides that employees who commence participation at or before age 40 accrue benefits in a manner which satisfies the 133⅓ percent method of determining accrued benefits and employees who commence participation after age 40 accrue benefits in a manner which satisfies the 3 percent method of determining accrued benefits, the plan would be so structured as to evade the requirements of section 411(b).) A defined benefit plan does not satisfy the requirements of section 411(b) and this section merely because the accrued benefit is defined as the ''reserve under the plan''. Special rules are provided for the first two years of service by a participant, certain insured defined benefit plans, and certain reductions in accrued benefits due to increasing age or service. In addition, a special rule is provided with respect to accruals for service before the effective date of section 411.

(2) *Cross references*—(i) *3 percent method*. For rules relating to the 3 percent method of determining accrued benefits, see paragraph (b)(1) of this section.

(ii) *133⅓ percent method*. For rules relating to the 133⅓ percent method of determining accrued benefits, see paragraph (b)(2) of this section.

(iii) *Fractional method*. For rules relating to the fractional method of determining accrued benefits, see paragraph (b)(3) of this section.

(iv) *Accruals before effective date*. For rules relating to accruals for service before the effective date of section 411, see paragraph (c) of this section.

(v) *First 2 years of service*. For special rules relating to determination of accrued benefit for first 2 continuous years of service, see paragraph (d)(1) of this section.

(vi) *Certain insured plans*. For special rules relating to determination of accrued benefit under a defined benefit plan funded exclusively by insurance contracts, see paragraph (d)(2) of this section.

(vii) *Accruals decreased by increasing age or service*. For special rules relating to prohibition of decrease in accrued benefit on account of increasing age or service, see paragraph (d)(3) of this section.

(viii) *Separate accounting*. For rules relating to requirements for separate accounting, see paragraph (e) of this section.

(ix) *Year of participation*. For definition of ''year of participation'', see paragraph (f) of this section.

(b) *Defined benefit plans*. A defined benefit plan satisfies the requirements of section 411(b)(1) and this paragrah for a plan year to which section 411 and this section apply if it satisfies the requirements of subparagraph (1), (2), or (3) of this paragraph for such year.

(1) *3 percent method*—(i) *General rule*. A defined benefit plan satisfies the requirements of this paragraph for a plan year if, as of the close of the plan year, the accrued benefit to which each participant is entitled, computed as if the participant separated from the service as of the close of such plan year, is not less than 3 percent of the 3 percent method benefit, multiplied by the number of years (not in excess of 33⅓) of his participation in the plan including years after his normal retirement age. For purposes of this subparagraph, the ''3 percent method benefit'' is the normal retirement benefit to which the participant would be entitled if he commenced participation at the earliest possible entry age for any individual who is or could be a participant under the plan and if he served continuously until the earlier of age 65 or the normal retirement age under the plan.

(ii) *Special rules*—(A) *Compensation*. In the case of a plan providing a retirement benefit based upon compensation during any period, the normal retirement benefit to which a participant would be entitled is determined as if he continued to earn annually the average rate of compensation which he earned during consecutive years of service, not in excess of 10, for which his compensation was the highest. For purposes of

this subdivision (A), the number of consecutive years of service used in computing average compensation shall be the number of years of service specified under the plan (not in excess of 10) for computing normal retirement benefits.

(B) *Social security, etc.* For purposes of this subparagraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(C) *Computation in certain cases.* In the case of any plan to which the provisions of section 411(b)(1)(D) and paragraph (c) of this section are applicable, for any plan year the accrued benefit of any participant shall not be less than the accrued benefit otherwise determined under this subparagraph, reduced by the excess of the accrued benefit determined under this subparagraph as of the first day of the first plan year to which section 411 applies over the accrued benefit determined under section 411(b)(1)(D) and paragraph (c) of this section and increased by the amount determined under paragraph (c)(2)(v) of this section.

(iii) *Examples.* The application of this subparagraph is illustrated by the following examples.

Example (1). The M Corporation's defined benefit benefit plan provides an annual retirement benefit commencing at age 65 or $4 per month for each year of participation. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The plan provides for no limit on the number of years of credited service. A, age 40, is a participant in the M Corporation's plan.

A has completed 12 years of participation in the plan of the M Corporation as of the close of the plan year. Under subdivision (i) of this subparagraph, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,920 [40×(12×$4)]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless A has accrued an annual benefit of at least $691 [0.03×($1,920×12)] as of the close of the plan year. Under the M Corporation plan, A is entitled to an accrued benefit of $576 [(12×12)×$4] as of the close of the plan year. Thus, with respect to A, the accrued benefit provided under the M Corporation plan does not satisfy the requirements of this subparagraph.

Example (2). Assume the same facts as in example (1) except that the M Corporation's plan provides that only the first 30 years of participation are taken into account. Under subdivision (i) of this subparagraph, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age under the plan (25) and served continuously until normal retirement age (65) is an annual benefit of $1.440 [30×$48]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless A has accrued an annual benefit of at least $518 [0.03×($1,440×12)] as of the close of the plan year. Under the M Corporation plan, A is entitled to an accrued benefit of $576 [(12×$48]. Thus, with respect to A, the accrued benefit provided under the M Corporation plan satisfies the requirements of this subparagraph.

Example (3). The N Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 50 percent of average compensation for the highest 3 consecutive years of compensation for an employee with 25 years of participation. A participant who separates from service before age 65 is entitled to 2 percent of average compensation for the highest 3 consecutive years of compensation for each year of participation not in excess of 25. The plan has no minimum age or service requirement for participation. The normal retirement age specified under the plan is age 65. On December 31, 1990, B, age 40, is a participant in the N Corporation's plan. B began employment with the N Corporation and became a participant in the N Corporation's plan on January 1, 1980. Under this subparagraph, the normal retirement benefit to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is 50 percent of average compensation for the highest 3 consecutive years of compensation per year commencing at age 65. Under this subparagraph, B must have accrued an annual benefit of at least 16.5 percent of his highest 3 consecutive years of compensation per year commencing at age 65 [0.03×50 percent of average compensation for the highest 3 consecutive years of compensation×11] as of the close of the plan year. Under the N Corporation plan, B has accrued an annual benefit of 22 percent of average compensation for his highest 3 consecutive years of compensation per year commencing at age 65. Thus, with respect to B, the accrued benefit under the N Corporation plan satisfies the requirements of this subparagraph.

Example (4). The P Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 50 percent of average compensation for the 3 consecutive years of compensation from the P Corporation next preceding normal retirement age. The plan has no minimum age or service requirement for participation. The normal retirement age under the plan is age 65. On December 31, 1990, C, age 55, separates from service with the P Corporation. C began employment with the P Corporation and became a participant in the P Corporation's plan on January 1, 1980. As of December 31, 1990. C's average compensation for the 3 consecutive years preceding his separation from service is $15,000. Under this subparagraph, the normal retirement benefit to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of 50 percent of average compensation for the 3 consecutive years of compensation from the P Corporation next preceding normal retirement age commencing at age 65. C must have accrued an annual benefit of at least $2,475 commencing at age 65 [0.03×(0.050×$15,000)×11] as of his separation from the service with the P Corporation in order for the P Corporation's plan to satisfy the requirements of this subparagraph with respect to C.

Example (5). On December 31, 1985, the R Corporation's defined benefit plan provided an annual retirement benefit commencing at age 65 of $100 for each year of participation, not to exceed 30. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The appropriate computation period is the calendar year. On January 1, 1986, the plan is amended to provide an annual retirement benefit commencing at age 65 of $200 for each year of participation (before and after the amendment), not to exceed 30. B, age 40, is a participant in the R Corporation's plan. B has completed 15 years of participation in the plan of the R Corporation as of December 31, 1990. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan an served continuously until normal retirement age (65) is an annual benefit of $6,000 [30×200]. Under subdivision (i) of this subparagraph, the plan does not satisfy the requirements of this subparagraph unless B has accrued an annual benefit of at least $2,700 [0.03×$6,000×15] as of December 31, 1990. Under the R Corporation plan, B is entitled to an accrued benefit of $3,000 [$200×15] as of December 31, 1990. Thus, with respect to B, the accrued benefit provided under the R Corporation plan satisfies the requirements of this subparagraph.

Example (6). On December 31, 1995, the J Corporation's defined benefit plan provided an annual retirement benefit commencing at age 65 of $4,800 after 30 years of participation. The normal retirement age specified under the plan is age 65. The appropriate computation period is the calendar year. On January 1, 1996, the plan is amended to provide an annual retirement benefit commencing at age 65 of $6,000. A, age 40, is a participant in the J Corporation's plan since its adoption on January 1, 1986. Under paragraph (b)(1)(i) of this section, on December 31, 1995, the normal retirement benefit commencing at age 5 to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of $4,800. Under paragraph (b)(1)(i) of this section, on January 1, 1996, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of $6,000. Under subdivision (i) of this subparagraph, the plan does not satisfy the requirements of this subparagraph unless A has an accrued benefit on December 31, 1995 of at least $1,440 [$4,800×0.02×10] and an accrued benefit on January 1, 1996 of at least $1,800 [$6,000×0.03×10].

Example (7). The X Company's defined benefit plan provides an annual retirement benefit commencing at age 65 of $4 per month for each year of participation (not to exceed 30). As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. D, age 68, is a participant in the X Company's plan. D has completed 20 years of participation in the X Company plan as of the close of the plan year. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit, commencing at age 65, of $1,440 [30×$48]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless D has accrued an annual benefit, commencing at age 65, of $864 [0.03×$1,440×20] as of the close of the plan year. Under the X Company plan, D has accrued an annual benefit, commencing at age 65, of $960 [20×$48]. Thus, with respect to D the accrued benefit provided under the X Company plan satisfies the requirements of this subparagraph.

Example (8). Assume the same facts as in example (7) except that for purposes of determining accrued benefits under the plan the X Company's plan disregards all years of participation after normal retirement age. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,440 [30×$48]. Under paragraph (b)(1)(i) of this section the plan does not satisfy the requirements of this subparagraph unless D has accrued an annual benefit, commencing at age 65, of $864 [0.03×$1,440×20] as of the close of the plan year. Under the X Company's plan D has accrued an annual benefit commencing at age 65, of $816 [17×$48]. Thus, with respect to D, the accrued benefit provided under the X Company plan does not satisfy the requirements of this subparagraph.

(2) *133⅓ percent rule*—(i) *General rule.* A defined benefit plan satisfies the requirements of this subparagraph for a particular plan year if—

(A) Under the plan the accrued benefit payable at the normal retirement age (determined under the plan) is equal to the normal retirement benefit (determined under the plan), and

(B) The annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year cannot be more than 133⅓ percent of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year and before such later plan year.

(ii) *Special rules.* For purposes of this subparagraph—

(A) *Plan amendments.* Any amendment to the plan which is in effect for the current plan year shall be treated as if it were in effect for all other plan years.

(B) *Change in accrual rate.* Any change in an accrual rate which change does not apply to any individual who is of could be a participant in the plan year is disregarded. Thus, for example, if for its plan year beginning January 1, 1980, a defined benefit plan provides an accrued benefit in plan year 1980 of 2 percent of a participant's average compensation for his highest 3 years of compensation for each year of service and provides that in plan year 1981 the accrued benefit will be 3 percent of such average compensation, the plan will not be treated as failing to satisfy the requirements of this subparagraph for plan year 1980 because in plan year 1980 the change in the accrual rate does not apply to any individual who is or could be a participant in plan year 1980. However, if, for example, a defined benefit plan provided for an accrued benefit of 1 percent of a participant's average compensation for his highest 3 years of compensation for each of the first 10 years of service and 1.5 percent of such average compensations for each year of service thereafter, the plan will be treated as failing to satisfy the requirements of this subparagraph for the plan year even though no participant is actually accruing at the 1.5 percent rate because an individual who could be a participant and who had over 10 years of service would accrue at the 1.5 percent rate, which rate exceeds 133⅓ percent of the 1 percent rate.

(C) *Early retirement benefits.* The fact that certain benefits under the plan may be payable to certain participants before normal retirement age is disregarded. Thus, the requirements of subdivision (i) of this subparagraph must be satisfied without regard to any benefit payable prior to the normal retirement benefit (such as an early retirement benefit which is not the normal retirement benefit (see §1.411(a)–7(c).

(D) *Social security, etc.* For purposes of this paragraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(E) *Postponed retirement.* A plan shall not be treated as failing to satisfy the requirements of this subparagraph for a plan year merely because no benefits under the plan accrue to a participant who continues service with the employer after such participant has attained normal retirement age.

(F) *Computation of benefit.* A plan shall not satisfy the requirements of this subparagraph if the base for the computation of retirement benefits changes solely by reason of an increase

in the number of years of participation. Thus, for example, a plan will not satisfy the requirements of this subparagraph if it provides a benefit, commencing at normal retirement age, of the sum of (*1*) 1 percent of average compensation for a participant's first 3 years of participation multiplied by his first 10 years of participation (or, if less than 10 his total years of participation) and (*2*) 1 percent of average compensation for a participant's 3 highest years of participation multiplied by each year of participation subsequent to the 10th year.

(iii) *Examples*. The application of this subparagraph is illustrated by the following examples:

Example (*1*). On January 1, 1980, the R Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of 5 consecutive years of participation for which his compensation is the highest. The percentage is 2 percent for each of the first 20 years of participation and 1 percent per year thereafter. The appropriate computation period is the calendar year. The R Corporation's plan satisfies the requirements of this subparagraph because the 133⅓ percent rule does not restrict subsequent accrual rate decreases.

Example (*2*). On January 1, 1980, the J Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of his final 5 consecutive years of participation. The percentage is 1 percent for each of the first 5 years of participation; 1⅓ percent for each of the next 5 years of participation; and 1⅞ percent for each year thereafter. The appropriate computation period is the calendar year. Even though no single accrual rate under the J Corporation's plan exceeds 133⅓ percent of the immediately preceding accrual rate, the J Corporation's plan does not satisfy the requirements of this subparagraph because the rate of accrual for all years of participation in excess of 10 (1⅞ percent) exceeds 133⅓ percent of the rate of accrual for any of the first 5 years of participation (1 percent).

Example (*3*). On January 1, 1980, the C Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of 3 consecutive years of participation for which his compensation is the highest. The percentage is 2 percent for each of the first 5 years of participation; 1 percent for each of the next 5 years of participation; and 1½ percent for each year thereafter. The appropriate computation period is the calendar year. Even though the average rate of accrual under the C Corporation's plan is not less rapidly than ratably, the C Corporation's plan does not satisfy the requirements of this subparagraph because the rate of accrual for all years of participation in excess of 10 (1½ percent) for any employee who is actually accruing benefits or who could accrue benefits exceeds 133⅓ percent of the rate of accrual for the sixth through tenth years of participation, respectively (1 percent).

(3) *Fractional rule*—(i) *In general*. A defined benefit plan satisfies the requirements of this paragraph if the accrued benefit to which any participant is entitled is not less than the fractional rule benefit multiplied by a fraction (not exceeding 1)—

(A) The numerator of which is his total number of years of participation in the plan, and

(B) The denominator of which is the total number of years he would have participated in the plan if he separated from the service at the normal retirement age under the plan.

(ii) *Special rules*. For purposes of this subparagraph—

(A) *Fractional rule benefit*. The ''fractional rule benefit'' is the annual benefit commencing at the normal retirement age under the plan to which a participant would be entitled if he continued to earn annually until such normal retirement age the same rate of compensation upon which his normal retirement benefit would be computed. Such rate of compensation shall be computed on the basis of compensation taken into account under the plan (but taking into account average compensation for no more than the 10 years of service immediately preceding the determination). For purposes of this subdivision (A), the normal retirement benefit shall be determined as if the participant had attained normal retirement age on the date any such determination is made.

(B) *Social security, etc*. For purposes of this subparagraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(C) *Postponed retirement*. A plan shall not be treated as failing to satisfy the requirements of this subparagraph

merely because no benefits under the plan accrue to a participant who continues service with the employer after such participant has attained normal retirement age under the plan.

(D) *Computation in certain cases.* In the case of any plan to which the provisions of section 411(b)(1)(D) and paragraph (c) of this section are applicable, for any plan year the accrued benefit of any participant shall not be less than the accrued benefit otherwise determined under this subparagraph, reduced by the excess of the accrued benefit determined under this subparagraph as of the first day of the first plan year to which section 411 applies over the accrued benefit determined under section 411(b)(1)(D) and paragraph (c) of this section and increased by the amount determined under paragraph (c)(2)(v) of this section.

(iii) *Examples.* The application of this subparagraph is illustrated by the following examples:

Example (1). The R Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 30 percent of a participant's average compensation for his highest 3 consecutive years of participation. If a participant separates from service prior to normal retirement age, the R Corporation's plan provides a benefit equal to an amount which bears the same ratio to 30 percent of such average compensation as the participant's actual number of years of participation in the plan bears to the number of years the participant would have participated in the plan had he separated from service at age 65. The plan further provides that normal retirement age is age 65. A, age 55, is a participant in the R Corporation's plan for the current year, and A has 15 years of participation in the R Corporation's plan. As of the current year, A's average compensation for his highest 3 years of compensation is $20,000. The R Corporation's plan satisfies the requirements of this subparagraph because if A separates from the service in the current year he will be entitled to an annual benefit of $3,600 commencing at age 65 [0.3×$20,000×15/25].

Example (2). The J Corporation's defined benefit plan provides a normal retirement benefit of 1 percent per year of a participant's average compensation from the employer. In the case of a participant who separates from service prior to normal retirement age (65), the plan provides that the annual benefit is an amount which is equal to 1 percent of such compensation multiplied by the number of years of plan participation actually completed by the participant. The plan year of the J Corporation's plan is the calendar year. B, age 55, is a participant in the J Corporation's plan for the current year. B became a participant in the J Corporation's plan on January 1, 1980. As of December 31, 1990, B's compensation history is as follows:

Year	Compensation
1980	$17,000
1981	18,000
1982	20,000
1983	20,000
1984	21,000
1985	22,000
1986	23,000
1987	25,000
1988	26,000
1989	29,000
1990	32,000

If B separates from service on December 31, 1990, he would be entitled to an annual benefit of $2,530 commencing at age 65. Because the J Corporation's plan does not limit the number of years of compensation to be taken into account in determining the normal retirement benefit, B's rate of compensation for purposes of determining his normal retirement benefit is $23,600 [$18,000 + $20,000 + $20,000 + $21,000 + $22,000 + $23,000 + $25,000 + $26,000 + $29,000 + $32,000]/10.

Under this subparagraph, B's accrued benefit under the J Corporation's plan as of December 31, 1990 must be not less than $2,561 per year commencing at age 65 [0.01 × ($17,000 + $18,000 + $20,000 + $20,000 + $21,000 + $22,000 + $23,000 + $25,000 + $26,000 + $29,000 + $32,000 + ($23,600 × 10)) × 11/21]. Thus, the J Corporation's plan would not satisfy the requirements of this subparagraph.

(c) *Accruals for service before effective date*—(1) *General rule.* For a plan year to which section 411 applies, a defined benefit plan does not satisfy the requirements of section 411(b)(1) and this section unless, under the plan, the accrued benefit of each participant for plan years beginning before section 411 applies is not less than the greater of—

(i) Such participant's accrued benefit (as of the day before section 411 applies) determined under the plan as in effect from time to time prior to September 2, 1974 (without regard to any amendment adopted after such date), or

(ii) One-half of the accrued benefit that would be determined with respect to the participant as of the day before section 411 applies if the participant's accrued benefit were computed for such prior plan years under a method which satisfies the requirements of section

411(b)(1) (A), (B), or (C) and paragraph (b) (1), (2), or (3) of this section. See 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans, for time participation deemed to begin.

(2) *Special rules*—(i) A plan shall not be deemed to fail to satisfy the requirements of section 411(b) and this section merely because the method for computing the accrued benefit of a participant for years of participation prior to the first plan year for which section 411 is effective with respect to the plan is not the same method for computing the accrued benefit of a participant for years of participation subsequent to such plan year.

(ii) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(A) and paragraph (b)(1) of this section shall be applied as if the participant separated from service with the employer on the day before the first day of the first plan year to which section 411 applies.

(iii) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(B) and paragraph (b)(2) of this section shall be applied in the following manner:

(A) Except as provided in (c)(2)(iii)(B) of this section, section 411(b)(1)(B) and paragraph (b)(2) of this section shall be applied as if the participant separated from service with the employer on the day before the first day of the first plan year to which section 411 applies.

(B) In the case that the plan does not satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section at any time prior to the day specified in (c)(2)(iii)(A) of this section, the plan shall be deemed revised to the extent necessary to satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section for all plan years beginning before the applicable effective date of section 411 and this section. For purposes of the preceding sentence, a plan shall not be deemed revised to the extent necessary to satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section for a plan year if the benefit a participant would receive if he were employed until normal retirement age is reduced by such revision or if the revised rate of accrual with respect to such accrued benefit does not otherwise satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section.

(iv) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(C) and paragraph (b)(3) of this section shall be applied as if the participant separated from service on the day before the first day of the first plan year to which section 411 applies.

(v) The excess of the accrued benefit payable at normal retirement age of any participant determined under section 411(b)(1) (A), (B), or (C) (without regard to section 411(b)(1)(D)), and paragraph (b)(1), (2), or (3) of this section (without regard to this paragraph) as of the day before the first day of the first plan year to which section 411 and this section applies over the accrued benefit determined under paragraph (c)(1) of this section shall be accrued in accordance with the provisions of the plan as in effect after the applicable effective date of section 411, as if the plan had been initially adopted on such effective date.

(d) *Special rules*—(1) *First 2 years of service*. Notwithstanding paragraphs (1), (2), and (3) of paragraph (b) of this section, under section 411(b)(1)(E) and this subparagraph, a plan shall not be treated as failing to satisfy the requirements of paragraph (b) of this section solely because the accrual of benefits under the plan does not become effective until the employee has completed 2 continuous years of service. For purposes of this subparagraph, continuous years of service are years of service (within the meaning of section 410(a)(3)((A)) which are not separated by a break in service (within the meaning of section 410(a)(5)). For years of service beginning after such 2 years of service, the accrued benefit of an employee shall not be less than that to which the employee would be entitled if section 411(b)(1)(E) and this subparagraph did not apply. Thus, for example, a plan which otherwise satisfies the requirements of paragraph (b)(2) of this section provides for a rate of accrual of 1 percent of average compensation for the highest 3 years of compensation beginning with the third year of service of a participant shall not be treated as

satisfying paragraph (b)(2) of this section because as of the time the employee completes 3 continuous years of service there is no accrual during the first 2 years of service. In addition, a plan which otherwise satisfies the requirements of paragraph (b)(1) of this section and which requires that an employee must attain age 25 and complete 1 year of service prior to becoming a participant will not satisfy the requirements of paragraph (b)(1) of this section if an employee who completes 2 years of service prior to attaining age 25 does not begin accruals immediately upon commencement of participation in the plan. For rules relating to years of service, see 29 CFR part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans.

(2) *Certain insured defined benefit plans.* Notwithstanding paragraphs (b) (1), (2), and (3) of this section, a defined benefit plan satisfies the requirements of paragraph (b) of this section if such plan is funded exclusively by the purchase of contracts from a life insurance company and such contracts satisfy the requirements of sections 412(i) (2) and (3) and the regulations thereunder. The preceding sentence is applicable only if an employee's accrued benefit as of any applicable date is not less than the cash surrender value such employee's insurance contracts would have on such applicable date if the requirements of section 412(i) (4), (5), and (6) and the regulations thereunder were satisfied.

(3) *Accrued benefit may not decrease on account of increasing age or service.* Notwithstanding paragraphs (b) (1), (2), and (3) of this section and paragraphs (d) (1) and (2) of this section, a defined benefit plan shall be treated as not satisfying the requirements of paragraphs (b) and (d) of this section if the participant's accrued benefit is reduced on account of any increase in his age or years of service. The preceding sentence shall not apply to social security supplements described in §1.411(a)–7(c)(4).

(e) *Separate accounting.* A plan satisfies the requirements of this paragraph if the requirements of paragraph (e) (1) or (2) of this paragraph are met.

(1) *Defined benefit plan.* In the case of a defined benefit plan, the requirements of this paragraph are satisfied if the plan requires separate accounting for the portion of each employee's accrued benefit derived from any voluntary employee contributions permitted under the plan. For purposes of this subparagraph the term ''voluntary employee contributions'' means all employee contributions which are not mandatory contributions within the meaning of section 411(c)(2)(C) and the regulations thereunder. See §1.411(c)–1(b)(1) for rules requiring the determination of such an accrued benefit by the use of a separate account.

(2) *Defined contribution plan.* In the case of a defined contribution plan, the requirements of this paragraph are not satisfied unless the plan requires separate accounting for each employee's accrued benefit. If a plan utilizes the break in service rule of section 411(a)(6)(C), an employee could have different percentages of vesting between pre-break and post-break accrued benefits. In such a case, the requirements of this paragraph are not satisfied unless the plan computes accrued benefits in a manner which takes into account different percentages. A plan which provides separate accounts for pre-break and post-break accrued benefits will be deemed to compute benefits in a reasonable manner.

(f) *Year of participation*—(1) *In general.* This paragraph is inapplicable to a defined contribution plan. For purposes of determining an employee's accrued benefit, a ''year of participation'' is a period of service determined under regulations prescribed by the Secretary of Labor in 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(2) *Additional rule relating to year of participation.* A trust shall not constitute a qualified trust if the plan of which such trust is a part provides for the crediting of a year of participation, or part thereof, and such credit results in the discrimination prohibited by section 401(a)(4).

(g) *Additional illustrations.* The application of this section may be illustrated by the following example:

Example. (i) The S Corporation established a defined benefit plan on January 1, 1980. The

plan provides a minimum age for participation of age 25. The normal retirement age under the plan is age 65. The appropriate computation periods are the calendar year. The plan provides an annual benefit, commencing at age 65, equal to $96 per year of service for the first 25 years of service, and $48 per year of service for each additional year of service.

(ii) The plan of the S Corporation does not satisfy the requirements of section 411(b)(1)(A) and paragraph (b)(1) of this section because the accrued benefit under the plan at some point will be less than the accrued benefit required under section 411(b)(1)(A) and paragraph (b)(1) of this section (i.e., 3 percent × normal retirement benefit × years of participation).

(iii) The plan of the S Corporation does satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section because the rate of benefit accrual is equal in each of the first 25 years of service and the rate decreases thereafter.

(iv) The plan of the S Corporation does satisfy the requirements of section 411(b)(1)(C) and paragraph (b)(3) of this section because the accrued benefit under the plan will equal or exceed the normal retirement benefit multiplied by the fraction described in paragraph (b)(3)(i) of this section.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42334, Aug. 23, 1977]

§ 1.411(c)–1 Allocation of accrued benefits between employer and employee contributions.

(a) *Accrued benefit derived from employer contributions.* For purposes of section 411 and the regulations thereunder, under section 411(c)(1), an employee's accrued benefit derived from employer contributions under a plan as of any applicable date is the excess, if any, of—

(1) The total accrued benefit under the plan provided for the employee as of such date, over

(2) The accrued benefit provided for the employee, derived from contributions made by the employee under the plan as of such date.

For computation of accrued benefit derived from employee contributions to a defined contribution plan or from voluntary employee contributions to a defined benefit plan, see paragraph (b) of this section. For computation of accrued benefit derived from mandatory employee contributions to a defined benefit plan, see paragraph (c) of this section.

(b) *Accrued benefit derived from employee contribution to defined contribution plan, etc.* For purposes of section 411 and the regulations thereunder, under section 411(c)(2)(A) the accrued benefit derived from employee contributions to a defined contribution plan is determined under paragraph (b)(1) or (2) of this section, whichever applies. Under section 411(d)(5), the accrued benefit derived from voluntary employee contributions to a defined benefit plan is determined under paragraph (b)(1) of this section.

(1) *Separate accounts maintained.* If a separate account is maintained with respect to an employee's contributions and all income, expenses, gains, and losses attributable thereto, the accrued benefit determined under this subparagraph as of any applicable date is the balance of such account as of such date.

(2) *Separate accounts not maintained.* If a separate account is not maintained with respect to an employee's contributions and the income, expenses, gains, and losses attributable thereto, the accrued benefit determined under this subparagraph is the employee's total accrued benefit determined under the plan multiplied by a fraction—

(i) The numerator of which is the total amount of the employee's contributions under the plan less withdrawals, and

(ii) The denominator of which is the sum of (A) the amount described in paragraph (b)(2)(i) of this section, and (B) the total contributions made under the plan by the employer on behalf of the employee less withdrawals.

For purposes of this subparagraph, contributions include all amounts which are contributed to the plan even if such amounts are used to provide ancillary benefits, such as incidental life insurance, health insurance, or death benefits, and withdrawals include only amounts distributed to the employee and do not reflect the cost of any death benefits under the plan.

(c) *Accrued benefit derived from mandatory employee contributions to a defined benefit plan*—(1) *General rule.* In the case of a defined benefit plan (as defined in section 414(j)) the accrued benefit derived from contributions made by an employee under the plan as of

any applicable date is an annual benefit, in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, equal to the amount of the employee's accumulated contributions (determined under paragraph (c)(3) of this section) multiplied by the appropriate conversion factor (determined under paragraph (c)(2) of this section). Paragraph (e) of this section provides rules for actuarial adjustments where the benefit is to be determined in a form other than the form described in this paragraph.

(2) *Appropriate conversion factor*. For purposes of this paragraph, the term ''appropriate conversion factor'' means the factor necessary to convert an amount equal to the accumulated contributions to a single life annuity (without ancillary benefits) commencing at normal retirement age and shall be 10 percent for a normal retirement age of 65 years. For other normal retirement ages the appropriate conversion factor shall be the factor as determined by the Commissioner.

(3) *Accumulated contributions*. For purposes of section 411(c) and this section, the term ''accumulated contributions'' means the total of—

(i) All mandatory contributions made by the employee (determined under paragraph (c)(4) of this section),

(ii) Interest (if any) on such contributions, computed at the rate provided by the plan to the end of the last plan year to which section 411(a)(2) does not apply (by reason of the applicable effective date), and

(iii) Interest on the sum of the amounts determined under paragraphs (c)(3)(i) and (ii) of this section compounded annually at the rate of 5 percent per annum from the beginning of the first plan year to which section 411(a)(2) applies (by reason of the applicable effective date) to the date on which the employee would attain normal retirement age.

For example, if under section 1017 of the Employee Retirement Income Security Act of 1974, section 411(a)(2) of the Code applies for plan years beginning after December 31, 1975, and for plan years beginning before 1975, the plan provided for 3 percent interest on employee contributions, an employee's accumulated contributions would be computed by crediting interest at the rate provided by the plan (3 percent) for plan years beginning before 1976 and by crediting interest at the rate of 5 percent (or another rate prescribed under section 411(c)(2)(D)) thereafter. Section 1017 of the Employee Retirement Income Security Act of 1974 and § 1.411(a)–2 provide the effective dates for the application of section 411(a)(2).

(4) *Mandatory contributions*. For purposes of section 411(c) and this section the term ''mandatory contributions'' means amounts contributed to the plan by the employee which are required as a condition of his employment, as a condition of his participation in the plan, or as a condition of obtaining benefits (or additional benefits) under the plan attributable to employer contributions. For example, if the benefit derived from employer contributions depends upon a specified level of employee contributions, employee contributions up to that level would be treated as mandatory contributions. Mandatory contributions, otherwise satisfying the requirements of this subparagraph, include amounts contributed to the plan which are used to provide ancillary benefits such as incidental life insurance, health insurance, or death benefits.

(d) *Limitation on accrued benefit*. The accrued benefit derived from mandatory employee contributions under a defined benefit plan (determined under paragraph (c) of this section) shall not exceed the greater of—

(1) The accrued benefit of the employee under the plan, or

(2) The accrued benefit derived from employee contributions determined without regard to any interest under section 411(c)(2)(C) (ii) and (iii) and under paragraphs (c)(3) (ii) and (iii) of this section.

(e) *Actuarial adjustments for defined benefit plans*—(1) *Accrued benefit*. In the case of a defined benefit plan (as defined in section 414(j)) if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age, such benefit (determined under section 411(c)(1) and paragraph (a) of this section) shall be the actuarial

equivalent of such benefit, as determined by the Commissioner.

(2) *Accrued benefit derived from employee contributions.* In the case of a defined benefit plan (as defined in section 414(j) if the accrued benefit derived from mandatory contributions made by an employee is to be determined with respect to a benefit other than an annual benefit in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, such benefit shall be the actuarial equivalent of such benefit (determined under section 411(c)(2)(B) and paragraph (c) of this section) as determined by the Commissioner.

(f) *Suspension of benefits, etc.*—(1) *Suspensions.* No adjustment to an accrued benefit is required on account of any suspension of benefits if such suspension is permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 855) (Code section 411(a)(3)(B)).

(2) *Employment after retirement.* No actuarial adjustment to an accrued benefit is required on account of employment after normal retirement age. For example, if a plan with a normal retirement age of 65 provides a benefit of $400 a month payable at age 65 the same $400 benefit (with no upward adjustment) could be paid to an employee who retires at age 68.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42338, Aug. 23, 1977]

§ 1.411(d)–1 Coordination of vesting and discrimination requirements. [Reserved]

§ 1.411(d)–2 Termination or partial termination; discontinuance of contributions.

(a) *General rule*—(1) *Required nonforfeitability.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan provides that—

(i) Upon the termination or partial termination of the plan, or

(ii) In addition, in the case of a plan to which section 412 (relating to minimum funding standards) does not apply, upon the complete discontinuance of contributions under the plan,

the rights of each affected employee to benefits accrued to the date of such termination or partial termination (or, in the case of a plan to which section 412 does not apply, discontinuance), to the extent funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable (within the meaning of § 1.411(a)–4.

(2) *Required allocation.* (i) A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan provides for the allocation of any previously unallocated funds to the employes covered by the plan upon the termination or partial termination of the plan (or, in the case of a plan to which section 412 does not apply, upon the complete discontinuance of contributions under the plan). Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination or partial termination of the plan for the discontinuance of contributions thereunder. In the case of a defined contribution plan under which unallocated forfeitures are held in a suspense account in order to satisfy the requirements of section 415, this subdivision shall not require such plan to provide for allocations from the suspense account to the extent that such allocations would result in annual additions to participants' accounts in excess of amounts permitted under section 415 for the year for which such allocations would be made.

(ii) Any provision for the allocation of unallocated funds which is found by the Secretary of Labor or the Pension Benefit Guaranty Corporation (whichever is appropriate) to satisfy the requirements of section 4044 or section 403(d)(1) of the Employee Retirement Income Security Act of 1974 is acceptable if it specifies the method to be used and does not conflict with the provisions of section 401(a)(4) of the Internal Revenue Code of 1954 and the regulations thereunder. Any allocation of funds required by paragraph (1), (2), (3), or (4)(A) of section 4044(a) of such Act shall be deemed not to result in discrimination prohibited by section 401(a)(4) of the Code (see, however, paragraph (e) of this section). Notwithstanding the preceding sentence, in the

case of a plan which establishes subclasses or categories pursuant to section 4044(b)(6) of such Act, the allocation of funds by the use of such subclasses or categories shall not be deemed not to result in discrimination prohibited by the Code. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees covered by the plan.

(iii) Paragraphs (a)(2) (i) and (ii) of this section do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) *Partial termination*—(1) *General rule*. Whether or not a partial termination of a qualified plan occurs (and the time of such event) shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Such facts and circumstances include: the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan; and plan amendments which adversely affect the rights of employees to vest in benefits under the plan.

(2) *Special rule*. If a defined benefit plan ceases or decreases future benefit accruals under the plan, a partial termination shall be deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer, or employers, maintaining the plan (determined as of the date such cessation or decrease is adopted) is created or increased. If no such reversion is created or increased, a partial termination shall be deemed not to occur by reason of such cessation or decrease. However, the Commissioner may determine that a partial termination of such a plan occurs pursuant to subparagraph (1) of this paragraph for reasons other than such cessation or decrease.

(3) *Effect of partial termination*. If a termination of a qualified plan occurs, the provisions of section 411(d)(3) apply only to the part of the plan that is terminated.

(c) *Termination*—(1) *Application*. This paragraph applies to a plan other than a plan described in section 411(e)(1) (relating to governmental, certain church plans, etc.).

(2) *Plans subject to termination insurance*. For purposes of this section, a plan to which title IV of the Employee Retirement Income Security Act of 1974 applies is considered terminated on a particular date if, as of that date—

(i) The plan is voluntarily terminated by the plan administrator under section 4041 of the Employee Retirement Income Security Act of 1974, or

(ii) The Pension Benefit Guaranty Corporation terminates the plan under section 4042 of the Employee Retirement Income Security Act of 1974.

For purposes of this subparagraph, the particular date of termination shall be the date of termination determined under section 4048 of such Act.

(3) *Other plans*. In the case of a plan not described in paragraph (c)(2) of this section, a plan is considered terminated on a particular date if, as of that date, the plan is voluntarily terminated by the employer, or employers, maintaining the plan.

(d) *Complete discontinuance*—(1) *General rule*. For purposes of this section, a complete discontiuance of contributions under the plan is contrasted with a suspension of contributions under the plan which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees. Among the factors to be considered in determining whether a suspension constitutes a discontinuance are:

(i) Whether the employer may merely be calling an actual discontinuance of contributions a suspension of such contributions in order to avoid the requirement of full vesting as in the case of a discontinuance, or for any other reason;

(ii) Whether contributions are recurring and substantial; and

(iii) Whether there is any reasonable probability that the lack of contributions will continue indefinitely.

(2) *Time of discontinuance.* In any case in which a suspension of a profit-sharing plan maintained by a single employer is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan. In the case of a profit-sharing plan maintained by more than one employer, the discontinuance becomes effective not later than the last day of the plan year following the plan year within which any employer made a substantial contribution under the plan.

(e) *Contributions or benefits which remain forfeitable.* Under section 411 (d) (2) and (3), section 411(a) and this section do not apply to plan benefits which may not be provided for designated employees in the event of early termination of the plan under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by section 401(a)(4). Accordingly, in such a case, plan benefits may be required to be reallocated without regard to this section. See § 1.401–4(c).

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42339, Aug. 23, 1977]

§ 1.411(d)–3 Other special rules.

(a) *Class year plans*—(1) *General rule.* Under section 411(d)(4), the requirements of section 411(a)(2) for a class year plan shall be deemed to be satisfied if such plan provides that each employee's rights to or derived from employer contributions on his behalf for any plan year are nonforfeitable no later than the end of the 5th plan year following the plan year for which such contributions were made. For purposes of section 411 and the regulations thereunder, the term ''class year plan'' means a profit-sharing, stock bonus, or money purchase plan which provides that the nonforfeitable rights of employees to or derived from employer contributions are determined separately for each plan year. ''See § 1.411(d)–5 for rules that apply to class year plans for contributions made for plan years beginning after October 22, 1986.''

(2) *Other rules*—(i) *Prohibited forfeiture on withdrawals.* In the case of a class year plan, section 401(a)(19) and the regulations thereunder shall be applied separately to each plan year.

(ii) *Distribution rules.* The rules of § 1.411(a)–7(d) apply to a class year plan. For example, under the rule in § 1.411(a)–7(d)(2)(ii)(D), a class year plan would be permitted to limit the time of repayment to a 5-year period beginning on the date of withdrawal, or under the rule in § 1.411(a)–7(d)(2)(iii), a class year plan would restore the amount of the forfeited account balance in the event of repayment. For purposes of applying subparagraphs (2) and (3) of § 1.411(a)–7(d), relating to withdrawal of mandatory contributions, a withdrawal of employee contributions shall be treated as a withdrawal of such contributions on a plan year by plan year basis in succeeding order of time. Any repayments shall be treated as being on account of plan years in succeeding order of time. For purposes of applying any rule of such paragraph (e.g., paragraph (d)(2)(ii)(C)) the term ''one-year break in service'' means any plan year in which under subparagraph (1) of this paragraph a class year plan may forfeit an employee's rights.

(iii) *Computation of years for withdrawals.* In applying the requirement of paragraph (a)(1) of this section that rights must be nonforfeitable no later than the end of the fifth plan year following the plan year for which contributions are made, any plan year for which there has been a withdrawal of contributions and no repayment of such contributions (determined as of the last day of the plan year) is not required to count toward the five years. For example, assume that contributions are made for A in 1981 to a calendar year plan. Under the general rule

of paragraph (a)(1) of this section, the contributions must be nonforfeitable on December 31, 1986. If in 1982, A withdraws the contributions for 1981, and repays these contributions in 1984, 1982 and 1983 are not required to be counted toward the five years because at the end of each year there is a withdrawal and no repayment of such withdrawal. Accordingly, the plan must provide that A's interest in the contribution for 1981 will be vested on December 31, 1988.

(b) *Prohibition against accrued benefit decrease*. Under section 411(d)(6) a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if a plan amendment decreases the accrued benefit of any plan participant, unless the plan amendment satisfies the requirements of section 412(c)(8) (relating to certain retroactive amendments) and the regulations thereunder. For purposes of determining whether or not any participant's accrued benefit is decreased, all the provisions of a plan affecting directly or indirectly the computation of accrued benefits which are amended with the same adoption and effective dates shall be treated as one plan amendment. Plan provisions indirectly affecting accrued benefits include, for example, provisions relating to years of service and breaks in service for determining benefit accrual, and to actuarial factors for determining optional or early retirement benefits.

(c) *Rules applicable to section 414(k) plan*. For special rules applicable to defined benefit plans which provide a benefit derived from employer contributions which is based partly on a participant's separate account, see section 414(k) and the regulations thereunder.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by T.D. 8038, 50 FR 29375, July 19, 1985; T.D. 8219, 53 FR 31854, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.411(d)–4 Section 411(d)(6) protected benefits.

Q–1: What are ''section 411(d)(6) protected benefits''?

A–1: (a) *In general*. The term ''section 411(d)(6) protected benefit'' includes any benefit that is described in one or more of the following categories—

(1) Benefits described in section 411(d)(6)(A),

(2) Early retirement benefits and retirement-type subsidies described in section 411(d)(6)(B)(i), including qualified social security supplements as defined in § 1.401(a)(4)–12, and

(3) Optional forms of benefit described in section 411(d)(6)(B)(ii).

Such benefits, to the extent they have accrued, are subject to the protection of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a) (including section 401(a)(25)) and cannot, therefore, be reduced, eliminated, or made subject to employer discretion except to the extent permitted by regulations.

(b) *Optional forms of benefit*—(1) *In general*. An ''optional form of benefit'' is a distribution form with respect to an employee's benefit (described in paragraph (a)(1) and/or (a)(2) of this Q&A–1) that is available under the plan and is identical with respect to all features relating to the distribution form, including the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in-kind), the portion of the benefit to which such distribution features apply and the election rights with respect to such optional forms. To the extent there are any differences in such features, the plan provides separate optional forms of benefit. Differences in amounts of benefits, methods of calculation, or values of distribution forms do not result in optional forms of benefit for purposes of this rule. However, such amounts, methods of calculation, or values may be protected benefits within section 411(d)(6)(A) and/or section 411(d)(6)(B)(i). See § 1.401(a)–4 for further discussion and examples relating to optional forms of benefits. See § 1.401(a)(4)–4(e)(1) for the definition of an optional form of benefit for plan years beginning on or after January 1, 1994 (or January 1, 1996, in the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans)).

(2) *Examples*. The following examples illustrate the meaning of the term

''optional form of benefit.'' Other issues, such as the requirement that the optional forms satisfy section 401(a)(4), are not addressed in these examples and no inferences are intended with respect to such requirements. Assume that the distribution forms, including those not described in these examples, provided under the plan in each of the following examples are identical in all respects not described.

Example 1. A plan permits each participant to receive his benefit under the plan as a single sum distribution; a level monthly distribution schedule over 15 years; a single life annuity; a joint and 50 percent survivor annuity; a joint and 75 percent survivor annuity; a joint and 50 percent survivor annuity with a benefit increase for the participant if the beneficiary dies before a specified date; and joint and 50 percent survivor annuity with a 10 year certain feature. Each of these benefit distribution options is an optional form of benefit (without regard to whether the values of these options are actuarially equivalent).

Example 2. A plan permits each participant to receive his benefit under the plan as a single life annuity commencing at termination from employment; a joint and 50 percent survivor annuity commencing at termination from employment; a single sum distribution that is actuarially equivalent to the single life annuity determined by using a specified interest rate (X percent) for the employees of division A; and a single sum distributions that is actuarially equivalent to the single life annuity determined by using an interst rate that is 80 percent of X percent for employees of Division B. This plan provides three optional forms of benefit. While the interest rates used to determine the single sum distributions available to the employees of Divisions A and the employees of Division B respectively differ, this difference does not result in two single sum optional forms of benefit.

Example 3. A plan permits each participant who is employed by division A to receive his benefit in a single sum distribution payable upon termination from employment and each participant who is employed by division B in a single sum distribution payable upon termination from employment on or after the attainment of age 50. This plan provides two single sum optional forms of benefit.

Example 4. A plan permits each participant to receive his benefit in a single life annuity that commences in the month after the participant's termination from employment or in a single life annuity that commences upon the completion of five consecutive one year breaks in service. These are two optional forms of benefit.

Example 5. A profit-sharing plan permits each participant who is employed by division A to receive an in-service distribution upon the satisfaction of objective criteria set forth in the plan designed to determine whether the participant has a heavy and immediate financial need, and each participant who is employed by division B to receive an in-service distribution upon the satisfaction of objective criteria set forth in the plan designed to determine whether the participant has a heavy and immediate financial need attributable to extraordinary medical expenses. These in-service distribution options are two optional forms of benefits.

Example 6. A profit-sharing plan permits each participant who is employed by division A to receive an in-service distribution up to $5,000 and each participant who is employed by division B to receive an in-service distribution of up to his total benefit. These in-service distribution options differ as to the portion of the accrued benefit that may be distributed in a particular form and are, therefore, two optional forms of benefit.

Example 7. A profit-sharing plan provides for a single sum distribution on termination of employment. The plan is amended in 1991 to eliminate the single sum optional form of benefit with respect to benefits accrued after the date of amendment. This single sum optional form of benefit continues to be a single optional form of benefit although, over time, the percentage of various employees' accrued benefits that are potentially payable under this single sum may vary because the form is only available with respect to benefits accrued up to and including the date of the amendment.

Example 8. A profit-sharing plan permits each participant to receive a single sum distribution of his benefit in cash or in the form of a specified class of employer stock. This plan provides two single sum distribution optinal forms of benefit.

Example 9. A stock bonus plan permits each participant to receive a single sum distribution of his benefit in cash or in the form of the property in which such participant's benefit was invested prior to the distribution. This plan's single sum distribution option provides two optional forms of benefit.

Example 10. A defined benefit plan provides for an early retirement benefit payable upon termination of employment after attainment of age 55 and either after ten years of service or, if earlier, upon plan termination to employees of Division A and provides for an identical early retirement benefit payable on the same terms with the exception of payment on plan termination to employees of Division B. The plan provides for two optional forms of benefit.

Example 11. A profit-sharing plan provides for loans secured by an employee's account balance. In the event of default on such a loan, there is an execution on such account

balances. Such execution is a distribution of the employee's accrued benefits under the plan. A distribution of an accrued benefit contingent on default under a plan loan secured by such accrued benefits is an optional form of benefit under the plan.

(c) *Plan terms*—(1) *General rule*. Generally, benefits described in section 411(d)(6)(A), early retirement benefits, retirement-type subsidies, and optional forms of benefit are section 411(d)(6) protected benefits only if they are provided under the terms of a plan. However, if an employer establishes a pattern of repeated plan amendments providing for similar benefits in similar situations for substantially consecutive, limited periods of time, such benefits will be treated as provided under the terms of the plan, without regard to the limited periods of time, to the extent necessary to carry out the purposes of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a), including section 401(a)(25). A pattern of repeated plan amendments providing that a particular optional form of benefit is available to certain named employees for a limited period of time is within the scope of this rule and may result in such optional form of benefit being treated as provided under the terms of the plan to all employees covered under the plan without regard to the limited period of time and the limited group of named employees.

(2) *Effective date*. The provisions of paragraph (c)(1)of this Q&A-1 are effective as of July 11, 1988. Thus, patterns or repeated plan amendments adopted and effective before July 11, 1988 will be disregarded in determining whether such amendments have created an ongoing optional form of benefit under the plan.

(d) *Benefits that are not section 411(d)(6) protected benefits*. The following benefits are examples of items that are not section 411(d)(6) protected benefits:

(1) Ancillary life insurance protection;

(2) Accident or health insurance benefits;

(3) Social security supplements described in section 411(a)(9), except qualified social security supplements as defined in § 1.401(a)(4)–12;

(4) The availability of loans (other than the distribution of an employee's accrued benefit upon default under a loan);

(5) The right to make after-tax employee contributions or elective deferrals described in section 402(g)(3);

(6) The right to direct investments;

(7) The right to a particular form of investment (e.g., investment in employer stock or securities or investment in certain types of securities, commercial paper, or other investment media);

(8) The allocation dates for contributions, forfeitures, and earnings, the time for making contributions (but not the conditions for receiving an allocation of contributions or forfeitures for a plan year after such conditions have been satisfied), and the valuation dates for account balances;

(9) Administrative procedures for distributing benefits, such as provisions relating to the particular dates on which notices are given and by which elections must be made; and

(10) Rights that derive from administrative and operational provisions, such as mechanical procedures for allocating investment experience among accounts in defined contribution plans.

Q–2: To what extent may section 411(d)(6) protected benefits under a plan be reduced or eliminated?

A–2: (a) *Reduction or elimination of section 411(d)(6) protected benefits*—(1) *In general*. A plan may not be amended to eliminate or reduce a section 411(d)(6) protected benefit that has already accrued, except as provided in sections 412(c)(8) and 4281, and in this section. This is generally the case even if such elimination or reduction is contingent upon the employee's consent. However, a plan may be amended to eliminate or reduce section 411(d)(6) protected benefits with respect to benefits not yet accrued as of the later of the amendment's adoption date or effective date without violating section 411(d)(6).

(2) *Selection of optional forms of benefit*—(i) *General rule*. A plan may treat a participant as receiving his entire nonforfeitable accrued benefit under the plan if the participant receives his benefit in an optional form of benefit in an amount determined under the plan that is at least the actuarial

equivalent of the employee's nonforfeitable accrued benefit payable at normal retirement age under the plan. This is true even though the participant could have elected to receive an optional form of benefit with a greater actuarial value than the value of the optional form received, such as an optional form including retirement-type subsidies, and without regard to whether such other, more valuable optional form could have commenced immediately or could have become available only upon the employee's future satisfaction of specified eligibility conditions.

(ii) *Election of an optional form.* Except as provided in paragraph (a)(2)(iii) of this Q&A–2, a plan does not violate section 411(d)(6) merely because an employee's election to receive a portion of his nonforfeitable accrued benefit in one optional form of benefit precludes the employee from receiving that portion of his benefit in another optional form of benefit. Such employee retains all 411(d)(6) protected rights with respect to the entire portion of such employee's nonforfeitable accrued benefit for which no distribution election was made. For purposes of this rule, an elective transfer of an otherwise distributable benefit is treated as the selection of an optional form of benefit. See Q&A–3 of this section.

(iii) *Buy-back rule.* Notwithstanding paragraph (a)(2)(ii) of this Q&A–2, an employee who received a distribution of his nonforfeitable benefit from a plan that is required to provide a repayment opportunity to such employee if he returns to service within the applicable period pursuant to the requirements of section 411(a)(7) and who, upon subsequent reemployment, repays the full amount of such distribution in accordance with section 411(a)(7)(C) must be reinstated in the full array of section 411(d)(6) protected benefits that existed with respect to such benefit prior to distribution.

(iv) *Examples.* The rules in this paragraph (a)(2) can be illustrated by the following examples:

Example 1. Defined benefit plan X provides, among its optional forms of benefit, for a subsidized early retirement benefit payable in the form of an annuity and available to employees who terminate from employment on or after their 55th birthdays. In addition plan X provides for a single sum distribution available on termination from employment or termination of the plan. The single sum distribution is determined on the basis of the present value of the accrued normal retirement benefit and does not take the early retirement subsidy into account. Plan X is terminated December 31, 1991. Employees U, age 47, V, age 55, and W, age 47, all continue in the service of the employer. Employees X, age 47, Y, age 55 and Z, age 47, terminate from employment with the employer during 1991. Employees U and V elect to take the single sum optional form of distribution at the time of plan termination. Employees X and Y elect to take the single sum distribution on termination from employment with the employer. The elimination of the subsidized early retirement benefit with respect to employees U, V, X and Y does not result in a violation of section 411(d)(6). This is the result even though employees U and X had not yet satisfied the conditions for the subsidized early retirement benefit. Because employees W and Z have not selected an optional form of benefit, they continue to have a 411(d)(6) protected right to the full array of section 411(d)(6) protected benefits provided under the plan, including the single sum distribution form and the subsidized early retirement benefit.

Example 2. A partially vested employee receives a single sum distribution of the present value of his entire nonforfeitable benefit on account of separation from service under a defined benefit plan providing for a repayment provision. Upon reemployment with the employer such employee makes repayment in the required amount in accordance with section 411(a)(7). Such employee may, upon subsequent termination of employment, elect to take such repaid benefits in any optional form provided under the plan as of the time of the employee's initial separation from service. If the plan was amended prior to such repayment, to eliminate the single sum optional form of benefit with respect to benefits accrued after the date of the amendment, such participant has a 411(d)(6) protected right to take distribution of the repaid benefit in the form of a single sum distribution.

(3) *Certain transactions*—(i) *Plan mergers and benefit transfers.* The prohibition against the reduction or elimination of section 411(d)(6) protected benefits already accrued applies to plan mergers, spinoffs, transfers, and transactions amending or having the effect of amending a plan or plans to transfer plan benefits. Thus, for example, if plan A, a profit-sharing plan that provides for distribution of plan benefits in annual installments over ten or

twenty years, is merged with plan B, a profit-sharing plan that provides for distribution of plan benefits in annual installments over life expectancy at time of retirement, the merged plan must retain the ten or twenty year installment option for participants with respect to benefits already accrued under plan A as of the merger and the installments over life expectancy for participants with benefits already accrued under plan B. Similarly, for example, if an employee's benefit under a defined contribution plan is transferred to another defined contribution plan (whether or not of the same employer), the optional forms of benefit available with respect to the employee's benefit accrued under the transferor plan may not be eliminated or reduced except as otherwise permitted under this regulation. See Q&A–3 of this section with respect to the transfer of benefits between and among defined benefit and defined contribution plans.

(ii) *Annuity contracts*—(A) *General rule*. The right of a participant to receive a benefit in the form of cash payments from the plan and the right of a participant to receive that benefit in the form of the distribution of an annuity contract that provides for cash payments that are identical in all respects to the cash payments from the plan except with respect to the source of the payments are not separate optional forms of benefit. Therefore, for example, if a plan includes an optional form of benefit under which benefits are distributed in the medium of an annuity contract that provides for cash payments, that optional form of benefit may be modified by a plan amendment that substitutes cash payments from the plan for the annuity contract, where those cash payments from the plan are identical to the cash payments payable from the annuity contract in all respects except with respect to the source of the payments. The protection provided by section 411(d)(6) may not be avoided by the use of annuity contracts. Thus, section 411(d)(6) protected benefits already accrued may not be eliminated or reduced merely because a plan uses annuity contracts to provide such benefits, without regard to whether the plan, a participant, or a beneficiary of a participant holds the contract or whether such annuity contracts are purchased as a result of the termination of the plan. However, to the extent that an annuity contract constitutes payment of benefits in a particular optional form elected by the participant, the plan does not violate section 411(d)(6) merely because it provides that other optional forms are no longer available with respect to such participant. See paragraph (a)(2) of this Q&A–2.

(B) *Examples*. The provisions of this paragraph (a)(3)(ii) can be illustrated by the following examples:

Example 1. A profit-sharing plan that is being terminated satisfies section 411(d)(6) only if the plan makes available to participants annuity contracts that provide for all section 411(d)(6) protected benefits under the plan that may not otherwise be reduced or eliminated pursuant to this Q&A–2. Thus, if such a plan provided for a single sum distribution upon attainment of early retirement age, and a provision for payment in the form of 10 equal annual installments, the plan would satisfy section 411(d)(6) only if the participants had the opportunity to elect to have their benefits provided under an annuity contract that provided for the same single sum distribution upon the attainment of the participant's early retirement age and the same 10 year installment optional form of benefit.

Example 2. A defined benefit plan permits each participant who separates from service on or after age 62 to receive a qualified joint and survivor annuity or a single life annuity commencing 45 days after termination from employment. For a participant who separates from service before age 62, payments under these optional forms of benefit commence 45 days after the participant's 62nd birthday. Under the plan, a participant is to elect among these optional forms of benefit during the 90-day period preceding the annuity starting date. However, during such period, a participant may defer both benefit commencement and the election of a particular benefit form to any later date, subject to section 401(a)(9). In January 1990, the employer decides to terminate the plan as of July 1, 1990. The plan will fail to satisfy section 411(d)(6) unless the optional forms of benefit provided under the plan are preserved under the annuity contract purchased on plan termination. Thus, such annuity contract must provide a participant the same optional benefit commencement rights that the plan provided. In addition, such contract must provide the same election rights with respect to such benefit options. This is the case even if, for example, in conjunction with the termination, the employer amended

the plan to permit participants to elect a qualified joint and survivor annuity, single life annuity, or single sum distribution commencing on July 1, 1990.

(4) *Benefits payable to a spouse or beneficiary*. Section 411(d)(6) protected benefits may not be eliminated merely because they are payable with respect to a spouse or other beneficiary.

(b) *Section 411(d)(6) protected benefits that may be eliminated or reduced only as permitted by the Commissioner*—(1) *In general*. The Commissioner may, consistent with the provisions of this section, provide for the elimination or reduction of section 411(d)(6) protected benefits that have already accrued only to the extent that such elimination or reduction does not result in the loss to plan participants of either a valuable right or an employer-subsidized optional form of benefit where a similar optional form of benefit with a comparable subsidy is not provided or to the extent such elimination or reduction is necessary to permit compliance with other requirements of section 401(a) (e.g., sections 401(a)(4), 401(a)(9) and 415). The Commissioner may exercise this authority only through the publication of revenue rulings, notices, and other documents of general applicability.

(2) *Section 411(d)(6) protected benefits that may be eliminated or reduced*. The elimination or reduction of certain section 411(d)(6) protected benefits that have already accrued in the following situations does not violate section 411(d)(6). The rules with respect to permissible eliminations and reductions provided in this paragraph (b)(2) generally are effective January 30, 1986; however, the rules of paragraphs (b)(2)(iii) (A) and (B) and (b)(2)(viii) of this Q&A–2 are effective for plan amendments that are adopted and effective on or after September 6, 2000. These exceptions create no inference with respect to whether any other applicable requirements are satisfied (for example, requirements imposed by section 401(a)(9) and section 401(a)(14)).

(i) *Change in statutory requirement*. A plan may be amended to eliminate or reduce a section 411(d)(6) protected benefit if the following three requirements are met: the amendment constitutes timely compliance with a change in law affecting plan qualification; there is an exercise of section 7805(b) relief by the Commissioner; and the elimination or reduction is made only to the extent necessary to enable the plan to continue to satisfy the requirements for qualified plans. In general, the elimination or reduction of a section 411(d)(6) protected benefit will not be treated as necessary if it is possible through other modifications to the plan (e.g., by expanding the availability of an optional form of benefit to additional employees) to satisfy the applicable qualification requirement.

(ii) *Joint and survivor annuity*. A plan that provides a range of three or more actuarially equivalent joint and survivor annuity options may be amended to eliminate any of such options, other than the options with the largest and smallest optional survivor payment percentages, even if the effect of such amendment is to change which of the options is the qualified joint and survivor annuity under section 417. Thus, for example, if a money purchase pension plan provides three joint and survivor annuity options with survivor payments of 50%, 75% and 100%, respectively, that are uniform with respect to age and are actuarially equivalent, then the employer may eliminate the option with the 75% survivor payment, even if this option had been the qualified joint and survivor annuity under the plan.

(iii) *In-kind distributions*—(A) *In-kind distributions payable under defined contribution plans in the form of marketable securities other than employer securities*. If a defined contribution plan includes an optional form of benefit under which benefits are distributed in the form of marketable securities, other than securities of the employer, that optional form of benefit may be modified by a plan amendment that substitutes cash for the marketable securities as the medium of distribution. For purposes of this paragraph (b)(2)(iii)(A) and paragraph (b)(2)(iii)(B) of this Q&A–2, the term *marketable securities* means marketable securities as defined in section 731(c)(2), and the term *securities of the employer* means securities of the employer as defined in section 402(e)(4)(E)(ii).

(B) *Amendments to defined contribution plans to specify medium of distribution.* If a defined contribution plan includes an optional form of benefit under which benefits are distributable to a participant in a medium other than cash, the plan may be amended to limit the types of property in which distributions may be made to the participant to the types of property specified in the amendment. For this purpose, the types of property specified in the amendment must include all types of property (other than marketable securities that are not securities of the employer) that are allocated to the participant's account on the effective date of the amendment and in which the participant would be able to receive a distribution immediately before the effective date of the amendment if a distributable event occurred. In addition, a plan amendment may provide that the participant's right to receive a distribution in the form of specified types of property is limited to the property allocated to the participant's account at the time of distribution that consists of property of those specified types.

(C) *In-kind distributions after plan termination.* If a plan includes an optional form of benefit under which benefits are distributed in specified property, that optional form of benefit may be modified for distributions after plan termination by substituting cash for the specified property as the medium of distribution to the extent that, on plan termination, an employee has the opportunity to receive the optional form of benefit in the form of the specified property. This exception is not available, however, if the employer that maintains the terminating plan also maintains another plan that provides an optional form of benefit under which benefits are distributed in the specified property.

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(2)(iii):

Example 1. (i) An employer maintains a profit-sharing plan under which participants may direct the investment of their accounts. One investment option available to participants is a fund invested in common stock of the employer. The plan provides that the participant has the right to a distribution in the form of cash upon termination of employment. In addition, the plan provides that, to the extent a participant's account is invested in the employer stock fund, the participant may receive an in-kind distribution of employer stock upon termination of employment. On October 18, 2000, the plan is amended, effective on January 1, 2001, to remove the fund invested in employer common stock as an investment option under the plan and to provide for the stock held in the fund to be sold. The amendment permits participants to elect how the sale proceeds are to be reallocated among the remaining investment options, and provides for amounts not so reallocated as of January 1, 2001, to be allocated to a specified investment option.

(ii) The plan does not fail to satisfy section 411(d)(6) solely on account of the plan amendment relating to the elimination of the employer stock investment option, which is not a section 411(d)(6) protected benefit. See paragraph (d)(7) of Q&A–1 of this section. Moreover, because the plan did not provide for distributions of employer securities except to the extent participants' accounts were invested in the employer stock fund, the plan is not required operationally to offer distributions of employer securities following the amendment. In addition, the plan would not fail to satisfy section 411(d)(6) on account of a further plan amendment, effective after the plan has ceased to provide for an employer stock fund investment option (and participants' accounts have ceased to be invested in employer securities), to eliminate the right to a distribution in the form of employer stock. See paragraph (b)(2)(iii)(B) of this Q&A–2.

Example 2. (i) An employer maintains a profit-sharing plan under which a participant, upon termination of employment, may elect to receive benefits in a single-sum distribution either in cash or in kind. The plan's investments are limited to a fund invested in employer stock, a fund invested in XYZ mutual funds (which are marketable securities), and a fund invested in shares of PQR limited partnership (which are not marketable securities).

(ii) The following alternative plan amendments would not cause the plan to fail to satisfy section 411(d)(6):

(A) A plan amendment that limits noncash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership. See paragraph (b)(2)(iii)(A) of this Q&A–2.

(B) A plan amendment that limits noncash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership, and that also provides that only participants with employer stock allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of employer stock, and that

only participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of shares of PQR limited partnership. To comply with the plan amendment, the plan administrator retains a list of participants with employer stock allocated to their accounts as of the effective date of the amendment, and a list of participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment. See paragraphs (b)(2)(iii) (A) and (B) of this Q&A–2.

(C) A plan amendment that limits non-cash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership to the extent that those assets are allocated to the participant's account at the time of the distribution. See paragraphs (b)(2)(iii) (A) and (B) of this Q&A–2.

(D) A plan amendment that limits non-cash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership, and that provides that only participants with employer stock allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of employer stock, and that only participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of shares of PQR limited partnership, and that further provides that the distribution of that stock or those shares is available only to the extent that those assets are allocated to those participants' accounts at the time of the distribution. To comply with the plan amendment, the plan administrator retains a list of participants with employer stock allocated to their accounts as of the effective date of the amendment, and a list of participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment. See paragraphs (b)(2)(iii) (A) and (B) of this Q&A–2.

Example 3. (i) An employer maintains a stock bonus plan under which a participant, upon termination of employment, may elect to receive benefits in a single-sum distribution in employer stock. This is the only plan maintained by the employer under which distributions in employer stock are available. The employer decides to terminate the stock bonus plan.

(ii) If the plan makes available a single-sum distribution in employer stock on plan termination, the plan will not fail to satisfy section 411(d)(6) solely because the optional form of benefit providing a single-sum distribution in employer stock on termination of employment is modified to provide that such distribution is available only in cash. See paragraph (b)(2)(iii)(C) of this Q&A–2.

(iv) *Coordination with diversification requirement.* A tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) may be amended to provide that a distribution is not available in employer securities to the extent that an employee elects to diversify benefits pursuant to section 401(a)(28).

(v) *Involuntary distributions.* A plan may be amended to provide for the involuntary distribution of an employee's benefit to the extent such involuntary distribution is permitted under sections 411(a)(11) and 417(e). Thus, for example, an involuntary distribution provision may be amended to require that an employee who terminates from employment with the employer receive a single sum distribution in the event that the present value of the employee's benefit is not more than $3,500, by substituting the cash-out limit in effect under §1.411(a)–11(c)(3)(ii) for $3,500, without violating section 411(d)(6). In addition, for example, the employer may amend the plan to reduce the involuntary distribution threshold from the cash-out limit in effect under §1.411(a)–11(c)(3)(ii) to any lower amount and to eliminate the involuntary single sum option for employees with benefits between the cash-out limit in effect under §1.411(a)–11(c)(3)(ii) and such lower amount without violating section 411(d)(6). This rule does not permit a plan provision permitting employer discretion with respect to optional forms of benefit for employees the present value of whose benefit is less than the cash-out limit in effect under §1.411(a)–11(c)(3)(ii).

(vi) *Distribution exception for certain profit-sharing plans*—(A) *In general.* If a defined contribution plan that is not subject to section 412 and does not provide for an annuity option is terminated, the plan may be amended to provide for the distribution of a participant's accrued benefit upon termination in a single sum optional form without the participant's consent. The preceding sentence does not apply if the employer maintains any other defined contribution plan (other than an

employee stock ownership plan as defined in section 4975(e)(7)).

(B) *Examples*. The provisions of this paragraph (b)(2)(vi) can be illustrated by the following examples:

Example 1. Employer X maintains a defined contribution plan that is not subject to section 412. The plan provides for distribution in the form of equal installments over five years or equal installments over twenty years. X maintains no other defined contribution plans. X terminates its defined contribution plan after amending the plan to provide for the distribution of all participants' accrued benefits in the form of single sum distributions, without obtaining participant consent. Pursuant to the rule in this paragraph (b)(2)(iv), this amendment does not violate the requirements of section 411(d)(6).

Example 2. Corporations X and Y are members of controlled group employer XY. Both X and Y maintain defined contribution plans. X's plan, which is not subject to section 412, covers only employees working for X. Y's plan, which is subject to section 412, covers only employees working for Y. X terminates its defined contribution plan. Because employer XY maintains another defined contribution plan, plan X may not provide for the distribution of participants' accrued benefits upon termination without a participants' consent.

(vii) *Distribution of benefits on default of loans*. Notwithstanding that the distribution of benefits arising from an execution on an account balance used to secure a loan on which there has been a default is an optional form of benefit, a plan may be amended to eliminate or change a provision for loans, even if such loans would be secured by an employee's account balance.

(viii) *Provisions for transfer of benefits between and among defined contribution plans and defined benefit plans*. A plan may be amended to eliminate provisions permitting the transfer of benefits between and among defined contribution plans and defined benefit plans.

(ix) *De minimis change in the timing of an optional form of benefit*. A plan may be amended to modify an optional form of benefit by changing the timing of the availability of such optional form if, after the change, the optional form is available at a time that is within two months of the time such optional form was available before the amendment. To the extent the optional form of benefit is available prior to termination of employment, six months may be substituted for two months in the prior sentence. Thus, for example, a plan that makes in-service distributions available to employees once every month may be amended to make such in-service distributions available only once every six months. This exception to section 411(d)(6) relates only to the timing of the availability of the optional form of benefit. Other aspects of an optional form of benefit may not be modified and the value of such optional form may not be reduced merely because of an amendment permitted by this exception.

(x) *Amendment of hardship distribution standards*. A qualified cash or deferred arrangement that permits hardship distributions under §1.401(k)–1(d)(2) may be amended to specify or modify nondiscriminatory and objective standards for determining the existence of an immediate and heavy financial need, the amount necessary to meet the need, or other conditions relating to eligibility to receive a hardship distribution. For example, a plan will not be treated as violating section 411(d)(6) merely because it is amended to specify or modify the resources an employee must exhaust to qualify for a hardship distribution or to require employees to provide additional statements or representations to establish the existence of a hardship. A qualified cash or deferred arrangement may also be amended to eliminate hardship distributions. The provisions of this paragraph also apply to profit-sharing or stock bonus plans that permit hardship distributions, whether or not the hardship distributions are limited to those described in §1.401(k)–1(d)(2).

(xi) *Section 415 benefit limitations*. Accrued benefits under a plan as of the first day of the first limitation year beginning after December 31, 1986, that exceed the benefit limitations under section 415 (b) or (e), effective on the first day of the plan's first limitation year beginning after December 31, 1986, because of a change in the terms and conditions of the plan made after May 5, 1986, or the establishment of a plan after that date, may be reduced to the

level permitted under section 415 (b) or (e).

(c) *Serial amendments.* A plan amendment that modifies an optional form of benefit with respect to benefits already accrued will be evaluated in light of previous amendments. Thus, for example, amendments made at different times that, when taken together, constitute the elimination or reduction of a valuable right, will be treated as the impermissible elimination or reduction of an optional form of benefit even though each amendment, considered alone, may otherwise be permissible.

(d) *ESOP and stock bonus plan exception*—(1) *In general.* Subject to the limitations in paragraph (d)(2) of this Q&A–2, a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) will not be treated as violating the requirements of section 411(d)(6) merely because of any of the circumstances described in paragraphs (d)(1)(i) through (d)(1)(iv) of this Q&A–2. In addition, a stock bonus plan that is not an employee stock ownership plan will not be treated as violating the requirements of section 411(d)(6) merely because of any of the circumstances described in paragraphs (d)(1)(ii) and (d)(1)(iv) of this Q&A–2.

(i) *Single sum or installment optional forms of benefit.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, a single sum optional form or installment optional form with respect to benefits that are subject to section 409(h)(1)(B), provided such elimination or retention of discretion is consistent with the distribution and payment requirements otherwise applicable to such plans (e.g., those required by section 409).

(ii) *Employer becomes substantially employee-owned or is an S corporation.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits subject to section 409(h) in the circumstances described in paragraph (d)(1)(ii)(A) or (B) of this Q&A–2, but only if the employer otherwise meets the requirements of section 409(h)(2)—

(A) The employer becomes substantially employee-owned; or

(B) For taxable years of the employer beginning after December 31, 1997, the employer is an S corporation as defined in section 1361.

(iii) *Employer securities become readily tradable.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, in cases in which the employer securities become readily tradable, optional forms of benefit by substituting distributions in the form of employer securities for distributions in cash with respect to benefits that are subject to section 409(h).

(iv) *Employer securities cease to be readily tradable or certain sales.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits that are subject to section 409(h) in the following circumstances:

(A) The employer stock ceases to be readily tradable;

(B) The employer stock continues to be readily tradable but there is a sale of substantially all of the stock of the employer or a sale of substantially all of the assets of a trade or business of the employer and, in either situation, the purchasing employer continues to maintain the plan.

In the situation described in paragraph (d)(1)(iv)(B) of this Q&A–2, the employer may also substitute distributions in the purchasing employer's stock for distributions in the form of employer stock of the predecessor employer.

(2) *Limitations on ESOP and stock bonus plan exceptions*—(i) *Nondiscrimination requirement.* Plan amendments and the retention and exercise of discretion permitted under the exceptions in paragraph (d)(1) must meet the nondiscrimination requirements of section 401(a)(4).

(ii) *ESOP investment requirement.* Except as provided in paragraph (d)(2)(iii) of this Q&A–2, benefits provided by employee stock ownership plans will not

be eligible for the exceptions in paragraph (d)(1) of this Q&A–2 unless the benefits have been held in a tax credit employee stock ownership plan (as defined in section 409 (a)) or an employee stock ownership plan (as defined in section 4975 (e)(7)) subject to section 409 (h) for the five-year period prior to the exercise of employer discretion or any amendment affecting such benefits and permitted under paragraph (d)(1) of this Q&A–2. For purposes of the preceding sentence, if benefits held under an employee stock ownership plan are transferred to a plan that is an employee stock ownership plan at the time of transfer, then the consecutive periods under the transferor and transferee employee stock ownership plans may be aggregated for purposes of meeting the five-year requirement. If the benefits are held in an employee stock ownership plan throughout the entire period of their existence, and such total period of existence is less than five years, then such lesser period may be substituted for the five year requirement.

(3) *Effective date*. The provisions of this paragraph (d) are effective beginning with the first day of the first plan year commencing on or after January 1, 1989. Prior to this effective date the reduction or elimination of a section 411(d)(6) protected benefit by a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) will not be treated as violating the requirements of section 411(d)(6) if such reduction or elimination reflects a reasonable interpretation of the statutory language of section 411(d)(6)(C).

(4) *Additional exceptions and requirements*. The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe such additional rules and exceptions, consistent with the purposes of this section, as may be necessary or appropriate.

(e) *Permitted plan amendments affecting alternative forms of payment under defined contribution plans*—(1) *General rule*. A defined contribution plan does not violate the requirements of section 411(d)(6) merely because the plan is amended to eliminate or restrict the ability of a participant to receive payment of accrued benefits under a particular optional form of benefit if—

(i) After the plan amendment is effective with respect to the participant, the alternative forms of payment available to the participant include payment in a single-sum distribution form that is otherwise identical to the optional form of benefit that is being eliminated or restricted; and

(ii) The amendment does not apply to the participant with respect to any distribution with an annuity starting date that is earlier than the earlier of—

(A) The 90th day after the date the participant has been furnished a summary that reflects the amendment and that satisfies the requirements of 29 CFR 2520.104b–3 (relating to a summary of material modifications) for pension plans; or

(B) The first day of the second plan year following the plan year in which the amendment is adopted.

(2) *Otherwise identical single-sum distribution*. For purposes of this paragraph (e), a single-sum distribution form is otherwise identical to an optional form of benefit that is eliminated or restricted pursuant to paragraph (e)(1) of this Q&A–2 only if the single-sum distribution form is identical in all respects to the eliminated or restricted optional form of benefit (or would be identical except that it provides greater rights to the participant) except with respect to the timing of payments after commencement. For example, a single-sum distribution form is not otherwise identical to a specified installment form of benefit if the single-sum distribution form is not available for distribution on the date on which the installment form would have been available for commencement, is not available in the same medium of distribution as the installment form, or imposes any condition of eligibility that did not apply to the installment form. However, an otherwise identical distribution form need not retain rights or features of the optional form of benefit that is eliminated or restricted to the extent that those rights or features would not be protected from elimination or restriction under section 411(d)(6) or this section.

(3) *Examples*. The following examples illustrate the application of this paragraph (e):

Example 1. (i) P is a participant in Plan M, a qualified profit-sharing plan with a calendar plan year that is invested in mutual funds. The distribution forms available to P under Plan M include a distribution of P's vested account balance under Plan M in the form of distribution of various annuity contract forms (including a single life annuity and a joint and survivor annuity). The annuity payments under the annuity contract forms begin as of the first day of the month following P's termination of employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)). P has not previously elected payment of benefits in the form of a life annuity, and Plan M is not a direct or indirect transferee of any plan that is a defined benefit plan or a defined contribution plan that is subject to section 412. Plan M provides that distributions on the death of a participant are made in accordance with section 401(a)(11)(B)(iii)(I). On May 15, 2001, Plan M is amended so that, after the amendment is effective, P is no longer entitled to any distribution in the form of the distribution of an annuity contract. However, after the amendment is effective, P is entitled to receive a single-sum cash distribution of P's vested account balance under Plan M payable as of the first day of the month following P's termination of employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)). The amendment does not apply to P if P elects to have annuity payments begin before the earlier of January 1, 2003, or 90 days after the date on which the plan administrator of Plan M furnishes P with a summary that reflects the amendment and that satisfies the requirements of 29 CFR 2520.104b–3. On December 14, 2001, the plan administrator of Plan M furnishes P with a summary plan description that reflects the amendment and that satisfies the requirements of 29 CFR 2520.104b–3.

(ii) Plan M does not violate the requirements of section 411(d)(6) (or section 401(a)(11)) merely because, as of March 14, 2002, the plan amendment has eliminated P's option to receive a distribution in any of the various annuity contract forms previously available.

Example 2. (i) P is a participant in Plan M, a qualified profit-sharing plan to which section 401(a)(11)(A) does not apply. Upon termination of employment, P is entitled to receive cash distributions from Plan M, payable as of the first day of the month following P's termination of employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)), in the form of a single-sum distribution, or in substantially equal monthly installment payments over either 5, 10, 15, or 20 years. On May 15, 2001, Plan M is amended so that, after the amendment is effective, P is no longer entitled to receive a distribution in the form of substantially equal monthly installment payments over 5, 10, 15, or 20 years. However, after the amendment is effective, P continues to be entitled to receive cash distributions from Plan M, payable as of the first day of the month following P's termination of employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)), in the form of a single-sum distribution. The amendment does not apply to P if P elects to have annuity payments begin before January 1, 2002. On September 20, 2001, the plan administrator of Plan M furnishes P with a summary of material modifications that reflects the amendment and that satisfies the requirements of 29 CFR 2520.104b–3.

(ii) Plan M does not violate the requirements of section 411(d)(6) merely because, as of January 1, 2002, the plan amendment has eliminated P's option to receive a distribution in the form of substantially equal monthly installment payments over 5, 10, 15, or 20 years.

(4) *Effective date*. This paragraph (e) applies to plan amendments that are adopted on or after September 6, 2000.

Q–3 Does the transfer of benefits between and among defined benefit plans and defined contribution plans (or similar transactions) violate the requirements of section 411(d)(6)?

A–3 (a) *Transfers and similar transactions*—(1) *General rule*. Section 411(d)(6) protected benefits may not be eliminated by reason of transfer or any transaction amending or having the effect of amending a plan or plans to transfer benefits. Thus, for example, except as otherwise provided in this section, an employer who maintains a money purchase pension plan that provides for a single sum optional form of benefit may not establish another plan that does not provide for this optional form of benefit and transfer participants' account balances to such new plan.

(2) *Defined benefit feature and separate account feature*. The defined benefit feature of an employee's benefit under a defined benefit plan and the separate account feature of an employee's benefit under a defined contribution plan are section 411(d)(6) protected benefits. Thus, for example, the elimination of

the defined benefit feature of an employee's benefit under a defined benefit plan, through transfer of benefits from a defined benefit plan to a defined contribution plan or plans, will violate section 411(d)(6).

(3) *Waiver prohibition.* In general, except as provided in paragraph (b) of this Q&A–3, a participant may not elect to waive section 411(d)(6) protected benefits. Thus, for example, the elimination of the defined benefit feature of a participant's benefit under a defined benefit plan by reason of a transfer of such benefits to a defined contribution plan pursuant to a participant election, at a time when the benefit is not distributable to the participant, violates section 411(d)(6).

(4) *Direct rollovers.* A direct rollover described in Q&A–3 of §1.401(a)(31)–1 that is paid to a qualified plan is not a transfer of assets and liabilities that must satisfy the requirements of section 414(l), and is not a transfer of benefits for purposes of applying the requirements under section 411(d)(6) and paragraph (a)(1) of this Q&A–3. Therefore, for example, if such a direct rollover is made to another qualified plan, the receiving plan is not required to provide, with respect to amounts paid to it in a direct rollover, the same optional forms of benefit that were provided under the plan that made the direct rollover. See §1.401(a)(31)–1, Q&A–14.

(b) *Elective transfers of benefits between defined contribution plans*—(1) *General rule.* A transfer of a participant's entire benefit between qualified defined contribution plans (other than any direct rollover described in Q&A–3 of §1.401(a)(31)–1) that results in the elimination or reduction of section 411(d)(6) protected benefits does not violate section 411(d)(6) if the following requirements are met—

(i) *Voluntary election.* The plan from which the benefits are transferred must provide that the transfer is conditioned upon a voluntary, fully-informed election by the participant to transfer the participant's entire benefit to the other qualified defined contribution plan. As an alternative to the transfer, the participant must be offered the opportunity to retain the participant's section 411(d)(6) protected benefits under the plan (or, if the plan is terminating, to receive any optional form of benefit for which the participant is eligible under the plan as required by section 411(d)(6)).

(ii) *Types of plans to which transfers may be made.* To the extent the benefits are transferred from a money purchase pension plan, the transferee plan must be a money purchase pension plan. To the extent the benefits being transferred are part of a qualified cash or deferred arrangement under section 401(k), the benefits must be transferred to a qualified cash or deferred arrangement under section 401(k). To the extent the benefits being transferred are part of an employee stock ownership plan as defined in section 4975(e)(7), the benefits must be transferred to another employee stock ownership plan. Benefits transferred from a profit-sharing plan other than from a qualified cash or deferred arrangement, or from a stock bonus plan other than an employee stock ownership plan, may be transferred to any type of defined contribution plan.

(iii) *Circumstances under which transfers may be made.* The transfer must be made either in connection with an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business (*i.e.*, an acquisition or disposition within the meaning of §1.410(b)–2(f)) or in connection with the participant's change in employment status to an employment status with respect to which the participant is not entitled to additional allocations under the transferor plan.

(2) *Applicable qualification requirements.* A transfer described in this paragraph (b) is a transfer of assets or liabilities within the meaning of section 414(l)(1) and, thus, must satisfy the requirements of section 414(l). In addition, this paragraph (b) only provides relief under section 411(d)(6); a transfer described in this paragraph must satisfy all other applicable qualification requirements. Thus, for example, if the survivor annuity requirements of sections 401(a)(11) and 417 apply to the plan from which the benefits are transferred, as described in this paragraph (b), but do not otherwise

apply to the receiving plan, the requirements of sections 401(a)(11) and 417 must be met with respect to the transferred benefits under the receiving plan. In addition, the vesting provisions under the receiving plan must satisfy the requirements of section 411(a)(10) with respect to the amounts transferred.

(3) *Status of elective transfer as other right or feature.* A right to a transfer of benefits from a plan pursuant to the elective transfer rules of this paragraph (b) is an other right or feature within the meaning of §1.401(a)(4)–4(e)(3), the availability of which is subject to the nondiscrimination requirements of section 401(a)(4) and §1.401(a)(4)–4. However, for purposes of applying the rules of §1.401(a)(4)–4, the following conditions are to be disregarded in determining the employees to whom the other right or feature is available—

(i) A condition restricting the availability of the transfer to benefits of participants who are transferred to a different employer in connection with a specified asset or stock disposition, merger, or other similar transaction involving a change in employer of the employees of a trade or business (*i.e.*, a disposition within the meaning of §1.410(b)–2(f)), or in connection with any such disposition, merger, or other similar transaction.

(ii) A condition restricting the availability of the transfer to benefits of participants who have a change in employment status to an employment status with respect to which the participant is not entitled to additional allocations under the transferor plan.

(c) *Elective transfers of certain distributable benefits between qualified plans*—(1) *In general.* A transfer of a participant's benefits between qualified plans that results in the elimination or reduction of section 411(d)(6) protected benefits does not violate section 411(d)(6) if—

(i) The transfer occurs at a time at which the participant's benefits are distributable (within the meaning of paragraph (c)(3) of this Q&A–3);

(ii) For a transfer that occurs on or after January 1, 2002, the transfer occurs at a time at which the participant is not eligible to receive an immediate distribution of the participant's entire nonforfeitable accrued benefit in a single-sum distribution that would consist entirely of an eligible rollover distribution within the meaning of section 401(a)(31)(C);

(iii) The voluntary election requirements of paragraph (b)(1)(i) of this Q&A–3 are met;

(iv) The participant is fully vested in the transferred benefit in the transferee plan;

(v) In the case of a transfer from a defined contribution plan to a defined benefit plan, the defined benefit plan provides a minimum benefit, for each participant whose benefits are transferred, equal to the benefit, expressed as an annuity payable at normal retirement age, that is derived solely on the basis of the amount transferred with respect to such participant; and

(vi) The amount of the benefit transferred, together with the amount of any contemporaneous section 401(a)(31) direct rollover to the transferee plan, equals the entire nonforfeitable accrued benefit under the transferor plan of the participant whose benefit is being transferred, calculated to be at least the greater of the single-sum distribution provided for under the plan for which the participant is eligible (if any) or the present value of the participant's accrued benefit payable at normal retirement age (calculated by using interest and mortality assumptions that satisfy the requirements of section 417(e) and subject to the limitations imposed by section 415).

(2) *Treatment of transfer*—(i) *In general.* A transfer of benefits pursuant to this paragraph (c) generally is treated as a distribution for purposes of section 401(a). For example, the transfer is subject to the cash-out rules of section 411(a)(7), the early termination requirements of section 411(d)(2), and the survivor annuity requirements of sections 401(a)(11) and 417. A transfer pursuant to the elective transfer rules of this paragraph (c) is not treated as a distribution for purposes of the minimum distribution requirements of section 401(a)(9).

(ii) *Status of elective transfer as optional form of benefit.* A right to a transfer of benefits from a plan pursuant to

the elective transfer rules of this paragraph (c) is an optional form of benefit under section 411(d)(6), the availability of which is subject to the nondiscrimination requirements of section 401(a)(4) and § 1.401(a)(4)–4.

(3) *Distributable benefits.* For purposes of paragraph (c)(1)(i) of this Q&A–3, a participant's benefits are distributable on a particular date if, on that date, the participant is eligible, under the terms of the plan from which the benefits are transferred, to receive an immediate distribution of these benefits (*e.g.*, in the form of an immediately commencing annuity) from that plan under provisions of the plan not inconsistent with section 401(a).

(d) *Effective date.* This Q&A–3 is applicable for transfers made on or after September 6, 2000.

Q–4: May a plan provide that the employer may, through the exercise of discretion, deny a participant a section 411(d)(6) protected benefit for which the participant is otherwise eligible?

A–4: (a) *In general.* Except as provided in paragraph (d) of Q&A–2 of this section with respect to certain employee stock ownership plans, a plan that permits the employer, either directly or indirectly, through the exercise of discretion, to deny a participant a section 411(d)(6) protected benefit provided under the plan for which the participant is otherwise eligible (but for the employer's exercise of discretion) violates the requirements of section 411(d)(6). A plan provision that makes a section 411(d)(6) protected benefit available only to those employees as the employer may designate is within the scope of this prohibition. Thus, for example, a plan provision under which only employees who are designated by the employer are eligible to receive a subsidized early retirement benefit constitutes an impermissible provision under section 411(d)(6). In addition, a pension plan that permits employer discretion to deny the availability of a section 411(d)(6) protected benefit violates the definitely determinable requirement of section 401(a), including section 401(a)(25). See § 1.401–1(b)(1)(i). This is the result even if the plan specifically limits the employer's discretion to choosing among section 411(d)(6) protected benefits, including optional forms of benefit, that are actuarially equivalent. In addition, the provisions of sections 411(a)(11) and 417(e) that allow a plan to make involuntary distributions of certain amounts are not excepted from this limitation on employer discretion. Thus, for example, a plan may not permit employer discretion with respect to whether benefits will be distributed involuntarily in the event that the present value of the employee's benefit is not more than the cash-out limit in effect under § 1.411(a)–11(c)(3)(ii) within the meaning of sections 411(a)(11) and 417(e). (An exception is provided for such provisions with respect to the nondiscrimination requirements of section 401(a)(4). See § 1.401(a)(4)–4(b)(2)(ii)(C).)

(b) *Exception for administrative discretion.* A plan may permit limited discretion with respect to the ministerial or mechanical administration of the plan, including the application of objective plan criteria specifically set forth in the plan. Such plan provisions do not violate the requirements of section 411(d)(6) or the definitely determinable requirement of section 401(a), including section 401(a)(25). For example, these requirements are not violated by the following provisions that permit limited administrative discretion:

(1) Commencement of benefit payments as soon as administratively feasible after a stated date or event;

(2) Employer authority to determine whether objective criteria specified in the plan (e.g., objective criteria designed to identify those employees with a heavy and immediate financial need or objective criteria designed to determine whether an employee has a permanent and total disability) have been satisfied; and

(3) Employer authority to determine, pursuant to specific guidelines set forth in the plan, whether the participant or spouse is dead or cannot be located.

Q–5: When will the exercise of discretion by some person or persons, other than the employer, be treated as employer discretion?

A–5: For purposes of applying the rules of this section and § 1.401(a)–4, the term ''employer'' includes plan administrator, fiduciary, trustee, actuary,

independent third party, and other persons. Thus, if a plan permits any person, other than the participant (and other than the participant's spouse), the discretion to deny or limit the availability of a section 411(d)(6) protected benefit for which the employee is otherwise eligible under the plan (but for the exercise of such discretion), such plan violates the requirements of sections 401(a), including section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a), including section 401(a)(25).

Q–6: May a plan condition the availability of a section 411(d)(6) protected benefit on the satisfaction of objective conditions that are specifically set forth in the plan?

A–6: (a) *Certain objective conditions permissible*—(1) *In general.* The availability of a section 411(d)(6) protected benefit may be limited to employees who satisfy certain objective conditions provided the conditions are ascertainable, clearly set forth in the plan and not subject to the employer's discretion except to the extent reasonably necessary to determine whether the objective conditions have been met. Also, the availability of the section 411(d)(6) protected benefit must meet the nondiscrimination requirements of section 401(a)(4). See § 1.401(a)–4.

(2) *Examples of permissible conditions.* The following examples illustrate of permissible objective conditions: a plan may deny a single sum distribution form to employees for whom life insurance is not available at standard rates as defined under the terms of the plan at the time the single sum distribution would otherwise be payable; a plan may provide that a single sum distribution is available only if the employee is in extreme financial need as defined under the terms of the plan at the time the single sum distribution would otherwise be payable; a plan my condition the availability of a single sum distribution on the execution of a covenant not to compete, provided that objective conditions with respect to the terms of such covenant and the employees and circumstances requiring execution of such covenant are set forth in the plan.

(b) *Conditions based on factors within employer's discretion generally impermissible.* A plan may not limit the availability of section 411(d)(6) protected benefits permitted under the plan on objective conditions that are within the employer's discretion. For example, the availability of section 411(d)(6) protected benefits in a plan may not be conditioned on a determination with respect to the level of the plan's funded status, because the amount of plan funding is within the employer's discretion. However, for example, although conditions based on the plan's funded status are impermissible, a plan may limit the availability of a section 411(d)(6) protected benefit (e.g., a single sum distribution) in an objective manner, such as the following:

(1) Single sum distributions of $25,000 and less are available without limit; and

(2) Single sum distributions in excess of $25,000 are available for a year only to the extent that the total amount of such single sum distributions for the year is not greater than $5,000,000; and

(3) An objective and nondiscriminatory method for determining which particular single sum distributions will not be available during a year in order for the $5,000,000 limit to be satisfied is set forth in the plan.

Q–7: May a plan be amended to add employer discretion or conditions restricting the availability of a section 411(d)(6) protected benefit?

A–7: No. The addition of employer discretion or objective conditions with respect to a section 411(d)(6) protected benefit that has already accrued violates section 411(d)(6). Also, the addition of conditions (whether or not objective) or any change to existing conditions with respect to section 411(d)(6) protected benefits that results in any further restriction violates section 411(d)(6). However, the addition of objective conditions to a section 411(d)(6) protected benefit may be made with respect to benefits accrued after the later of the adoption or effective date of the amendment. In addition, objective conditions may be imposed on section 411(d)(6) protected benefits accrued as of the date of an amendment where permitted under the transitional rules of § 1.401(a)–4 Q&A–5 and Q&A–8 of this

section. Finally, objective conditions may be imposed on section 411(d)(6) protected benefits to the extent permitted by the permissible benefit cutback provisions of Q&A–2 of this section.

Q–8: If a plan contains an impermissible employer discretion provision with respect to a section 411(d)(6) protected benefit, what acceptable alternative exist for amending the plan without violating the requirements of section 411(d)(6)?

A–8: (a) *In general.* The following rules apply for purposes of making necessary amendments to existing plans (as defined in Q&A–9 of this section) that contain discretion provisions with respect to the availability of section 411(d)(6) protected benefits that violate the requirements of section 401(a), including sections 401(a)(25) and 411(d)(6), and this section. These transitional rules are provided under the authority of section 411(d)(6) and section 7805(b).

(b) *Transitional alternatives.* If the availability of an optional forms of benefit, early or late retirement benefit, or retirement-type subsidy under an existing plan is conditioned on the exercise of employer discretion, the plan must be amended either to eliminate the optional form of benefit, early or late retirement benefit, or retirement-type subsidy to make such benefit available to all participants without limitation, or to apply objective and nondiscriminatory conditions to the availability of the optional form of benefit, early or later retirement benefit, or retirement-type subsidy. See paragraph (d) of this Q&A–8 for rules limiting the period during which section 411(d)(6) protected benefits may be eliminated or reduced under this paragraph.

(c) *Compliance and amendment date provisions*—(1) *Operational compliance requirement.* On or before the applicable effective date for the plan (as determined under Q&A–9 of this section), the plan sponsor must select one of the alternatives permitted under paragraph (b) of the Q&A–8 with respect to each affected section 411(d)(6) protected benefit and the plan must be operated in accordance with this selection. This is an operational requirement and does not require a plan amendment prior to the period set forth in paragraph (c)(2) of this Q&A–8. There are no special reporting requirements under the Code or this section with respect to this selection.

(2) *Deferred amendment date.* If paragraph (c)(1) of this Q&A–8 is satisfied, a plan amendment conforming the plan to the particular alternative selected under paragraph (b) of this Q&A–8 must be adopted within the time period permitted for amending plans in order to meet the requirements of section 410(b) as amended by TRA '86. The plan amendment to conform the plan to these regulations may be made at an earlier date. Such conforming amendment must be consistent with the sponsor's selection as reflected by plan practice during the period from the effective date to the date the amendment is adopted. Thus, for example, if any existing calendar year noncollectively bargained defined benefit plan has a single sum distribution option that is subject to employer discretion as of August 1, 1986, and such employer makes one or more single sum distributions available on or after January 1, 1989 and before the effective date by which plan amendment is required pursuant to this section, then such employer may not adopt a plan amendment eliminating the single sum distribution, but rather must adopt an amendment eliminating the discretion provision. Any objective conditions that are adopted as part of such amendment must not be inconsistent with the plan practice for the applicable period prior to the amendment. A conforming amendment under this paragraph (c)(2) must be made with respect to each section 411(d)(6) protected benefit for which such amendment is required and must be retroactive to the applicable effective date.

(d) *Limitation on transitional alternatives.* The transitional alternatives permitting the elimination or reduction of section 411(d)(6) protected benefits are only permissible until the applicable effective date for the plan (see Q&A–9 of this section). After the applicable effective date, any amendment (other than one permitted under paragraph (c)(2) of this Q&A–8) that eliminates or reduces a section 411(d)(6) protected benefit or imposes new objective

conditions on the availability of such benefit will fail to qualify for the exception to section 411(d)(6) provided in this Q&A–8. This is the case without regard to whether the section 411(d)(6) protected benefit is subject to employer discretion.

Q–9: What are the applicable effective date rules for purposes of this section?

A–9: (a) *General effective date*. Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986.

(b) *New plans*—(1) *In general*. Unless otherwise provided in paragraph (b)(2) of this Q&A–9, plans that are either adopted or made effective on or after August 1, 1986, are ''new plans''. With respect to such new plans, this section is effective August 1, 1986. This effective date is applicable to such plans whether or not they are collectively bargained.

(2) *Exception with respect to certain new plans*. Plans that are new plans as defined in paragraph (b)(1) of this Q&A–9; under which the availability of a section 411(d)(6) protected benefit is subject to employer discretion; and that receive a favorable determination letter that covered such plan provisions with respect to an application submitted prior to July 11, 1988, will be treated as existing plans with respect to such section 411(d)(6) protected benefit for purposes of the transitional rules of this section. Thus, such plans are eligible for the compliance and amendment alternatives set forth in the transitional rule in Q&A–8 of this section.

(c) *Existing plans*—(1) *In general*. Plans, including plans that are adoptions of master or prototype plans, that are both adopted and in effect prior to August 1, 1986, are ''existing plans'' for purposes of this section. In addition, a plan that is established after July 31, 1986, but before January 1, 1989, as an initial adoption of a master or prototype plan for which a favorable opinion letter was issued by the Service after July 18, 1985 and before January 1, 1989, will be deemed to be an existing plan for purposes of this section. See sections 4.01 and 4.02 of Rev. Proc. 84–23, 1984–1 C.B. 457, 459, for the definitions of master prototype plans. However, if such plan ceases to be covered under an opinion letter of the type described above, as a result of amendment of the plan or adoption of a new plan, prior to the first day of the first plan year beginning on or after January 1, 1989, then the effective date for such plan will be determined as though the plan were a new plan initially adopted as of the date of such amendment or adoption of a new plan. Finally, new plans described in paragraph (b)(2) of this Q&A–9 are treated as existing plans with respect to certain section 411(d)(6) protected benefits. Subject to the limitations in paragraph (c) of this Q&A–9, the effective dates set forth in paragraphs (c)(2), (c)(3), and (c)(4) of this Q&A–9 apply to these existing plans for purposes of this section:

(2) *Existing noncollectively bargained plans*. With respect to existing plans other than collectively bargained plans this section is effective for the first day of the first plan year commencing on or after January 1, 1989.

(3) *Existing collectively bargained plans*. With respect to existing collectively bargained plans this section is effective for the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b) as amended by TRA '86 apply to such plan.

(4) *Existing master and prototype plans*. With respect to existing plans that are adoptions of master or prototype plans the effective date will be the first day of the first plan year commencing on or after January 1, 1989.

(d) *Delayed effective date not applicable to new alternatives or conditions*—(1) *In general*. The delayed effective dates in paragraphs (c)(2) and (c)(3) of this Q&A–9 for existing plans are only applicable with respect to a section 411(d)(6) protected benefit if both the section 411(d)(6) protected benefit and the condition providing employer discretion as to the availability of such benefit are both adopted and in effect prior to August 1, 1986. If the preceding sentence is not satisfied with respect to a particular section 411(d)(6) protected benefit, this section is effective with respect to such section 411(d)(6) protected benefit as if the plan were a new plan.

(2) *Addition of discretion on or after January 30, 1986*. The delayed effective dates in paragraphs (c)(2) and (c)(3) of this Q&A–9 are not available with respect to any section 411(d)(6) protected benefit if the section 411(d)(6) protected benefit was provided for in the plan prior to January 30, 1986, and the availability of such benefit was made subject to the exercise of employer discretion on or after January 30, 1986. If the conditions set forth in this paragraph are not satisfied with respect to a particular section 411(d)(6) protected benefit, this section is effective with respect to such section 411(d)(6) protected benefit as if the plan were a new plan. A limited exception is provided with respect to existing plans that provided a particular section 411(d)(6) protected benefit prior to January 30, 1986, and then amended the plan after January 30, 1986, and before August 1, 1986, to add a provision for employer discretion with respect to the availability of such benefit. Such plans are required to have been amended retroactively by December 31, 1987, to remove such provision for employer discretion, and, if the benefit made subject to such discretion was subsequently eliminated, the plan is required to have been further amended, by the same date, to retroactively reinstate the benefit.

(3) *Exception for certain amendments covered by a favorable determination letter*. If an amendment adding a section 411(d)(6) protected benefit subject to employer discretion was adopted or made effective after August 1, 1986, and the plan receives a favorable determination letter covering such provision with respect to an application for such letter made prior to July 11, 1988, then the effective date for purposes of amending such provision under the transitional rules is the applicable effective date determined under the rules with respect to existing plans.

(e) *Transitional rule effective date*. The transitional rule provided in Q&A–8 of this section is effective January 30, 1986.

Q–10: If a plan provides for an age 70½ distribution option that commences prior to retirement from employment with the employer maintaining the plan, to what extent may the plan be amended to eliminate this distribution option?

A–10: (a) *In general*. The right to commence benefit distributions in a particular form and at a particular time prior to retirement from employment with the employer maintaining the plan is a separate optional form of benefit within the meaning of section 411(d)(6)(B) and Q&A–1 of this section, even if the plan provision creating this right was included in the plan solely to comply with section 401(a)(9), as in effect for years before January 1, 1997. Therefore, except as otherwise provided in paragraph (b) of this Q&A–10 or any other Q&A in this section, a plan amendment violates section 411(d)(6) if it eliminates an age 70½ distribution option (within the meaning of paragraph (c) of this Q&A–10) to the extent that it applies to benefits accrued as of the later of the adoption date or effective date of the amendment.

(b) *Permitted elimination of age 70½ distribution option*. An amendment of a plan will not violate the requirements of section 411(d)(6) merely because the amendment eliminates an age 70½ distribution option to the extent that the option provides for distribution to an employee prior to retirement from employment with the employer maintaining the plan, provided that—

(1) The amendment eliminating this optional form of benefit applies only to benefits with respect to employees who attain age 70½ in or after a calendar year, specified in the amendment, that begins after the later of—

(i) December 31, 1998; or

(ii) The adoption date of the amendment;

(2) The plan does not, except to the extent required by section 401(a)(9), preclude an employee who retires after the calendar year in which the employee attains age 70½ from receiving benefits in any of the same optional forms of benefit (except for the difference in the timing of the commencement of payments) that would have been available had the employee retired in the calendar year in which the employee attained age 70½; and

(3) The amendment is adopted no later than—

(i) The last day of the remedial amendment period that applies to the

plan for changes under the Small Business Job Protection Act of 1996 (110 Stat. 1755); or

(ii) Solely in the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before September 3, 1998, the last day of the twelfth month beginning after the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after September 3, 1998), if later than the date described in paragraph (b)(3)(i) of this Q&A–10. For purposes of this paragraph (b)(3)(ii), the rules of § 1.410(b)–10(a)(2) apply for purposes of determining whether a plan is maintained pursuant to one or more collective bargaining agreements, except that September 3, 1998 is substituted for March 1, 1986, as the date before which the collective bargaining agreements must be ratified.

(c) *Age 70½ distribution option.* For purposes of this Q&A–10, an age 70½ distribution option is an optional form of benefit under which benefits payable in a particular distribution form (including any modifications that may be elected after benefit commencement) commence at a time during the period that begins on or after January 1 of the calendar year in which an employee attains age 70½ and ends April 1 of the immediately following calendar year.

(d) *Examples.* The provisions of this Q&A–10 are illustrated by the following examples:

Example 1. Plan A, a defined benefit plan, provides each participant with a qualified joint and survivor annuity (QJSA) that is available at any time after the later of age 65 or retirement. However, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan A provides that if an employee does not retire by the end of the calendar year in which the employee attains age 70½, then the QJSA commences on the following April 1. On October 1, 1998, Plan A is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence before the employee retires but must commence no later than the April 1 following the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. This amendment satisfies this Q&A–10 and does not violate section 411(d)(6).

Example 2. Plan B, a money purchase pension plan, provides each participant with a choice of a QJSA or a single sum distribution commencing at any time after the later of age 65 or retirement. In addition, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan B provides that benefits will commence in the form of a QJSA on April 1 following the calendar year in which the employee attains age 70½, except that, with spousal consent, a participant may elect to receive annual installment payments equal to the minimum amount necessary to satisfy section 401(a)(9) (calculated in accordance with a method specified in the plan) until retirement, at which time a participant may choose between a QJSA and a single sum distribution (with spousal consent). On June 30, 1998, Plan B is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence prior to retirement but benefits must commence no later than April 1 after the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. The amendment further provides that the option described above to receive annual installment payments prior to retirement will not be available under the plan to an employee who is not a 5-percent owner and who attains age 70½ after 1998. This amendment satisfies this Q&A–10 and does not violate section 411(d)(6).

Example 3. Plan C, a profit-sharing plan, contains two distribution provisions. Under the first provision, in any year after an employee attains age 59½, the employee may elect a distribution of any specified amount not exceeding the balance of the employee's account. In addition, the plan provides a section 401(a)(9) override provision under which, if, during any year following the year that the employee attains age 70½, the employee does not elect an amount at least equal to the minimum amount necessary to satisfy section 401(a)(9) (calculated in accordance with a method specified in the plan), Plan C will distribute the difference by December 31 of that year (or for the year the employee attains age 70½, by April 1 of the following year). On December 31, 1996, Plan C is amended to provide that, for an employee other than an employee who is a 5-percent owner in the year the employee attains age 70½, in applying the section 401(a)(9) override provision, the later of the year of retirement or year of attainment of age 70½, is substituted for the year of attainment of age 70½. After the amendment, Plan C still permits each employee to elect to receive the same amount as was available before the amendment. Because this amendment does not eliminate an optional form of benefit, the amendment does not violate section 411(d)(6). Accordingly, the amendment is not required

to satisfy the conditions of paragraph (b) of this Q&A–10.

(e) *Effective date*. This Q&A–10 applies to amendments adopted and effective after June 5, 1998.

Q–11: To what extent may a plan amendment that is made pursuant to the Taxpayer Relief Act of 1997 (TRA '97) (Public Law 105–34, 111 Stat. 788), reduce or eliminate section 411(d)(6) protected benefits?

A–11: A plan amendment does not violate the requirements of section 411(d)(6) merely because the plan amendment reduces or eliminates section 411(d)(6) protected benefits as of the effective date of the plan amendment, provided that—

(a) The plan amendment is made pursuant to an amendment made by title XV, or subtitle H of title X, of TRA '97; and

(b) The plan amendment is adopted no later than the last day of any remedial amendment period that applies to the plan pursuant to §§1.401(b)–1 and 1.401(b)–1T for changes under TRA '97.

[53 FR 26058, July 11, 1988, as amended by T.D. 8360, 56 FR 47602, Sept. 19, 1991; T.D. 8357, 56 FR 40549, Aug. 15, 1991; T.D. 8360, 57 FR 4721, Feb. 7, 1992; T.D. 8485, 58 FR 46828, Sept. 3, 1993; T.D. 8581, 59 FR 66180, Dec. 23, 1994; T.D. 8769, 63 FR 30623, June 5, 1998; T.D. 8781, 63 FR 47173, Sept. 4, 1998; T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8806, 64 FR 1126, Jan. 8, 1999; T.D. 8806, 64 FR 38826, July 20, 1999; T.D. 8891, 65 FR 44682, July 19, 2000; T.D. 8900, 65 FR 53906, Sept. 6, 2000]

§ 1.411(d)–5 Class year plans; plan years beginning after October 22, 1986.

(a) *Plan years beginning prior to 1989*. (1) The requirements of section 411(a)(2) shall be treated as satisfied in the case of a class-year plan if such plan provides that 100 percent of each employee's right to or derived from the contributions of the employer on the employee's behalf with respect to any plan year is nonforfeitable not later than when such participant was performing services for the employer as of the close of each of 5 plan years (whether or not consecutive) after the plan year for which the contributions were made.

(2) For purposes of paragraph (a)(1) of this section if—

(i) Any contributions are made on behalf of a participant with respect to any plan year, and

(ii) Before such participant meets the requirements of paragraph (a)(1) of this section, such participant was not performing services for the employer as of the close of each of any 5 consecutive plan years after such plan year, then the plan may provide that the participant forfeits any right to or derived from the contributions made with respect to such plan year.

(3) This paragraph (a) applies to contributions made for plan years beginning after October 22, 1986.

(b) *Plan years beginning after 1988*. (1) The special class year vesting rule in section 411(d)(4) was repealed by section 1113(b) of the Tax Reform Act of 1986 (1986 Act). The repeal is generally effective for plan years beginning after December 31, 1988. See section 1111(e) of the 1986 Act for a special effective date rule applicable to certain plans maintained pursuant to collective bargaining agreements.

(2)(i) This subparagraph (2) provides a special rule for class year plans that were in compliance with section 411(d)(4) immediately before the first plan year beginning after section 411(d)(4) is repealed. These plans are not required to retroactively compute years of service under the general section 411(a)(2) rules. Instead, a participant must receive a year of service for each such prior plan year if the employee was performing services on the last day of such year. Similarly, if the participant was not performing services on the last day of such years, the participant will be treated as if a one-year break– in–service occurred for such plan year. This subdivision (i) applies to plan years to which this section applies.

(ii) In the case of a plan year to which §1.411(d)–3 applied, a class year plan must compute years of service and breaks in service in a manner consistent with the rules in this paragraph (b)(2)(i), giving appropriate regard to the statutory changes made to section 411(d)(4).

[T.D. 8219, 53 FR 31854, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.411(d)–6 Section 204(h) notice.

Q–1: What are the requirements of section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) (29 U.S.C 1054(h))?

A–1: (a) *Requirements of section 204(h).* Section 204(h) of ERISA (''section 204(h)'') generally requires written notice of an amendment to certain plans that provides for a significant reduction in the rate of future benefit accrual. Section 204(h) generally requires the notice to be provided to plan participants, alternate payees, and employee organizations. The plan administrator must provide the notice after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment.

(b) *Other notice requirements.* Other provisions of law may require that certain parties be notified of a plan amendment. See, for example, sections 102 and 104 of ERISA, and the regulations thereunder, for requirements relating to summary plan descriptions and summaries of material modifications.

Q–2: To which plans does section 204(h) apply?

A–2: Section 204(h) applies to defined benefit plans that are subject to part 2 of subtitle B of title I of ERISA and to individual account plans that are subject to both such part 2 and the funding standards of section 302 of ERISA. Accordingly, individual account plans that are not subject to the funding standards of section 302, such as profit-sharing and stock bonus plans, are not subject to section 204(h).

Q–3: What is ''section 204(h) notice''?

A–3: ''Section 204(h) notice'' is notice that complies with section 204(h) and the rules in this section.

Q–4: For which amendments is section 204(h) notice required?

A–4: (a) *In general.* Section 204(h) notice is required for an amendment to a plan described in Q&A–2 of this section that provides for a significant reduction in the rate of future benefit accrual.

(b) *Delegation of authority to Commissioner.* The Commissioner of Internal Revenue may provide through publication in the Internal Revenue Bulletin of revenue rulings, notices, or other documents (see § 601.601(d)(2) of this chapter) that section 204(h) notice need not be provided for plan amendments otherwise described in paragraph (a) of this Q&A–4 that the Commissioner determines to be necessary or appropriate, as a result of changes in the law, to maintain compliance with the requirements of the Internal Revenue Code of 1986, as amended (Code) (including requirements for tax qualification), ERISA, or other applicable federal law.

Q–5: What is an amendment that affects the rate of future benefit accrual for purposes of section 204(h)?

A–5: (a) *In general*—(1) *Defined benefit plans.* For purposes of section 204(h), an amendment to a defined benefit plan affects the rate of future benefit accrual only if it is reasonably expected to change the amount of the future annual benefit commencing at normal retirement age. For this purpose, the annual benefit commencing at normal retirement age is the benefit payable in the form in which the terms of the plan express the accrued benefit (or, in the case of a plan in which the accrued benefit is not expressed in the form of an annual benefit commencing at normal retirement age, the benefit payable in the form of a single life annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit expressed under the terms of the plan, as determined in accordance with the principles of section 411(c)(3) of the Code).

(2) *Individual account plans.* For purposes of section 204(h), an amendment to an individual account plan affects the rate of future benefit accrual only if it is reasonably expected to change the amounts allocated in the future to participants' accounts. Changes in the investments or investment options under an individual account plan are not taken into account for this purpose.

(b) *Determination of rate of future benefit accrual.* In accordance with paragraph (a) of this Q&A–5, the rate of future benefit accrual is determined without regard to optional forms of benefit (other than the annual benefit described in paragraph (a) of this Q&A–5), early retirement benefits, or retirement-type subsidies, within the meaning of such terms as used in section

411(d)(6) of the Code (section 204(g) of ERISA). The rate of future benefit accrual is also determined without regard to ancillary benefits and other rights or features as defined in §1.401(a)(4)–4(e).

(c) *Examples*. These examples illustrate the rules in this Q&A–5:

Example 1. A plan is amended with respect to future benefit accruals to eliminate a right to commencement of a benefit prior to normal retirement age. Because the amendment does not change the annual benefit commencing at normal retirement age, it does not reduce the rate of future benefit accrual for purposes of section 204(h).

Example 2. A plan is amended to modify the actuarial factors used in converting an annuity form of distribution to a single sum form of distribution. The use of these modified assumptions results in a lower single sum. Because the amendment does not affect the annual benefit commencing at normal retirement age, it does not change the rate of future benefit accrual for purposes of section 204(h).

Q–6: What plan provisions are taken into account in determining whether there has been a reduction in the rate of future benefit accrual?

A–6: (a) *Plan provisions taken into account*. All plan provisions that may affect the rate of future benefit accrual of participants or alternate payees must be taken into account in determining whether an amendment provides for a significant reduction in the rate of future benefit accrual. Such provisions include, for example, the dollar amount or percentage of compensation on which benefit accruals are based; in the case of a plan using permitted disparity under section 401(l) of the Code, the amount of disparity between the excess benefit percentage or excess contribution percentage and the base benefit percentage or base contribution percentage (all as defined in section 401(l)); the definition of service or compensation taken into account in determining an employee's benefit accrual; the method of determining average compensation for calculating benefit accruals; the definition of normal retirement age in a defined benefit plan; the exclusion of current participants from future participation; benefit offset provisions; minimum benefit provisions; the formula for determining the amount of contributions and forfeitures allocated to participants' accounts in an individual account plan; and the actuarial assumptions used to determine contributions under a target benefit plan (as defined in §1.401(a)(4)–8(b)(3)(i)).

(b) *Plan provisions not taken into account*. Plan provisions that do not affect the rate of future benefit accrual of participants or alternate payees are not taken into account in determining whether there has been a reduction in the rate of future benefit accrual. For example, provisions such as vesting schedules or optional forms of benefit (other than the annual benefit described in Q&A–5(a) of this section) are not taken into account.

(c) *Examples*. The following example illustrates the rules in this Q&A–6:

Example. A defined benefit plan provides a normal retirement benefit equal to 50% of final average compensation times a fraction (not in excess of one), the numerator of which equals the number of years of participation in the plan and the denominator of which is 20. A plan amendment that changes the numerator or denominator of that fraction must be taken into account in determining whether there has been a reduction in the rate of future benefit accrual.

Q–7: What is the basic principle used in determining whether an amendment provides for a significant reduction in the rate of future benefit accrual for purposes of section 204(h)?

A–7: Whether an amendment provides for a significant reduction in the rate of future benefit accrual for purposes of section 204(h) is determined based on reasonable expectations taking into account the relevant facts and circumstances at the time the amendment is adopted. For a defined benefit plan this is done by comparing the amount of the annual benefit commencing at normal retirement age as determined under Q&A–5(a)(1) under the terms of the plan as amended, with the amount of the annual benefit commencing at normal retirement age as determined under Q&A–5(a)(1) under the terms of the plan prior to amendment. For an individual account plan, this is done in accordance with Q&A–5(a)(2) by comparing the amounts to be allocated in the future to participants' accounts under the terms of the plan as

amended, with the amounts to be allocated in the future to participants' accounts under the terms of the plan prior to amendment.

Q–8: Are employees who have not yet become participants in a plan at the time an amendment to the plan is adopted taken into account in applying section 204(h) with respect to the amendment?

A–8: No. Employees who have not yet become participants in a plan at the time an amendment to the plan is adopted are not taken into account in applying section 204(h) with respect to the amendment. Thus, if section 204(h) notice is required with respect to an amendment, the plan administrator need not provide section 204(h) notice to such employees.

Q–9: If section 204(h) notice is required with respect to an amendment, must such notice be provided to participants or alternate payees whose rate of future benefit accrual is not reduced by the amendment?

A–9: (a) *In general.* A plan administrator need not provide section 204(h) notice to any participant whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to any alternate payee under an applicable qualified domestic relations order whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment. A plan administrator need not provide section 204(h) notice to an employee organization unless the employee organization represents a participant to whom section 204(h) notice is required to be provided.

(b) *Facts and circumstances test.* Whether a participant or alternate payee is described in paragraph (a) of this Q&A–9 is determined based on all relevant facts and circumstances at the time the amendment is adopted.

(c) *Examples.* The following examples illustrate the rules in this Q&A–9:

Example 1. Plan A is amended to reduce significantly the rate of future benefit accrual of all current employees who are participants in the plan. It is reasonable to expect based on the facts and circumstances that the amendment will not reduce the rate of future benefit accrual of former employees who are currently receiving benefits or that of former employees who are entitled to vested benefits. Accordingly, the plan administrator is not required to provide section 204(h) notice to such former employees.

Example 2. The facts are the same as in Example 1 except that Plan A also covers two groups of alternate payees. The alternate payees in the first group are entitled to a certain percentage or portion of the former spouse's accrued benefit, and for this purpose the accrued benefit is determined at the time the former spouse begins receiving retirement benefits under the plan. The alternate payees in the second group are entitled to a certain percentage or portion of the former spouse's accrued benefit, and for this purpose the accrued benefit was determined at the time the qualified domestic relations order was issued by the court. It is reasonable to expect that the benefits to be received by the second group of alternate payees will not be affected by any reduction in a former spouse's rate of future benefit accrual. Accordingly, the plan administrator is not required to provide section 204(h) notice to the alternate payees in the second group.

Example 3. Plan B covers hourly employees and salaried employees. Plan B provides the same rate of benefit accrual for both groups. The employer amends Plan B to reduce significantly the rate of future benefit accrual of the salaried employees only. At that time, it is reasonable to expect that only a small percentage of hourly employees will become salaried in the future. Accordingly, the plan administrator is not required to provide section 204(h) notice to the participants who are currently hourly employees.

Example 4. Plan C covers employees in Division M and employees in Division N. Plan C provides the same rate of benefit accrual for both groups. The employer amends Plan C to reduce significantly the rate of future benefit accrual of employees in Division M. At that time, it is reasonable to expect that in the future only a small percentage of employees in Division N will be transferred to Division M. Accordingly, the plan administrator is not required to provide section 204(h) notice to the participants who are employees in Division N.

Example 5. The facts are the same facts as in *Example 4*, except that at the time the amendment is adopted, it is expected that soon thereafter Division N will be merged into Division M in connection with a corporate reorganization (and the employees in Division N will become subject to the plan's amended benefit formula applicable to the employees in Division M). In this instance, the plan administrator must provide section 204(h) notice to the participants who are employees in Division M and to the participants who are employees in Division N.

Q–10: Does a notice fail to comply with section 204(h) if it contains a summary of the amendment and the effective date, without the text of the amendment itself?

A–10: No, the notice does not fail to comply with section 204(h) merely because the notice contains a summary of the amendment, rather than the text of the amendment, if the summary is written in a manner calculated to be understood by the average plan participant and contains the effective date. The summary need not explain how the individual benefit of each participant or alternate payee will be affected by the amendment.

Q–11: How may section 204(h) notice be provided?

A–11: A plan administrator (including a person acting on behalf of the plan administrator such as the employer or plan trustee) may use any method reasonably calculated to ensure actual receipt of the section 204(h) notice. First class mail to the last known address of the party is an acceptable delivery method. Likewise, hand delivery is acceptable. Section 204(h) notice may be enclosed with or combined with other notice provided by the employer or plan administrator. For example, a notice of intent to terminate under title IV of ERISA or a notice to interested parties of the application for a determination letter may also serve as section 204(h) notice if it otherwise meets the requirements of this section.

Q–12: How may the 15-day notice requirement be satisfied?

A–12: (a) *Generally*. A section 204(h) notice is deemed to have been provided at least 15 days before the effective date of the amendment if it has been provided by the end of the 15th day before the effective date. When notice is delivered by first class mail, the notice is considered provided as of the date of the United States postmark stamped on the cover in which the document is mailed.

(b) *Example*. The following example illustrates the provisions of this Q&A–12:

Example. Plan A is amended to reduce significantly the rate of future benefit accruals effective December 1, 1999. The plan administrator causes section 204(h) notice to be mailed to all affected participants. The mailing is postmarked November 16, 1999. Accordingly, the section 204(h) notice is considered to be given not less than 15 days before the effective date of the plan amendment.

Q–13: If a plan administrator fails to provide section 204(h) notice to some participants or alternate payees, will the plan administrator be considered to have complied with section 204(h) with respect to participants and alternate payees who were provided with section 204(h) notice?

A–13: The plan administrator will be considered to have complied with section 204(h) with respect to a participant to whom section 204(h) notice is required to be provided if the participant and any employee organization representing the participant were provided with section 204(h) notice, and if the plan administrator has made a good faith effort to comply with the requirements of section 204(h). The plan administrator will be considered to have complied with section 204(h) with respect to an alternate payee to whom section 204(h) notice is required to be provided if the alternate payee was provided with section 204(h) notice, and if the plan administrator made a good faith effort to comply with the requirements of section 204(h). If these conditions are satisfied the amendment will become effective in accordance with its terms with respect to the participants and alternate payees to whom section 204(h) notice was provided. Except to the extent provided in Q&A–14, the amendment will not become effective with respect to those participants and alternate payees who were not provided with section 204(h) notice.

Q–14: Will a plan be considered to have complied with section 204(h) if the plan administrator provides section 204(h) notice to all but a de minimis percentage of participants and alternate payees to whom section 204(h) notice must be provided?

A–14: The plan will be considered to have complied with section 204(h) and the amendment will become effective in accordance with its terms with respect to all parties to whom section 204(h) notice was required to be provided (including those who did not receive notice prior to discovery of the omission), if the plan administrator—

(a) Has made a good faith effort to comply with the requirements of section 204(h);

(b) Has provided section 204(h) notice to each employee organization that represents any participant to whom section 204(h) notice is required to be provided;

(c) Has failed to provide section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom section 204(h) notice is required to be provided; and

(d) Provides section 204(h) notice to those participants and alternate payees promptly upon discovering the oversight.

Q–15: How does section 204(h) apply to the sale of a business?

A–15: (a) *Generally*. Whether section 204(h) notice is required in connection with the sale of a business depends on whether a plan amendment is adopted that significantly reduces the rate of future benefit accrual.

(b) *Examples*. The following examples illustrate the rules of this Q&A–15:

Example 1. Corporation Q maintains Plan A, a defined benefit plan that covers all employees of Corporation Q, including employees in its Division M. Plan A provides that participating employees cease to accrue benefits when they cease to be employees of Corporation Q. On January 1, 2000, Corporation Q sells all of the assets of Division M to Corporation R. Corporation R maintains Plan B, which covers all of the employees of Corporation R. Under the sale agreement, employees of Division M become employees of Corporation R on the date of the sale (and cease to be employees of Corporation Q), Corporation Q continues to maintain Plan A following the sale, and the employees of Division M become participants in Plan B. In this Example, no section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. The employees of Division M who become employees of Corporation R ceased to accrue benefits under Plan A because their employment with Corporation Q terminated.

Example 2. Subsidiary Y is a wholly owned subsidiary of Corporation S. Subsidiary Y maintains Plan C, a defined benefit plan that covers employees of Subsidiary Y. Corporation S sells all of the stock of Subsidiary Y to Corporation T. At the effective date of the sale of the stock of Subsidiary Y, in accordance with the sale agreement between Corporation S and Corporation T, Subsidiary Y amends Plan C so that all benefit accruals cease. In this Example, section 204(h) notice is required to be provided because Subsidiary Y adopted a plan amendment that significantly reduced the rate of future benefit accrual in Plan C.

Example 3. Corporation U maintains two plans: Plan D covers employees of Division N and Plan E covers the rest of the employees of Corporation U. Plan E provides a significantly lower rate of future benefit accrual than Plan D. Plan D is merged with Plan E, and all of the employees of Corporation U will accrue benefits under the merged plan in accordance with the benefit formula of former Plan E. In this Example, section 204(h) notice is required.

Example 4. Corporation V maintains several plans, including Plan F, which covers employees of Division P. Plan F provides that participating employees cease to accrue further benefits under the plan when they cease to be employees of Corporation V. Corporation V sells all of the assets of Division P to Corporation W, which maintains Plan G for its employees. Plan G provides a significantly lower rate of future benefit accrual than Plan F. Plan F is merged with Plan G as part of the sale, and employees of Division P who become employees of Corporation W will accrue benefits under the merged plan in accordance with the benefit formula of former Plan G. In this Example, no section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. Under the terms of Plan F as in effect prior to the merger, employees of Division P cease to accrue any further benefits under Plan F after the date of the sale because their employment with Corporation V terminated.

Q–16: How are amendments to cease accruals and terminate a plan treated under section 204(h)?

A–16: (a) *General rule*—(1) *Rule*. An amendment providing for the cessation of benefit accruals on a specified future date and for the termination of a plan is subject to section 204(h).

(2) *Example*. The following example illustrates the rule of paragraph (a)(1) of this Q&A–16:

Example. (i) An employer adopts an amendment that provides for the cessation of benefit accruals under a defined benefit plan on December 31, 2001, and for the termination of the plan pursuant to title IV of ERISA as of a proposed termination date that is also December 31, 2001. As part of the notice of intent to terminate required under title IV in order to terminate the plan, the plan administrator gives section 204(h) notice of the amendment ceasing accruals, which states

that benefit accruals will cease ''on December 31, 2001.'' However, because all the requirements of title IV for a plan termination are not satisfied, the plan cannot be terminated until a date that is later than December 31, 2001.

(ii) Nonetheless, because section 204(h) notice was given stating that the plan was amended to cease accruals on December 31, 2001, section 204(h) does not prevent the amendment to cease accruals from being effective on December 31, 2001. The result would be the same had the section 204(h) notice informed the participants that the plan was amended to provide for a proposed termination date of December 31, 2001, and to provide that ''benefit accruals will cease on the proposed termination date whether or not the plan is terminated on that date.'' However, the cessation of accruals would not be effective on December 31, 2001, had the section 204(h) notice merely stated that benefit accruals would cease ''on the termination date or on the proposed termination date.

(b) *Terminations in accordance with title IV of ERISA*. A plan that is terminated in accordance with title IV of ERISA is deemed to have satisfied section 204(h) not later than the termination date (or date of termination, as applicable) established under section 4048 of ERISA. Accordingly, section 204(h) would in no event require that any additional benefits accrue after the effective date of the termination.

(c) *Amendment effective before termination date of a plan subject to title IV of ERISA*. To the extent that an amendment providing for a significant reduction in the rate of future benefit accrual has an effective date that is earlier than the termination date (or date of termination, as applicable) established under section 4048 of ERISA, that amendment is subject to section 204(h). Accordingly, the plan administrator must provide section 204(h) notice (either separately or with or as part of the notice of intent to terminate) with respect to such an amendment.

Q–17: When does section 204(h) become effective?

A–17: (a) *Statutory effective date*. With respect to defined benefit plans, section 204(h) generally applies to plan amendments adopted on or after January 1, 1986. With respect to individual account plans, section 204(h) applies to plan amendments adopted on or after October 22, 1986.

(b) *Regulatory effective date*—(1) *General regulatory effective date*. This section is applicable for amendments adopted on or after December 12, 1998.

(2) *Special rule for amendments adopted under the temporary regulations*. Whether an amendment that is adopted on or after December 15, 1995 and before December 12, 1998 complies with section 204(h) is determined under the rules of § 1.411(d)–6T in effect prior to December 14, 1998 (See 1.411(d)–6T in 26 CFR part 1 revised as of April 1, 1998).

[T.D. 8795, 63 FR 68680, Dec. 14, 1998]

§ 1.412(b)–2 Amortization of experience gains in connection with certain group deferred annuity contracts.

(a) *Experience gain treatment*. Dividends, rate credits, and credits for forfeitures arising in a plan described in paragraph (b) of this section are experience gains described in section 412(b)(3)(B)(ii) (relating to the amortization of experience gains).

(b) *Plan*. A plan is described in this paragraph (b) if—

(1) The plan is funded solely through a group deferred annuity contract,

(2) The annual single premium required under the contract for the purchase of the benefits accruing during the plan year is treated as the normal cost of the plan for that year, and

(3) The amount necessary to pay in equal annual installments, over the appropriate amortization period, an amount equal to the single premium necessary to provide all past service benefits not initially funded, together with interest thereon, is treated as the annual amortization amount determined under section 412(b)(2)(B) (i), (ii) or (iii).

(c) *Effective date*. This section applies for the first plan year to which section 412 applies that begins after May 22, 1981.

[T.D. 7764, 46 FR 6923, Jan. 22, 1981]

§ 1.412(b)–5 Election of the alternative amortization method of funding.

(a) *Alternative amortization method in general*. Section 1013(d) of the Employee Retirement Income Security Act of 1974 provides an alternative method which may be used by certain multiemployer plans (as defined in section

414(f)) which were in existence on January 1, 1974, for funding certain unfunded past service liability. The multiemployer plans which may elect to use this alternative method are those plans (1) under which, on January 1, 1974, contributions were based on a percentage of pay, (2) which use actuarial assumptions with respect to pay that are reasonably related to past and projected experience, and (3) which use rates of interest that are determined on the basis of reasonable acturial assumptions. The unfunded past service liability to which this method applies is that amount existing as of the date 12 months after the date on which section 412 first applies to the plan. The alternative method allows the plan to fund this liability over a period of 40 plan years by charging the funding standard account with an equal annual percentage of the aggregate pay of all participants in the plan instead of the level dollar charges required under section 412(b)(2)(B). Paragraphs (b), (c), (d) and (e) of this section contain procedural rules for electing this alternative method.

(b) *Election procedure*. To elect the alternative amortization method, a multiemployer plan must attach a statement to the annual report required under section 6058(a) for the plan year for which the election is made, stating that the alternative method for funding unfunded past service liability is being adopted. Advance approval from the Internal Revenue Service is not required. The alternative method must be adopted on or before the last day prescribed for filing the annual report corresponding to the last plan year beginning before January 1, 1982.

(c) *Charges to which the alternative amortization method is applicable*. Once elected, the alternative amortization method is applicable to the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. This results in charges to the funding standard account which are in lieu of—

(1) Charges required under clause (i) of section 412(b)(2)(B), and

(2) Charges required under clause (iii) of section 412(b)(2)(B) if the plan amendments referred to in such clause result in a net increase in the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. Such charges generally will arise only with respect to plan amendments adopted in the first plan year to which section 412 applies.

If the election is made on an annual report corresponding to a plan year after the first plan year to which section 412 applies, recomputation of the contributions due in the prior years (to which section 412 applied) will be necessary.

(d) *Limitation*. The sum of the charges described in this paragraph may not be less than the interest on the unfunded past service liabilities described in section 412(b)(2)(B) (i) and (iii), determined as of the date 12 months after the date on which section 412 first applies to the plan.

(e) *Reporting requirements*. Each annual report required by section 6058(a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the alternative amortization method as may be required by the applicable forms and the instructions for such forms.

[T.D. 7702, 45 FR 40113, June 13, 1980]

§ 1.412(c)(1)–1 Determinations to be made under funding method—terms defined.

(a) *Actuarial cost method and funding method*. Section 3 (31) of the Employee Retirement Income Security Act of 1974 (''ERISA'') provides certain acceptable (and unacceptable) actuarial cost methods which may (or may not) be used by employee plans. The term ''funding method'' when used in section 412 has the same meaning as the term ''actuarial cost method'' in section 3 (31) of ERISA. For shortfall method for certain collectively bargained plans, see § 1.412(c)(1)–2; for principles applicable to funding methods in general, see regulations under section 412(c)(3).

(b) *Computations included in funding method*. The funding method of a plan includes not only the overall funding method used by the plan but also each specific method of computation used in applying the overall method. However, the choice of which actuarial assumptions are appropriate to the overall

method or to the specific method of computation is not a part of the funding method. For example, the decision to use or not to use a mortality factor in the funding method of a plan is not a part of such funding method. Similarly, the specific mortality rate determined to be applicable to a particular plan year is not part of the funding method. See section 412(c)(5) for the requirement of approval to change the funding method used by a plan.

[T.D. 7733, 45 FR 75202, Nov. 14, 1980]

§ 1.412(c)(1)–2 Shortfall method.

(a) *In general*—(1) *Shortfall method.* The shortfall method is a funding method that adapts a plan's underlying funding method for purposes of section 412. As such, the use of the shortfall method is subject to section 412(c)(3). A plan described in paragraph (a)(2) of this section may elect to determine the charges to the funding standard account required by section 412(b) under the shortfall method. These charges are computed on the basis of an estimated number of units of service or production (for which a certain amount per unit is to be charged). The difference between the net amount charged under this method and the net amount that otherwise would have been charged under section 412 for the same period is a shortfall loss (gain) and is to be amortized over certain subsequent plan years.

(2) *Eligibility for use of shortfall.* No plan may use the shortfall method unless—

(i) The plan is a collectively bargained plan described in section 413(a), and

(ii) Contributions to the plan are made at a rate specified under the terms of a legally binding agreement applicable to the plan.

For purposes of this section, a plan maintained by a labor organization which is exempt from tax under section 501(c)(5) is treated as a collectively bargained plan and the governing rules of the organization (such as its constitution, bylaws, or other document that can be altered only through action of a convention of the organization) are treated as a collectively bargained agreement.

(b) *Computation and effect of net shortfall charge*—(1) *In general.* The ''net shortfall charge'' to the funding standard account under the shortfall method is the product of (i) the estimated unit charge described in paragraph (c) of this section that applies for a particular plan year, multiplied by (ii) the actual number of base units (for example, units of service or production) which occurred during that plan year. When the shortfall method is used, the net shortfall charge is a substitute for the specific charges and credits to the funding standard account described in section 412 (b)(2) and (3)(B).

(2) *Example.* Paragraph (b)(1) of this section may be illustrated by the following example:

Example. A pension plan uses the calendar year as the plan year and the shortfall method. Its estimated unit charge applicable to 1980 is 80 cents per hour of covered employment. During 1980, there were 125,000 hours of covered employment. The net shortfall charge for the plan year is $100,000 (*i.e.*, 125,000×$.80), regardless of the amount which would be charged and credited to the funding standard account under section 412 (b)(2) and (3)(B) had the shortfall method not applied. The funding standard account for 1980 will be separately credited for the amount considered contributed for the plan year under section 412 (b)(3)(A). The other items which may be credited, if applicable, are a waived funding deficiency and the alternative minimum funding standard credit adjustment under section 412(b)(3)(C) and (D) because these items are not credits under section 412(b)(3)(B).

(3) *Plans with more than one contract, contribution rate, employer, or benefit level*—(i) *General rule.* A single plan with more than one contract, contribution rate, employer, or benefit level may compute a separate net shortfall charge for each contract, contribution rate, each employer, or each benefit level. The sum of these charges is the plan's total net shortfall charge. under § 1.412(c)(1)–1(b), the use of separate computations would be a specific method of computation used in applying the overall funding method. See also paragraph (f)(5) of this section.

(ii) *Single valuation.* Only one actuarial valuation shall be made for the single plan on each actuarial valuation date.

(iii) *Reasonableness test.* The specific method of computation of the net

shortfall charge must be reasonable, determined in the light of the facts and circumstances.

(c) *Estimated unit charge.* The estimated unit charge is the annual computation charge described in paragraph (d) of this section divided by the estimated base units of service or production described in paragraph (e) of this section.

(d) *Annual computation charge.* The annual computation charge for a plan year is the sum of the following amounts:

(1) The net charges and credits which, but for using the shortfall method, would be made under section 412 (b)(2) and (b)(3)(B).

(2) The amount described in paragraph (g)(3) of this section, if applicable, for amortization of shortfall gain or loss.

(e) *Estimated base units*—(1) *In general.* The estimated base units are the expected units of service or production for a plan year (hours, days, tons, dollars of compensation, etc.), determined as of the base unit estimation date for that plan year under paragraph (f) of this section. This estimate must be based on the past experience of the plan and the reasonable expectations of the plan for the plan year. The specific type of unit used must be described in the statement of funding method for the plan year. (See paragraph (i)(3) of this section for reporting requirements.)

(2) *Reasonable expectations.* The reasonableness of expectations used under paragraph (e)(1) of this section is determined under the facts and circumstances of the plan for each plan year as of the relevant base unit estimation date. Expectations will be considered unreasonable if, for example, they do not reflect a consistent and substantial decline or growth in actual base units that has occurred over the course of recent years and that is likely to continue beyond the base unit estimation date. This determination of reasonableness is independent of determinations made under section 412(c)(3) of the reasonableness of actuarial assumptions.

(f) *Base unit estimation date*—(1) *In general.* The base unit estimation date for the current plan year is determined under this paragraph (f). This date shall be an actuarial valuation date no earlier than the last actuarial valuation date occurring at least one year before the earliest date any current collectively bargained agreement in existence during the plan year came into effect.

(2) *Four-month rule.* For purposes of this paragraph (f), a current collectively bargained agreement is one in effect during at least four months of the current plan year.

(3) *Effective date of agreement.* For purposes of this paragraph (f), a collectively bargained agreement shall be deemed to have come into effect on the effective date of the agreement containing the currently effective provision for contributions to the plan or the benefits provided under the plan.

(4) *Long-term contract rule.* The effective date of a collectively bargained agreement shall be deemed not to occur prior to the first day of the third plan year preceding the current year.

(5) *Special rule for plans computing separate net shortfall charge.* A plan that computes a separate net shortfall charge for each contract, contribution rate, employer, or benefit level under paragraph (b)(3) of this section shall determine the base unit estimation date for each separate charge without regard to any collectively bargained agreement that does not relate to that contract, contribution rate, employer, or benefit level. If a collective bargaining agreement requiring contributions by a certain employer, or prescribing a certain benefit level, is in effect on December 31, 1980, the preceding sentence shall not apply to the computation of a separate net shortfall charge for that employer or benefit level until the earlier of—

(i) The first plan year beginning after the date on which expires the collective bargaining agreement requiring contributions by that employer (or the last collective bargaining agreement relating to that benefit level), or

(ii) The first plan year beginning after December 31, 1983.

(6) *Example.* The rules contained in paragraph (f) of this section are illustrated by the following table. In the table, ''V'' signifies actuarial valuation date (January 1 in each case shown);

''B'' signifies beginning of a contract; and ''E'' signifies end of a contract. The table shows the resulting earliest base unit estimation date with respect to the following assumed items:

COMPUTATION OF EARLIEST BASE UNIT ESTIMATION DATE

Example	Plan year (calendar year basis)											
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Plan A	V			V			V			V		
Contract 1	.....	.....	E/B	.....	.....	E/B	.....	E/B	.....	.....	.....	E/B
Base unit estimation date [1]				1973	1973	1973	1976	1976	1979	1979	1979	1979
Plan B	V			V			V			V		
Contract 2	[2]	[2]	[2]	B*	.....	E/B	.....	.....	.....	E/B*	.....	.....
Contract 3	E/B	.....	.....	E/B	.....	.....	E/B	.....	.....	E/B	.....	.....
Base unit estimation date [1]	.....	.....	.....	1973	1973	1973	1976	1976	1976	1976	1979	1979
Plan C	V	V	V	V	V	V	V	V	V	V	V	V
Contract 4	.....	.....	E/B	.....	.....	E/B*	.....	.....	.....	E/B*	.....	.....
Contract 5	.....	.....	E/B	.....	.....	E/B*	.....	.....	.....	.....	E/B*	.....
Base unit estimation date [1]				1974	1974	1977	1977	1977	1977	1978	1979	1981

[1] The base unit estimation date may be on or any time after the actuarial valuation date in the year indicated on this line.
[2] No contract.
* Denotes that a prior contract ends and a new contract begins prior to the fifth month of a plan year.

(g) *Amortization of shortfall gain or loss*—(1) *Definition*. The shortfall gain for a plan is the excess for the plan year of—

(i) The net shortfall charge computed under paragraph (b) of this section over

(ii) The annual computation charge described in paragraph (d) of this section.

The shortfall loss for a plan is the excess for the plan year of the annual computation charge over the net shortfall charge.

(2) *Shortfall amortization period*—(i) *First year*. The plan year in which the amortization of a shortfall gain or loss must begin is the earlier of two years: the fifth plan year following the plan year in which the shortfall gain or loss arose, or the first plan year beginning after the latest scheduled expiration date of a collectively bargained agreement in effect with respect to the plan during the plan year in which the shortfall gain or loss arose. For purposes of this subparagraph, a contract expiring on the last day of a plan year shall be deemed to be renewed on such last day for the same period of years as the contract that succeeds the expiring contract.

(ii) *Last year*. The plan year in which the amortization of a shortfall gain or loss must end is the 15th plan year following the plan year in which the shortfall gain or loss arose. For a multiemployer plan described in section 414(f), the amortization must end with the 20th plan year instead of the 15th.

(3) *Annual amortization amount*. The shortfall gain or loss must be amortized in equal annual installments. The total amount to be amortized must be adjusted for interest at the rate used for determining the plan's normal cost.

(4) *Shortfall gain or loss under spread gain type of funding method*—(i) *In general*. A spread gain type of funding method spreads experience gains and losses over future periods as part of a plan's normal cost. (Examples of spread gain types of funding methods are the aggregate cost method, the frozen initial liability method, and the attained age normal method.) However, a shortfall gain or loss is not an experience gain or loss. Therefore, a plan using a spread gain type of funding method together with the shortfall method must amortize shortfall gains and losses and otherwise meet the requirements of paragraph (g) of this section.

(ii) *Asset adjustment for aggregate method*. A plan using the shortfall method with the aggregate cost method of funding must adjust its plan assets for a shortfall gain or loss in calculating normal cost. The unamortized

portion of any shortfall gain is subtracted from plan assets. The unamortized portion of any shortfall loss is added to plan assets.

(5) *Reconciliation of shortfall gain or loss with funding standard account.* At the beginning of each year, the actual unfunded liability under the method used by the plan must equal the outstanding balance of all amortization bases, including bases for shortfall gains and losses, less the credit balance under the funding standard account at the end of the prior year.

(6) *Example.* This paragraph is illustrated by the following examples:

Example (1). A multiemployer plan described in section 414 (f) is maintained with the calendar year as the plan year and uses the shortfall method. The plan uses the frozen initial liability funding method. A five percent interest assumption is used by the plan, with payments computed as of the first day of each plan year for all items. The expiration dates of contracts in effect during plan years 1976, 1977, and 1978 are such that the amortization of gains or losses for each year must begin in the fifth following plan year. The assumed plan costs and estimated base units for selected years, and the computations under this section which follow from such assumptions are shown in the following table. In the table, ''*'' denotes an assumed item. The remaining figures have been calculated on the basis of these assumptions.

(A) COMPUTATION OF NET SHORTFALL CHARGE AND SHORTFALL GAIN OR LOSS

Plan year	1976	1977	1978
1. Normal cost*	$100,000	$100,000	$100,000
2. Amortization of unfunded liability*	50,000	50,000	50,000
3. Total annual computation charges	$150,000	$150,000	$150,000
4. Estimated base units*	100,000	100,000	100,000
5. Estimated unit charge (line 3÷line 4)	$1.50	$1.50	$1.50
6. Actual units during year*	80,000	90,000	110,000
7. Net shortfall charge for year (line 5×line 6)	120,000	135,000	165,000
8. Shortfall (gain) or loss (line 3 − line 7)	30,000	15,000	($15,000)

(B) ANNUAL AMORTIZATION AMOUNT

9. Year of shortfall gain or loss	1976	1977	1978
10. First year of amortization	1981	1982	1983
11. Last year of amortization	1996	1997	1998
12. (Gain) or loss adjusted for interest to year amortization begins (1–1–76 to 1–1–81, etc.)	$38,288	$19,144	($19,144)
13. Annual amortization (16 years)	$3,364	$1,682	($1,682)

(C) COMPUTATION OF NET SHORTFALL CHARGES FOR SELECTED YEARS (INCLUDING SHORTFALL AMORTIZATION)

Plan year	1981	1982	1983
14. Normal cost*	$120,000	$125,000	$130,000
15. Amortization of unfunded liability*	50,000	50,000	50,000
16. Shortfall amortization (see line 13) from:			
1976	3,364	3,364	3,364
1977	.....	1,682	1,682
1978	.....	.....	(1,682)
17. Total annual computation charges	173,364	180,046	183,364
18. Estimated base units*	110,000	110,000	110,000
19. Estimated unit charge (line 17÷line 18)	1.576	1.637	1.667
20. Actual units during year*	105,000	110,000	105,000
21. Net shortfall charge for year (line 19×line 20)	165,480	180,070	175,035
22. Shortfall (gain) loss (line 17 − line 21)	7,884	(24)	8,329

The amounts in line 22 will be amortized beginning 1986, 1987, and 1988, respectively. The $24 gain in 1982 results from rounding the estimated unit charge.

Example (2). Assume the facts in Example (1). Also assume that the plan uses the frozen initial liability funding method, that the unfunded liability as of January 1, 1976 (corresponding to a 40-year charge of $50,000 due at the beginning of the year) is $900,850, and that actual contributions at the rate of $1.75 per unit are paid at mid-year in 1976.

(A) COMPUTATION OF THE UNFUNDED LIABILITY AS OF DECEMBER 31, 1976

1. Unfunded liability as of 1/1/76	$900,850
2. Normal cost (that used in the calculation of the total annual computation charges)	100,000

(A) COMPUTATION OF THE UNFUNDED LIABILITY AS OF DECEMBER 31, 1976—Continued

3. Interest at 5% due on items 1 and 2	50,043
4. Contribution with interest: $1.75×80,000×1.025 (actual contribution rate times acutal base units times interest adjustment from mid-year)	143,500
5. Unfunded liability as of 12/31/76: item 1+item 2+item 3 − item 4	907,393

(B) COMPUTATION OF THE OUTSTANDING BALANCE OF THE BASES AS OF DECEMBER 31, 1976

1. Original base: ($900,850 − $50,000)×1.05	$893,393
2. Shortfall loss $30,000×1.05	31,500
3. Total	924,893

(C) COMPUTATION OF THE CREDIT BALANCE AS OF DECEMBER 31, 1976

1. Net shortfall charge (§ 1.412 (c) (1)–2 (b)) adjusted for interest: $120,000×1.05	$126,000
2. Actual contributions with interest	143,500
3. Credit balance as of 12/31/76: item 2 − item 1	17,500

(D) RECONCILIATION OF COMPUTATIONS

As of January 1, 1977, the unfunded liability ($907,393) equals the outstanding balance of the bases minus the credit balance ($924,893 − $17,500=$907,393).

(h) *Amortization of experience gain or loss*—(1) *General rule*. In the case of a plan using an immediate gain type of funding method, an experience gain or loss shall be amortized pursuant to section 412 (b)(2)(B)(iv) or (b)(3)(B)(ii). (Examples of the immediate gain type of funding method are the unit credit method, the entry age normal cost method, and the individual level premium cost method.) For purposes of this section, a shortfall gain or loss is not an experience gain or loss. The amount of the experience gain or loss must be adjusted for interest at the rate used for determining the plan's normal cost.

(2) *Experience amortization period under shortfall method*—(i) *First year*. The plan year in which the amortization of an experience gain or loss must begin in the case of a plan using the shortfall method is the earlier of two years: the fifth plan year following the plan year in which the experience gain or loss arose, or the first plan year beginning after the last scheduled expiration date of a contract in effect during the plan year in which the experience gain or loss arose. For purposes of this subparagraph a contract expiring on the last day of the plan year shall be deemed to be renewed on such last day for the same period of years as the contract that succeeds the expiring contract.

(ii) *Last year*. The plan year in which the amortization of an experience gain or loss must end in the case of a plan using the shortfall method is the 15th plan year following the plan year in which the experience gain or loss arose. For a multi-employer plan described in section 414 (f), the amortization must end with the 20th plan year instead of the 15th.

(3) *Use of annual computation charge in determining experience gain or loss*. In the case of a plan using an immediate gain type of funding method, an experience gain or loss is the difference between the expected unfunded liability and the actual unfunded liability under the plan. The expected unfunded liability as of the end of a plan year equals the actual unfunded liability as of the beginning of the year plus normal cost, minus contributions, all adjusted for interest. If the plan adopts the shortfall method, the expected unfunded liability is computed by using the normal cost applicable for the plan year in determining the annual computation charge under paragraph (d) of this section. The same normal cost is used in computing the unfunded liability under the frozen initial liability funding method.

(4) *Example*. This paragraph is illustrated by the following example:

Example. Assume the facts in Example (2) from paragraph (g) (6) of this section, except that the entry age normal funding method is used. Also assume that as of December 31, 1976, the actual unfunded liability is $900,000.

(A) COMPUTATION OF EXPECTED UNFUNDED LIABILITY

1. Actual unfunded liability as of 1–1–76	$900,850
2. Normal cost portion of annual computation charge as of 1–1–76	100,000
3. Interest at 5% due on items 1 and 2	50,043
4. Contribution received with interest: $1.75 × 80,000 × 1.025 (actual contribution rate times actual base units times interest adjustment at mid-year)	143,500
5. Expected unfunded liability as of 12–31–76 (item 1 + item 2 + item 3 − item 4)	907,393

(B) COMPUTATION OF GAIN OR LOSS

1. Expected unfunded liability as of 12–31–76	$907,393
2. Actual unfunded liability as of 12–31–76	900,000
3. Gain (or loss) (item 1 − item 2)	7,393

(i) *Election procedure*—(1) *In general.* To elect the shortfall method, a collectively bargained plan must attach a statement to the annual report required under section 6058 (a) for the first plan year to which it is applied. The statement shall state that the shortfall method is adopted, beginning with the plan year covered by such report. Advance approval from the Internal Revenue Service is not required if the shortfall method is first adopted on or before the later of—

(i) The first plan year to which section 412 applies or

(ii) The last plan year commencing before December 31, 1981.

However, approval must be received pursuant to section 412(c)(5) prior to the adoption of the shortfall method at a later time, or the discontinuance of such method, once adopted.

(2) *Use of specific computation method.* A specific method of computation under the shortfall method is described in paragraph (b)(3) of this section, regarding the treatment of more than one contract, employer, or benefit level under the plan. This specific method may be adopted with respect to any plan year to which the shortfall method applies. Approval from the Commissioner must be received under section 412(c)(5) prior to the adoption of this specific computation method for a plan year subsequent to the first plan year to which the shortfall method applies, or prior to the discontinuance of a specific computation method, once adopted.

(3) *Reporting requirements.* Each annual report required by section 6058(a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the shortfall method as may be required by the applicable forms and the instructions for such forms.

(j) *Transitional rule.* In lieu of paragraphs (g)(2) and (h)(2) of this section relating to the amortization period for shortfall and experience gains and losses, for gains and losses arising in plan years beginning before January 1, 1981, a plan may rely on the prior published position of the Internal Revenue Service with respect to the amortization period for shortfall and experience gains and losses.

(k) *Supersession.* This section and § 1.412 (c) (1)–1 supersede §§ 11.412 (c) (1)–1 and (c) (1)–2 of the Temporary Income Tax Regulations Under the Employee Retirement Income Security Act of 1974.

(Secs. 412, 7805, Internal Revenue Code of 1954 (88 Stat. 914 and 68A Stat. 917; (26 U.S.C. 412 and 7805)), and sec. 3 (31) of the Employee Retirement Income Security Act of 1974 (88 Stat. 837; (29 U.S.C. 1002)))

[T.D. 7733, 45 FR 75202, Nov. 14, 1980]

§ 1.412(c)(1)–3 Applying the minimum funding requirements to restored plans.

(a) *In general*—(1) *Restoration method.* The restoration method is a funding method that adapts the underlying funding method of section 412 in the case of certain plans that are or have been terminated and are later restored by the Pension Benefit Guaranty Corporation (PBGC). The normal operation of the funding standard account, and all other provisions of section 412 and the regulations thereunder, are unchanged except as provided in this § 1.412(c)(1)–3. Under the restoration method, the PBGC shall determine a restoration payment schedule, extending over no more than 30 years, that replaces all charges and credits to the funding standard account attributable to pre-restoration amortization bases. The restoration payment schedule is determined on the basis of an actuarial valuation of the accrued liability of the plan on the initial post-restoration valuation date less the actuarial value of the plan assets on that date. The initial post-restoration valuation date is the date of the valuation that falls in the first plan year beginning on or after the date of the restoration order.

(2) *Applicability of restoration method.* A plan must use the restoration method if, and only if—

(i) The plan is being or has been terminated pursuant to section 4041(c) or section 4042 of the Employee Retirement Income Security Act of 1974 (ERISA); and

(ii) The plan has been restored by the PBGC pursuant to its authority under section 4047 of ERISA.

(b) *Computation and effect of the initial restoration amortization base*—(1) *In general.* The initial restoration amortization base is determined under the underlying funding method used by the plan. When the plan uses a spread gain funding method that does not maintain an unfunded liability, the plan must change either to an immediate gain method that directly calculates an accrued liability or to a spread gain method that maintains an unfunded liability. A plan may adopt any cost method that satisfies this requirement and that is acceptable under section 412 and the regulations thereunder, provided that the plan administrator follows the procedures established by the Commissioner for changes in funding methods. The initial restoration amortization base is determined using the valuation for the plan year in which the initial post-restoration valuation date falls. The initial restoration amortization base equals the accrued liability with respect to plan benefit liabilities returned by the PBGC less the value of the plan assets returned by the PBGC. The initial restoration amortization base replaces all prior amortization bases including those under section 412(b)(2) (B), (C), and (D) and under section 412(b)(3)(B). Any base resulting from a change in funding method, including a change required under this paragraph, is treated as a prior amortization base within the meaning of this paragraph (b). Any accumulated funding deficiency or credit balance in the funding standard account is set equal to zero when the initial restoration amortization base is established.

(2) *Example.* The following example illustrates the provisions of this paragraph (b):

Example. A pension plan uses the calendar year as its plan year, makes its annual periodic valuation as of January 1, and uses the unit credit actuarial cost method for funding purposes. The plan is in the process of being terminated. By order of the PBGC the plan is restored as of July 1, 1991. The initial post-restoration valuation date is January 1, 1992, and a restoration payment schedule order is issued on October 31, 1992. If, as of January 1, 1992, the accrued liability of the plan is $1,000,000 and the value of the plan assets is $200,000, the initial restoration amortization base is $800,000.

(c) *Establishment of a restoration payment schedule*—(1) *Certification requirement.* When the PBGC establishes a restoration payment schedule, the Executive Director of the PBGC must certify to the PBGC's Board of Directors, and to the Internal Revenue Service, that the PBGC has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the PBGC deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

(2) *Requirements for restoration payment schedule*—(i) *Amortization of base over period of no more than 30 years.* The restoration payment schedule must be prescribed in an order requiring the employer to make stated contributions to the plan sufficient to amortize the initial restoration amortization base over a period extending not more than 30 years after the initial post-restoration valuation date (the restoration payment period). Payments included in the restoration payment schedule order are charged to the funding standard account of the plan at the end of each plan year in accordance with paragraph (d) of this section. The restoration payment schedule must provide for total charges that are sufficient to amortize the entire amount of the initial restoration amortization base by the end of the restoration payment period. The scheduled charges need not be in level amounts, but the present value of the prescribed charges on the initial post-restoration valuation date, computed with interest at the valuation rate, must equal the initial restoration amortization base.

(ii) *Minimum annual charge.* The restoration payment schedule must prescribe annual charges that are sufficient to prevent the outstanding balance of the initial restoration amortization base from exceeding whichever

of the following amounts is applicable—

(A) During the first 10 plan years on the restoration payment schedule, the amount of the initial restoration amortization base on the date the base was established; or

(B) During plan years 11 through 20 on the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the tenth plan year, as calculated under paragraph (c)(2)(iii) of this section; or

(C) During plan years 21 through the end of the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the twentieth plan year, as calculated under paragraph (c)(2)(iii) of this section.

(iii) *Interim amortization requirements.* The restoration payment schedule must provide for sufficient periodic charges so that the outstanding balance of the initial restoration amortization base at the end of the tenth plan year and at the end of the twentieth plan year of the restoration payment period will not be larger than the outstanding balance that would have remained at the end of the tenth plan year and at the end of the twentieth plan year, respectively, if the initial restoration amortization base had been amortized in level annual amounts over the restoration payment period at the valuation rate.

(3) *Amendments to the restoration payment schedule.* The order establishing the restoration payment schedule may be amended by the PBGC from time to time with respect to any remaining payments, provided that no amendment may extend the restoration payment period beyond 30 years from the initial post-restoration valuation date, and provided further that the restoration payment schedule, as amended, satisfies the requirements of paragraph (c)(2) of this section.

(4) *Deferral of minimum scheduled annual payment amounts*—(i) *Authority to grant deferral.* Not later than 2½ months following the end of the plan year, the PBGC may grant a deferral of the charges required in the restoration payment schedule for that plan year if the requirements in paragraph (c)(4)(ii) of this section are satisfied. The PBGC may require the plan sponsor and its controlled group members to provide security to the plan as a condition to granting a deferral.

(ii) *Determination of business hardship.* Before granting a deferral under this paragraph (c)(4), the PBGC must make a determination that the granting of the deferral is in the best interests of plan participants and the plan termination insurance system, and that the plan sponsor and its controlled group members are unable to make the scheduled restoration payments without experiencing temporary substantial business hardship. In making these determinations, the factors the PBGC shall consider, include, but are not limited to, the following—

(A) Whether the plan sponsor and its controlled group members are operating at an economic loss;

(B) Whether there is substantial unemployment or underemployment in the trades or businesses of the plan sponsor and its controlled group members;

(C) Whether the sales and profits of the industry or industries are depressed or declining; and

(D) Whether it is reasonable to expect that the plan termination insurance system will suffer a greater loss if the plan is terminated than if it is continued as a restored plan.

(iii) *Amount of deferral.* The amount of the deferral for any particular plan year may not exceed the lesser of the amount that would have been required to be contributed under the restoration payment schedule for that year or interest at the valuation rate on the outstanding balance of the initial restoration amortization base for that year. An amortization payment for a deferral granted for a prior plan year may not be deferred. No deferral may extend the overall restoration payment period beyond 30 years.

(iv) *Modification of payment schedule.* The restoration payment schedule must be adjusted to reflect any deferral granted for a plan year in the manner prescribed in this paragraph (c). The charge otherwise specified in the schedule is reduced by the amount of any deferral. The charges under the

restoration payment schedule for the subsequent plan years are increased by the amounts in paragraph (c)(4)(v) of this section.

(v) *Amortization of deferred amount.* The amount of any deferral granted by the PBGC for any plan year must be amortized in level amounts over five years or such shorter period as may be prescribed by the PBGC, at the valuation rate, beginning with the plan year following the year of the deferral.

(vi) *Number of deferrals permitted.* The PBGC may not grant more than five deferrals of the minimum scheduled payments as required by this section during the restoration payment period and no more than three of these deferrals may be granted during the first ten years of that period.

(vii) *Deferrals override minimum annual charges and interim amortization requirements.* In determining the minimum annual charge under paragraph (c)(2)(ii) of this section and in applying the interim amortization requirements of paragraph (c)(2)(iii) of this section, the unamortized balances of any deferrals granted by the PBGC under this paragraph shall be added to the outstanding balance of the initial restoration amortization base otherwise allowable.

(d) *Charging the scheduled restoration payments to the funding standard account.* In addition to any other charges and credits prescribed in the normal operation of the funding standard account under section 412, the amount of each payment specified in the restoration payment schedule shall be charged against the funding standard account of the plan for the plan year to which that payment is attributed in the restoration payment schedule. To the extent that the restoration payment schedule provides for payments before the end of the plan year, the annual charge to the funding standard account attributable to the restoration payment schedule is equal to the sum of the periodic payments for the plan year accumulated with interest at the valuation rate to the last day of the plan year.

(e) *Changes in actuarial assumptions or methods.* The plan administrator must notify the PBGC of any changes in the actuarial assumptions or methods used by the plan. Upon notification of any such change, the PBGC may make any changes to the restoration payment schedule that it deems appropriate.

(f) *Change to restoration method.* A plan that has been restored must use the restoration method until the initial restoration amortization base has been fully amortized. The use of this method does not require prior approval from the Commissioner. A plan using the restoration method must compute the charges to the funding standard account to amortize the initial restoration amortization base in accordance with the order of the PBGC and in accordance with this section.

(g) *Deficit reduction contribution*—(1) *Calculation of deficit reduction contribution.* For any plan using the restoration method, the deficit reduction contribution under section 412(l)(2) is equal to the sum of—

(i) The unfunded section 412(l) restoration liability amount; plus

(ii) The unfunded new liability amount.

(2) *Unfunded section 412(l) restoration liability amount.* The unfunded section 412(l) restoration liability amount is the amount necessary to amortize fully the unfunded section 412(l) restoration liability in installments, as prescribed by the PBGC, over not more than 30 years. The annual amount need not be level, but at all times the present value of the future amortization charges prescribed under the restoration payment schedule, at the current liability interest rate, must equal the outstanding balance of the unfunded section 412(l) restoration liability and the schedule must provide that at the end of no more than 30 years the entire amount of the unfunded section 412(l) restoration liability base will have been fully amortized. The schedule prescribed for amortization of the unfunded section 412(l) restoration liability must comply with the requirements imposed in paragraph (c) of this section on the restoration payment schedule, except as provided in paragraph (g)(7) of this section and except that the maximum permitted outstanding balance of the unfunded section 412(l) restoration liability at the end of the tenth plan year must not be greater than the outstanding balance of the section 412(l)

restoration liability that would have remained at the end of the tenth plan year if the unfunded section 412(l) restoration liability had been amortized in level amounts over the restoration payment period at the actual current liability interest rate for each year, increased by the current liability interest rate differential as defined under paragraph (g)(7) of this section. The unfunded section 412(l) restoration liability amount for the tenth plan year otherwise prescribed under the restoration payment schedule is increased by any outstanding current liability interest rate differential. By issuing an appropriate order, the PBGC may permit the outstanding current liability interest rate differential to be amortized over the tenth through the fourteenth plan years. If the PBGC permits the amortization of the outstanding current liability interest rate differential, then the unfunded section 412(l) restoration liability amount for each year to which an amortization payment is attributed under the order shall be increased by such payment. The outstanding balance otherwise required by paragraph (g)(2) of this section is increased by the outstanding balance, if any, of the base resulting from the amortization of the current liability interest rate differential. The PBGC may amend the amortization schedule for the unfunded section 412(l) restoration liability subject to the limits on amendments to the amortization schedule prescribed for the initial restoration amortization base.

(3) *Establishment of unfunded section 412(l) restoration liability*. In the plan year in which the initial post-restoration valuation date falls, the unfunded section 412(l) restoration liability is equal to the unfunded current liability of the plan.

(4) *Unfunded new liability amount*. In the case of a plan using the restoration method, the unfunded new liability amount is the applicable percentage, as defined in section 412(l)(4)(C), of the unfunded new liability determined under paragraph (g)(5) of this section.

(5) *Unfunded new liability*. The unfunded new liability of a plan using the restoration method is the excess, if any, of the unfunded current liability of the plan, within the meaning of section 412(l)(8)(A) for the plan year (determined without taking into account any unpredictable contingent event benefits, even if the event has occurred) over the outstanding balance of the unfunded section 412(l) restoration liability determined under paragraph (g)(3) of this section.

(6) *Offset of amortization charges*. The amounts charged to the funding standard account pursuant to the restoration payment schedule in order to amortize the initial restoration base, as described in paragraph (d) of this section, must be offset against the deficit reduction contribution in paragraph (g)(1) of this section along with any other applicable amounts provided in section 412(l)(1)(A)(ii).

(7) *Interest rate differential*. During the first 10 plan years after the initial post-restoration valuation date, the restoration payment schedule must prescribe an unfunded section 412(l) restoration liability amount for each plan year that is sufficient to prevent the outstanding balance of the unfunded section 412(l) restoration liability from exceeding the initial amount of the unfunded section 412(l) restoration liability increased by the current liability interest rate differential. The current liability interest rate differential at any point during the first ten years of the restoration payment period is the excess, if any, of the outstanding balance of the unfunded section 412(l) restoration liability determined using the actual current liability interest rate for each year, taking into account the charges described in paragraph (d) of this section, over the outstanding balance of the unfunded section 412(l) restoration liability determined using the lowest, for each year, of the initial current liability interest rate, the current liability interest rate for the computation year, and the valuation interest rate, taking into account the charges described in paragraph (d) of this section.

(h) *Election of the alternative minimum funding standard*. A plan using the restoration method may not elect the alternative minimum funding standard under section 412(g).

(i) *Funding review by the PBGC*. The PBGC must review the funding of any plan using the restoration method at

least once in each plan year. As a result of a funding review, the PBGC may amend the restoration payment schedule as provided in paragraph (c)(3) of this section. As part of the funding review, the Executive Director of the PBGC must certify to the PBGC's Board of Directors, and to the Internal Revenue Service, that the PBGC has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the PBGC deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

[T.D. 8494, 58 FR 54491, Oct. 22, 1993]

§ 1.412(c)(1)–3T Applying the minimum funding requirements to restored plans (temporary).

(a) *In general*—(1) *Restoration method.* The restoration method is a funding method that adapts the underlying funding method of section 412 in the case of certain plans that are or have been terminated and are later restored by the Pension Benefit Guaranty Corporation. The normal operation of the funding standard account, and all other provisions of section 412 and the regulations thereunder, are unchanged except as provided in this § 1.412(c)(1)–3T. Under the restoration method, the Pension Benefit Guaranty Corporation shall determine a restoration payment schedule, extending over no more than 30 years, that replaces all charges and credits to the funding standard account attributable to pre-restoration amortization bases. The restoration payment schedule is determined on the basis of an actuarial valuation of the accrued liability of the plan on the initial post-restoration valuation date less the actuarial value of the plan assets on that date. The initial post-restoration valuation date is the date of the first valuation that falls in the first plan year beginning on or after the later of October 23, 1990, or the date of the restoration order.

(2) *Applicability of restoration method.* A plan must use the restoration method if, and only if:

(i) The plan is being or has been terminated pursuant to section 4041(c) or section 4042 of the Employee Retirement Income Security Act of 1974 (ERISA), and

(ii) The plan has been restored by the Pension Benefit Guaranty Corporation pursuant to its authority under section 4047 of ERISA.

(b) *Computation and effect of the initial restoration amortization base*—(1) *In general.* The initial restoration amortization base is determined under the underlying funding method used by the plan. When the plan uses a spread gain funding method that does not maintain an unfunded liability, the plan must change either to an immediate gain method that directly calculates an accrued liability or to a spread gain method that maintains an unfunded liability. A plan may adopt any cost method that satisfies this requirement and that is acceptable under section 412 and the regulations thereunder, provided that the plan follows the procedures established by the Commissioner for changes in funding methods. The initial restoration amortization base is determined using the valuation for the plan year in which the initial post-restoration valuation date falls. The initial restoration amortization base equals the accrued liability with respect to plan benefit liabilities returned by the Pension Benefit Guaranty Corporation less the value of the plan assets returned by the Pension Benefit Guaranty Corporation. The initial restoration amortization base replaces all prior amortization bases including those under subparagraphs (B), (C), and (D) of section 412(b)(2) and under subparagraph (B) of section 412(b)(3). Any base resulting from a change in funding method is treated as a prior amortization base within the meaning of this paragraph (b). Any accumulated funding deficiency or credit balance in the funding standard account is set equal to zero when the initial restoration amortization base is established.

(2) *Example.* A pension plan uses the calendar year as its plan year, makes

its annual periodic valuation as of January 1, and uses the unit credit actuarial cost method for funding purposes. The plan is in the process of being terminated. By order of the Pension Benefit Guaranty Corporation the plan is restored as of July 1, 1991, and a restoration payment schedule order issued on October 31, 1992. The initial post-restoration valuation date is January 1, 1993. If, as of that date, the accrued liability of the plan is $1,000,000 and the value of the plan assets is $200,000, the initial restoration amortization base is $800,000.

(c) *Establishment of a restoration payment schedule*—(1) *Certification requirement.* When the PBGC establishes a restoration payment schedule, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

(2) *Requirements for restoration payment schedule*—(i) *Amortization of base over period of no more than 30 years.* The restoration payment schedule must be prescribed in an order requiring the employer to make stated contributions to the plan sufficient to amortize the initial restoration amortization base over a period extending not more than 30 years after the initial post-restoration valuation date (the restoration payment period). The restoration payment schedule must be sufficient to amortize the entire amount of the initial restoration amortization base by the end of the restoration payment period. The scheduled charges need not be in level amounts, but the present value of the prescribed charges on the initial post-restoration valuation date, computed with interest at the valuation rate, must equal the initial restoration amortization base.

(ii) *Minimum annual charge.* The restoration payment schedule must require annual charges that are sufficient to prevent the outstanding balance of the initial restoration amortization base from exceeding whichever of the following amounts is applicable:

(A) During the first 10 plan years on the restoration payment schedule, the amount of the initial restoration amortization base on the date the base was established, or

(B) During plan years 11 through 20 on the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the tenth plan year, as calculated under paragraph (c)(2)(iii) below, or

(C) During plan years 21 through the end of the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the twentieth plan year, as calculated under paragraph (c)(2)(iii) below.

(iii) *Interim amortization requirements.* The restoration payment schedule must provide for sufficient periodic charges so that the outstanding balance of the initial restoration amortization base at the end of the tenth plan year and at the end of the twentieth plan year of the restoration payment period will not be larger than the outstanding balance that would have remained at the end of the tenth plan year and at the end of the twentieth plan year, respectively, if the initial restoration amortization base had been amortized in level amounts over the restoration payment period at the valuation rate.

(3) *Amendments to the restoration payment schedule.* The order establishing the restoration payment schedule may be amended by the Pension Benefit Guaranty Corporation from time to time with respect to any remaining payments, provided that no amendment may extend the restoration payment period beyond 30 years from the initial post-restoration valuation date, and provided further that the restoration payment schedule, as amended, satisfies the requirements of paragraph (c)(2) of this section.

(4) *Deferral of minimum scheduled annual payment amounts*—(i) *Authority to grant deferral.* Not later than 2½ months following the end of the plan year, the Pension Benefit Guaranty Corporation may grant a deferral of the charges required in the restoration payment schedule for that plan year if the requirements in paragraph (c)(4)(ii) of this section are satisfied. The Pension Benefit Guaranty Corporation may require the plan sponsor and its controlled group members to provide security to the plan as a condition to granting a deferral.

(ii) *Determination of business hardship.* Before granting a deferral under this paragraph (c)(4), the Pension Benefit Guaranty Corporation must make a determination that the granting of the deferral is in the best interests of plan participants and the plan termination insurance system, and that the plan sponsor and its controlled group members are unable to make the scheduled restoration payments without experiencing temporary substantial business hardship. In making these determinations, the factors the Pension Benefit Guaranty Corporation shall consider, include, but are not limited to, the following:

(A) Whether the plan sponsor and its controlled group members are operating at an economic loss,

(B) Whether there is substantial unemployment or underemployment in the trades or businesses of the plan sponsor and its controlled group members,

(C) Whether the sales and profits of the industry or industries are depressed or declining, and

(D) Whether it is reasonable to expect that the plan termination insurance system will suffer a greater loss if the plan is terminated than if it is continued as a restored plan.

(iii) *Amount of deferral.* The amount of the deferral for any particular plan year may not exceed the lesser of the amount that would have been required to be contributed under the restoration payment schedule for that year or interest on the outstanding balance of the initial restoration amortization base for that year. An amortization payment for a deferral granted for a prior plan year may not be deferred. No deferral may extend the overall restoration payment period beyond 30 years.

(iv) *Modification of payment schedule.* The restoration payment schedule must be adjusted to reflect any deferral granted for a plan year in the manner prescribed in this paragraph (c). The charge otherwise specified in the schedule is reduced by the amount of any deferral. The charges under the restoration payment schedule for the subsequent plan years are increased by the amounts in paragraph (c)(4)(v) of this section.

(v) *Amortization of deferred amount.* The amount of any deferral granted by the Pension Benefit Guaranty Corporation for any plan year must be amortized in level amounts over five years or such shorter period as may be prescribed by the Pension Benefit Guaranty Corporation, at the valuation rate, beginning with the plan year following the year of the deferral.

(vi) *Number of deferrals permitted.* The Pension Benefit Guaranty Corporation may not grant more than five deferrals of the minimum scheduled payments as required by this section during the restoration payment period and no more than three of these deferrals may be granted during the first ten years of that period.

(d) *Charging the scheduled restoration charges to the funding standard account.* In addition to any other charges and credits prescribed in the normal operation of the funding standard account under section 412, the amount of each charge specified in the restoration payment schedule shall be charged against the funding standard account of the plan for the plan year to which that payment is attributed in the restoration payment schedule.

(e) *Changes in actuarial assumptions.* If changes in actuarial assumptions increase or decrease the charges that would be required to amortize the outstanding balance of the initial restoration amortization base over the remaining years of the restoration payment schedule, the plan must notify the Pension Benefit Guaranty Corporation of the changes so that it may make appropriate changes to the restoration payment schedule.

(f) *Change to restoration method.* A plan that has been restored must use the restoration method until the initial restoration amortization base has been fully amortized. The use of this method does not require prior approval from the Commissioner. A plan using the restoration method must compute the charges and credits to the initial restoration amortization base in accordance with the order of the Pension Benefit Guaranty Corporation and in accordance with this section.

(g) *Deficit reduction contribution*—(1) *Calculation of deficit reduction contribution.* For any plan using the restoration method, the deficit reduction contribution under section 412(l)(2) is equal to the sum of—

(i) The unfunded section 412(l) restoration liability amount, plus

(ii) The unfunded new liability amount.

(2) *Unfunded section 412(l) restoration liability amount.* The unfunded section 412(l) restoration liability amount is the amount necessary to amortize fully the unfunded section 412(l) restoration liability in installments, as prescribed by the Pension Benefit Guaranty Corporation, over not more than 30 years. The annual amount need not be level, but at all times the present value of the future amortization charges under the restoration payment schedule, at the current liability interest rate, must equal the outstanding balance of the unfunded section 412(l) restoration liability and the schedule must provide that at the end of no more than 30 years the entire amount of the unfunded section 412(l) restoration liability base will have been fully amortized. The schedule prescribed for amortization of the unfunded section 412(l) restoration liability must comply with the requirements imposed in paragraph (c) of this section on the restoration payment schedule, except as provided in paragraph (g)(7) of this section and except that the maximum permitted outstanding balance of the unfunded section 412(l) restoration liability at the end of the tenth plan year must not be greater than the outstanding balance of the section 412(l) restoration liability that would have remained at the end of the tenth plan year if the unfunded section 412(l) restoration liability had been amortized in level amounts over the restoration payment period at the current liability interest rate, increased by the current liability interest rate differential as defined under paragraph (g)(7) of this section. The Pension Benefit Guaranty Corporation may amend the amortization schedule for the unfunded section 412(l) restoration liability subject to the limits on amendments to the amortization schedule prescribed for the initial restoration amortization base.

(3) *Establishment of unfunded section 412(l) restoration liability.* In the plan year in which the initial post-restoration valuation date falls, the unfunded section 412(l) restoration liability is equal to the unfunded current liability of the plan.

(4) *Unfunded new liability amount.* In the case of a plan using the restoration method, the unfunded new liability amount is the applicable percentage, as defined in section 412(l)(4)(C), of the unfunded new liability determined under paragraph (g)(5) of this section.

(5) *Unfunded new liability.* The unfunded new liability of a plan using the restoration method is the unfunded current liability of the plan for the plan year less the outstanding balance of the unfunded section 412(l) restoration liability determined under paragraph (g)(3) of this section and less any unpredictable contingent event benefit liabilities (without regard to whether or not the event has occurred).

(6) *Offset of amortization charges.* The charges specified in the restoration payment schedule to amortize the initial restoration amortization base, must be offset against the deficit reduction contribution in paragraph (g)(1) of this section along with any other applicable amounts provided in section 412 (l)(1)(A)(ii).

(7) *Interest rate differential.* During the first 10 plan years after the initial post-restoration valuation date, the unfunded section 412(l) restoration liability amount for the plan as determined for purposes of this section must be sufficient to prevent the outstanding balance of the unfunded section 412(l) restoration liability from exceeding the initial amount of the unfunded section 412(l) restoration liability increased by the current liability

interest rate differential. The current liability interest rate differential at any point during the first ten years of the restoration payment period is the excess if any of the accumulated interest on the unfunded section 412(l) restoration liability computed at the current liability interest rate over the accumulated interest on the unfunded section 412(l) restoration liability computed at the least of the valuation rate, the current liability interest rate and current liability interest rate for the plan year in which the initial post restoration valuation date falls. The current liability interest rate differential is charged to the funding standard account at the end of the tenth plan year, but the Pension Benefit Guaranty Corporation may, as part of the restoration payment schedule order, or a modification to that order, direct that the charging of this amount must be spread over not more than 5 years, beginning with the eleventh plan year.

(h) *Election of the alternative minimum funding standard.* A plan using the restoration method may not elect the alternative minimum funding standard under section 412(g).

(i) *Funding review by the Pension Benefit Guaranty Corporation.* The Pension Benefit Guaranty Corporation must review the funding of any plan using the restoration method at least once in each plan year. As a result of a funding review, the Pension Benefit Guaranty Corporation may amend the restoration payment schedule as provided in paragraph (c)(3) of this section. As part of the funding review, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

[T.D. 8317, 55 FR 42707, Oct. 23, 1990; 56 FR 19038, Apr. 25, 1991]

§ 1.412(c)(2)–1 Valuation of plan assets; reasonable actuarial valuation methods.

(a) *Introduction*—(1) *In general.* This section prescribes rules for valuing plan assets under an actuarial valuation method which satisfies the requirements of section 412(c)(2)(A). An actuarial valuation method is a funding method within the meaning of section 412(c)(3) and the regulations thereunder. Therefore, certain changes affecting the actuarial valuation method are identified in this section as changes in a plan's funding method.

(2) *Exception for certain bonds, etc.* The rules of this section do not apply to bonds or other evidences of indebtedness for which the election described in section 412(c)(2)(B) has been made, nor are such assets counted in applying paragraphs (b) or (c) of this section. Also, an election under section 412(c)(2)(B) is not a change in funding method within the meaning of section 412(c)(5).

(3) *Money purchase pension plan.* A money purchase pension plan must value assets for the purpose of satisfying the requirements of section 412(c)(2)(A) solely on the basis of their fair market value (under paragraph (c) of this section).

(4) *Defined benefit plans.* (i) To satisfy the requirements of section 412(c)(2)(A), an actuarial method valuing assets of a defined benefit plan must meet the requirements of paragraph (b) of this section.

(ii) In general, the purpose of paragraph (b) of this section is to permit use of reasonble actuarial valuation methods designed to mitigate short-run changes in the fair market value of plan assets. The funding of plan benefits and the charges and credits to the funding standard account required by section 412 are generally based upon the assumption that the defined benefit plan will be continued by the employer. Thus, short-run changes in the value of plan assets presumably will offset one another in the long term. Accordingly,

in the determination of the amount required to be contributed under section 412 it is generally not necessary to recognize fully each change in fair market value of the assets in the period in which it occurs.

(iii) The asset valuation rules contained in paragraph (b) produce a ''smoothing'' effect. Thus, investment performance, including appreciation or depreciation in the market value of the assets occurring in each plan year, may be recognized gradually over several plan years. This ''smoothing'' is in addition to the ''smoothing'' effect which results, for example, from amortizing experience losses and gains over 15 or 20 years under section 412(b)(2 (B)(iv) and (3)(B)(ii).

(b) *Asset valuation method requirements*—(1) *Consistent basis*. (i) The actuarial asset valuation method must be applied on a consistent basis. Any change in meeting the requirements of this paragraph (b) is a change in funding method subject to section 412(c)(5).

(ii) A method may satisfy the consistency requirement even though computations are based only on the period elapsed since the adoption of the method or on asset values occurring during that period.

(2) *Statement of plan's method*. The method of determining the actuarial value (but not fair market value) of the assets must be specified in the plan's actuarial report (required under section 6059). The method must be described in sufficient detail so that another actuary employing the method described would arrive at a reasonably similar result. Whether a deviation from the stated actuarial valuation method is a change in funding method is to be determined in accordance with section 412(c)(5) and the regulations thereunder. A deviation to include a type of asset not previously held by the plan would not be a change in funding method.

(3) *Consistent valuation dates*. The same day or days (such as the first or the last day of a plan year) must be used for all purposes to value the plan's assests for each plan year, or portion of plan year, for which a valuation is made. For purposes of this section, each such day is a valuation date. A change in the day or days used is a change in funding method.

(4) *Reflect fair market value*. The valuation method must take into account fair market value by making use of the—

(i) Fair market value (determined under paragraph (c) of this section), or

(ii) Average value (determined under paragraph (b)(7) of this section) of the plan's assets as of the applicable asset valuation date. This is done either directly in the computation of their actuarial value or indirectly in the computation of upper or lower limits placed on that value.

(5) *Results above and below fair market or average value*. A method will not satisfy the requirements of this paragraph (b) if it is designed to produce a result which will be consistently above or below the values described in paragraph (b)(4) (i) and (ii). However, a method designed to produce a result which consistently falls between fair market value and average value will satisfy this requirement. See Example (5) in paragraph (b)(9) of this section for an illustration of a method described in the preceding sentence.

(6) *Corridor limits*. (i) Regardless of how the method reflects fair market value under paragraph (b)(4), the method must result in an actuarial value of the plan's assets which is not less than a minimum amount and not more than a maximum amount. The minimum amount is the lesser of 80 percent of the current fair market value of plan assets as of the applicable asset valuation date or 85 percent of the average value (as described in subparagraph (7)) of plan assets as of that date. The maximum amount is the greater of 120 percent of the current fair market value of plan assets as of the applicable asset valuation date or 115 percent of the average value of plan assets as of that date.

(ii) Under a plan's method, a preliminary computation of the expected actuarial value may fall outside the prescribed corridor. A method meets the requirements of paragraph (b)(6)(i) of this section is such a case only by adjusting the expected actuarial value to the nearest corridor limit applicable under the method. A plan may use an

actuarial valuation method with a narrower corridor than the general corridor required under paragraph (b)(6)(i). The adjustment to the nearest corridor limit of such a method for purposes of this subdivision (ii) would be determined by the narrower corridor stated in the description of the plan's method.

(7) *Average value.* the average value of plan assets is computed by—

(i) Determining the fair market value of plan assets at least annually,

(ii) Adding the current fair market value of the assets (as of the applicable valuation date) and their adjusted values (as described in paragraph (b)(8) of this section) for a stated period not to exceed the five most recent plan years (including the current year), and

(iii) Dividing this sum by the number of values (including the current fair market value) considered in computing the sum described in subdivision (ii).

(8) *Adjusted value.* (i) the adjusted value of plan assets for a prior valuation date is their fair market value on that date with certain positive and negative adjustments. These adjustments reflect changes that occur between the prior asset valuation date and the current valuation date. However, no adjustment is made for increases or decreases in the total value of plan assets that result from the purchase, sale, or exchange of plan assets or from the receipt of payment on a debt obligation held by the plan.

(ii) In determining the adjusted value of plan assets for a prior valuation date, there is added to the fair market value of the plan assets of that date the sum of all additions to the plan assets since that date, excluding appreciation in the fair market value of the assets. The additions would include, for example, any contribution to the plan; any interest or dividend paid to the plan; and any asset not taken into account in a prior valuation of assets, but taken into account for the current year, in computing the fair market value of plan assets under paragraph (c) of this section.

(iii) In determining the adjusted value of plan assets for a prior valuation date, there is subtracted from the fair market value of the plan assets on that date the sum of all reductions in plan assets since that date, excluding depreciation in the fair market value of the assets. The reductions would include, for example, any benefit paid from plan assets; any expense paid from plan assets; and any asset taken into account in a prior valuation of assets but not taken into account for the current year, in computing the fair market value of plan assets under paragraph (c) of this section.

(9) *Examples.* This paragraph (b) may be illustrated by the following examples. In each example, assume that the pension plan uses a consistent actuarial method of valuing its assets within the meaning of paragraph (b)(1), (2), and (3) of this section.

Example (1). Plan A considers the value of its assets to be initial cost, increased by an assumed rate of growth of X percent annually. Under the circumstances, the X-percent factor used by the plan is a reasonable assumption. Thus, this method is not designed to produce results consistently above or below fair market value as prohibited by paragraph (b)(5) of this section. Also, the method requires that the actuarial value be adjusted as required to fall within the corridor under paragraph (b) (6) and (7) of this section. Therefore, the method reflects fair market value as required by paragraph (b)(4) of this section.

Example (2). Plan B computes the actuarial value of its assets as follows: It determines the fair market value of the plan assets. Then the fair market value is adjusted to the extent necessary to make the actuarial value fall within a ''5 percent'' corridor. This corridor is plus or minus 5 percent of the following amount: the fair market value of the assets at the beginning of the valuation period plus an assumed annual growth of 4 percent with adjustments for contributions and benefit payments during the period. This method reflects fair market value in a manner prescribed by paragraph (b)(4) of this section. If the 4 percent factor used by the plan is a reasonable assumption, this method is not designed to produce results consistently above or below fair market value, and thus it satisfies paragraph (b)(5). However, this method is unacceptable because in some instances it may result in an actuarial value outside the corridor described in paragraph (b)(6) of this section. This method would be permitted if a second corridor were imposed which would adjust the value of the total plan assets to the corridor limits as required by paragraph (b)(6).

Example (3). Plan C values its assets by multiplying their fair market value by an index number. The use of the index results in the hypothetical average value that plan assets present on the valuation date would

have had if they had been held during the current and four preceding years, and had appreciated or depreciated at the actual yield rates including appreciation and depreciation experienced by the plan during that period. However, the method requires an adjustment to the extent necessary to bring the resulting actuarial value of the assets inside the corridor described in the statement of the plan's actuarial valuation method. In this case, the stated corridor is 90 to 110 percent of fair market value, a corridor narrower than that described in paragraph (b)(7) of this section. This method is permitted.

Example (4). Plan D values its assets by multiplying their fair market value by 95 percent. Although the method reflects fair market value and the results of this method will always be within the required corridor, it is not acceptable because it will consistently result in a value less than fair market value.

Example (5). Plan E values its assets by using a five-year average method with appropriate adjustments for the period. Under the particular method used by Plan E, assets are not valued below 80 percent of fair market value or above 100 percent of fair market value. If the average produces a value that exceeds 100 percent of fair market value, the excess between 100 and 120 percent is recorded in a ''value reserve account.'' In years after one in which the average exceeds 100 percent of fair market value, amounts are subtracted from this account and added, to the extent necessary, to raise the value produced by the average for that year to 100 percent of fair market value. This method is permitted because it reflects fair market value under paragraph (b)(4) of this section by appropriately computing an average value, it satisfies paragraph (b)(5) by producing a result that falls consistently between fair market value and average value, and it properly reflects the corridor described in paragraph (b)(7).

Example (6). All assets of Plan F are invested in a trust fund and the plan year is the calendar year. The actuarial value is determined by averaging fair market value over 4 years. An actuarial valuation is performed as of December 31, 1988.

(i) The average value as of December 31, 1988, is computed as follows:

	1986	1986	1987	1987	1988	1988
Fair market value: Jan. 1	.....	$150,000	.....	$196,500	.....	$238,000
Contributions	$65,000	.....	$62,000	.....	$66,000	.....
Benefit payments	(22,000)	.....	(24,000)	.....	(25,000)	.....
Expenses	(6,500)	.....	(7,000)	.....	(7,500)	.....
Interest and dividends	8,000	44,500	7,500	38,500	7,000	240,500
Net realized gains (losses)	.....	(2,000)	.....	6,000	.....	(8,000)
Balancing item [1]	.....	4,000	.....	(3,000)	.....	(42,000)
Fair market value: Dec. 31	.....	196,500	.....	238,000	.....	228,000

[1] This equals the increase (decrease) in unrealized appreciation.

Adjusted values	1985	1986	1987	1988
Fair market value: Dec. 31	$150,000	$196,500	$238,000	$228,000
Net adjustments:				
1988	40,500	40,500	40,500	.....
1987	38,500	38,500	.....	.....
1986	44,500	.....	.....	.....
Total	273,500	275,500	278,500	228,000

Average value: 1988=$273,500 + $275,500 + $278,500 + $228,000 ÷ 4=$263,875

(ii) Plan F properly determines an average value under paragraph (b)(7) of this section for use as an actuarial value. Therefore, the valuation method meets the requirements of this section.

Example (7). Plan G computes the actuarial value of the plan assets as follows: The current fair market value of the plan assets is averaged with the most recent prior adjusted actuarial value. This average value is adjusted up or down toward the current fair market value by 20 percent of the difference between it and the current fair market value of the assets. This value is further adjusted to the extent necessary to fall within the corridor described in the statement of the plan's actuarial valuation method. The lower end of the corridor is the lesser of 80 percent of the fair market value of the plan assets or 85 percent of the average value of the plan assets. The higher end of the corridor is the greater of 120 percent of the fair market value of plan assets or 115 percent of the average value of plan assets. Average value for purposes of the corridor is determined under paragraph (b)(7) of this section. Assuming

the numerical data of Example (6), the application of the corridor is as follows. The actuarial asset value as of December 31, 1988, must not be less than $182,400 (80 percent of current fair market value, $228,000) nor greater than $303,456 (115 percent of average value, 263,875). This method is permitted because it reflects fair market value in a manner permitted by paragraph (b)(4) of this section, it produces an actuarial value which is neither consistently above nor consistently below fair market or average value to satisfy paragraph (b)(5), and it is appropriately limited by the corridor described in paragraph (b)(6).

(c) *Fair market value of assets*—(1) *General rules*. Except as otherwise provided in this paragraph (c), the fair market value of a plan's assets for purposes of this section is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

(d) *Methods for taking into account the fair market value of certain agreements*. [Reserved]

(e) *Effective date and transition rules*—(1) *Effective date*. This section applies to plan years to which section 412, or section 302 of the Employee Retirement Income Security Act of 1974, applies.

(2) *Special rule for certain plan years*. For plan years beginning prior to November 12, 1980, the amounts required to be determined under section 412 may be computed on the basis of any reasonable actuarial method of asset valuation which takes into account the fair market value of the plan's assets, even if the method does not meet all of the requirements of paragraphs (a) through (c) of this section.

(3) *Plan years beginning on or after November 12, 1980*. Paragraphs (a) through (c) of this section apply beginning with the first valuation of plan assets made for a plan year to which section 412 applies that begins on or after November 12, 1980. The statement of the plan's actuarial asset valuation method required by paragraph (b)(2) of this section must be included with the plan's actuarial report for that year, in addition to any subsequent reports.

(4) *Effect of change of asset valuation method*. A plan which is required to change its asset valuation method to comply with paragraphs (a) through (c) of this section must make the change no later than the time when the plan is first required to comply with this section under paragraph (e)(3). A method of adjustment must be used to take account of any difference in the actuarial value of the plan's assets based on the old and new valuation methods. The plan may use either—

(i) A method of adjustment described in paragraph (e)(5) or (e)(6) of this section without prior approval by the Commissioner, or

(ii) Any other method of adjustment if the Commissioner gives prior approval under section 412(c)(5).

(5) *Retroactive recomputation method*. (i) Under this method of adjustment, the plan recomputes the balance of the funding standard account as of the beginning of the first plan year for which it uses its new asset valuation method to comply with paragraphs (a) through (c) of this section. This new balance is recomputed by retroactively applying the plan's new method as of the first day of the first plan year to which section 412 applies.

(ii) Beginning with the first plan year for which it uses its new method, the plan computes the normal cost and amortization charges and credits to the funding standard account based on the retroactive application of its new method as of the first day of the first plan year to which section 412 applies.

(iii) If the recomputed aggregate charges exceed the recomputed aggregate credits to the funding standard account as of the end of the first plan year for which the plan uses its new method, an additional contribution to the plan may be necessary to avoid an accumulated funding deficiency in that year. The use of the retroactive recomputation method may also result in an accumulated funding deficiency for years prior to that first year. In such cases, the rules of section 412(c)(10), relating to the time when certain contributions are deemed to have been made, apply.

(6) *Prospective gain or loss adjustment method*. (i) Under this method of adjustment the plan values its assets under its new method no later than the valuation date for the first plan year beginning after [the publication date of this section]

(ii) Regardless of the type of funding method used by a plan, the difference in the value of the assets under the old and the new asset valuation methods may be treated as arising from an experience loss or gain; or alternatively it may be treated as arising from a change in actuarial assumptions.

(iii) The treatment of this difference as an experience gain or loss or as a change in actuarial assumptions must be consistent with the treatment of such gains, losses, or changes under the funding method used by the plan. Thus, if a plan uses a spread gain type funding method other than the aggregate cost method, the difference in the value of assets under the old and the new asset valuation methods may be either amortized or spread over future periods as a part of normal cost. Examples of this type of funding method are the frozen initial liability cost method and the attained age normal cost method. With an aggregate method, the difference in the value of assets under the old and the new asset valuation methods must be spread over future periods as a part of normal cost.

(Secs. 412(c)(2) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 916 and 68A Stat. 917; 26 U.S.C. 412(c)(2) and 7805))

[T.D. 7734, 45 FR 74718, Nov. 12, 1980]

§ 1.412(c)(3)–1 Reasonable funding methods.

(a) *Introduction*—(1) *In general.* This section prescribes rules for determining whether or not, in the case of an ongoing plan, a funding method is reasonable for purposes of section 412(c)(3). A method is unreasonable only if it is found to be inconsistent with a rule prescribed in this section. The term ''reasonable funding method'' under this section has the same meaning as the term ''acceptable actuarial cost method'' under section 3(31) of the Employee Retirement Income Security Act of 1974 (ERISA).

(2) *Computations included in method.* See § 1.412(c)(1)–1(b) for a discussion of matters that are, and are not, included in the funding method of a plan.

(3) *Plans using shortfall.* The shortfall method is a method of determining charges to the funding standard account by adapting the underlying funding method of certain collectively bargained plans in the manner described in § 1.412(c)(1)–2. As such, the shortfall method is a funding method. The underlying method of a plan that uses the shortfall method must be a reasonable funding method under this section. The rules contained in this section, relating to cost under a reasonable funding method, apply in the shortfall method to the annual computation charge under § 1.412(c)(1)–2(d).

(4) *Scope of funding method.* Except for the shortfall method, a reasonable funding method is applied to the computation of—

(i) The normal cost of a plan for a plan year; and, if applicable,

(ii) The bases established under section 412(b)(2)(B), (C), and (D), and (3)(B) (''amortizable bases'').

(b) *General rules for reasonable funding methods*—(1) *Basic funding formula.* At any time, except as provided by the Commissioner, the present value of future benefits under a reasonable funding method must equal the sum of the following amounts:

(i) The present value of normal costs (taking into account future mandatory employee contributions, within the meaning of section 411(c)(2)(C), in the case of a contributory plan) over the future working lifetime of participants;

(ii) The sum of the unamortized portions of amortizable bases, if any, treating credit bases under section 412(b)(3)(B) as negative numbers; and

(iii) The plan assets, decreased by a credit balance (and increased by a debit balance) in the funding standard account under section 412(b).

(2) *Normal cost.* Normal cost under a reasonable funding method must be expressed as—

(i) A level dollar amount, or a level percentage of pay, that is computed from year to year on either an individual basis or an aggregate basis; or

(ii) An amount equal to the present value of benefits accruing under the method for a particular plan year.

(3) *Application to shortfall.* Paragraph (b)(2) will not fail to be satisfied merely because an amount described in (i) or (ii) is expressed as permitted under the shortfall method.

(c) *Additional requirements*—(1) *Inclusion of all liabilities.* Under a reasonable

funding method, all liabilities of the plan for benefits, whether vested or not, must be taken into account.

(2) *Production of experience gains and losses.* If each actuarial assumption is exactly realized under a reasonable funding method, no experience gains or losses are produced.

(3) *Plan population*—(i) *In general.* Under a reasonable funding method, the plan population must include three classes of individuals: participants currently employed in the service of the employer; former participants who either terminated service with the employer, or retired, under the plan; and all other individuals currently entitled to benefits under the plan. See §1.412(c)(3)–1(d)(2) for rules concerning anticipated future participants.

(ii) *Limited exclusion for certain recent participants.* Under a reasonable funding method, certain individuals may be excluded from the first class of individuals described in paragraph (c)(3)(i) of this section unless otherwise provided by the Commissioner. The excludable individuals are participants who would be excluded from participation by the minimum age or service requirement of section 410 but who, under the terms of the plan, participate immediately upon entering the service of the employer.

(iii) *Special exclusion for ''rule of parity'' cases.* Under a reasonable funding method, certain individuals may be excluded from the second class of individuals described in paragraph (c)(3)(i) of this section. The excludable individuals are those former participants who have terminated service with the employer without vested benefits and whose service might be taken into account in future years because the ''rule of parity'' of section 411(a)(6)(D) does not permit that service to be disregarded. However if the plan's experience as to separated employees' returning to service has been such that the exclusion described in this subparagraph would be unreasonable, the exclusion would no longer apply.

(4) *Use of salary scale*—(i) *General acceptability.* The use of a salary scale assumption is not inappropriate merely because of the funding method with which it is used. Therefore, in determining whether actuarial assumptions are reasonable, a salary scale will not be considered to be prohibited merely because a particular funding method is being used.

(ii) *Projection to appropriate salary.* Under a reasonable funding method, salary scales reflected in projected benefits must be the expected salary on which benefits would be based under the plan at the age when the receipt of benefits is expected to begin.

(5) *Treatment of allocable items.* Under a reasonable funding method that allocates assets to individual participants to determine costs, the allocation of assets among participants must be reasonable. An initial allocation of assets among participants will be considered reasonable only if it is in proportion to related liabilities. However, the Commissioner may determine, based on the facts and circumstances, that it is unreasonable to continue to allocate assets on this basis beyond the initial year. Under a reasonable funding method that allocates liabilities among different elements of past and future service, the allocation of liabilities must be reasonable.

(d) *Prohibited considerations under a reasonable funding method*—(1) *Anticipated benefit changes*—(i) *In general.* Except as otherwise provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year.

(ii) *Exception for collectively bargained plans.* A collectively bargained plan described in section 413(a) may on a consistent basis anticipate benefit increases scheduled to take effect during the term of the collective-bargaining agreement applicable to the plan. A plan's treatment of benefit increases scheduled in a collective bargaining agreement is part of its funding method. Accordingly, a change in a plan's treatment of such benefit increases (for example, ignoring anticipated increases after taking them into account) is a change of funding method.

(2) *Anticipated future participants.* A reasonable funding method must not anticipate the affiliation with the plan of future participants not employed in the service of the employer on the plan

valuation date. However, a reasonable funding method may anticipate the affiliation with the plan of current employees who have not satisfied the participation requirements of the plan.

(e) *Special rules for certain funding methods*—(1) *Applicability of special rules*. Paragraph (e) of this section applies to a funding method that determines normal cost under paragraph (b)(2)(ii) of this section.

(2) *Use of salary scale*. For rules relating to use of a salary scale assumption, see paragraph (c)(4) of this section.

(3) *Allocation of liabilities*. In determining a plan's normal cost and accrued liability for a particular plan year, the projected benefits of the plan must be allocated between past years and future years. Except in the case of a career average pay plan, this allocation must be in proportion to the applicable rates of benefit accrual under the plan. Thus, the allocation to past years is effected by multiplying the projected benefit by a fraction. The numerator of the fraction is the participant's credited years of service. The denominator is the participant's total credited years of service at the anticipated benefit commencement date. Adjustments are made to account for changes in the rate of benefit accrual. An allocation based on compensation is not permitted. In the case of a career average pay plan, an allocation between past and future service benefits must be reasonable.

(f) *Treatment of ancillary benefit costs*—(1) *General rule*. Under a reasonable funding method, except as otherwise provided by this paragraph (f), ancillary benefit costs must be computed by using the same method used to compute retirement benefit costs under a plan.

(2) *Ancillary benefit defined*. For purposes of this paragraph an ancillary benefit is a benefit that is paid as a result of a specified event which—

(i) Occurs not later than a participant's separation from service, and

(ii) Was detrimental to the participant's health.

Thus, for example, benefits payable if a participant dies or becomes disabled prior to separation from service are ancillary benefits because the events giving rise to the benefits are detrimental to the participant's health. However, an early retirement benefit, a social security supplement (as defined in §1.411(a)–7(c)(4)(ii)), and the vesting of plan benefits (even if more rapid than is required by section 411) are not ancillary benefits because those benefits do not result from an event which is detrimental to the participant's health.

(3) *Exception for certain insurance contracts*. Under a reasonable funding method, regardless of the method used to compute retirement benefit costs, the cost of an ancillary benefit may equal the premium paid for that benefit under an insurance contract if—

(i) The ancillary benefit is provided under the contract, and

(ii) The benefit is guaranteed under the contract.

(4) *Exception for 1-year term funding and other approved methods*. [Reserved]

(5) *Section 401(h) benefits*. Section 412 does not apply to benefits that are described in section 401(h) and for which a separate account is maintained.

(g) *Examples*. The principles of this section are illustrated by the following examples:

Example (1). Assume that a plan, using funding method A, is in its first year. No contributions have been made to the plan, other than a nominal contribution to establish a corpus for the plan's trust. There is no past service liability, and the normal cost is a constant percentage of an annually determined amount. The constant percentage is 99 percent, and the annually determined amount is the excess of the present value of future benefits over plan assets. The present value of future benefits is $10,000. Under paragraph (b)(1) of this section, the present value of future benefits must equal the present value of future normal costs plus plan assets. (No amortizable bases exist, nor are there credit or debit balances.) Under method A, the present value of future normal costs would equal the sum of a series of annually decreasing amounts. Because of the constant percentage factor, the present value of future normal costs over the years can never equal $10,000, the present value of future benefits. In effect, then, assets under method A can never equal the present value of future benefits if all assumptions are exactly realized. Therefore, method A is not a reasonable funding method.

Example (2). Assume that a plan, using funding method B, determines normal cost by computing the present value of benefits expected to be accrued under the plan by the

end of 10 years after the valuation date and adding to this the present value of benefits expected to be paid within these 10 years. Plan assets are subtracted from the sum of the two present value amounts. The difference then is divided by the present value of salaries projected over the 10 years. Under paragraph (c)(1) of this section, all liabilities of a plan must be taken into account. Because method B takes into account only benefits paid or accrued by the end of 10 years, it is not a reasonable funding method.

Example (3). Assume that a plan, using funding method C, determines normal cost as a constant percentage of compensation. (This percentage is determined as follows: The excess of projected benefits over accrued benefits is computed. Then the present value of this excess is divided by the present value of future salaries.) However, the accrued liability is computed each year as the present value of accrued benefits. (This computation does not reflect normal cost as a constant percentage of compensation. Thus, normal cost under the plan does not link accrued liabilities under the plan for consecutive years as would be the case, for example, under a unit credit cost method.) In determining gains and losses, method C compares the actual unfunded liability (the accrued liability less assets) with the expected unfunded liability (the sum of the actual unfunded liability in the previous year and the normal cost for the previous year less the contribution made for the previous year, all adjusted for interest). Under paragraph (c)(2) of this section, if actuarial assumptions are exactly realized, experience gains and losses must not be produced. Under method C, the use of a constant percentage in computing normal cost (and the expected unfunded liability) coupled with the manner of computing the accrued liability (and the actual unfunded liability) generally produces gains in the earlier years and losses in the later years if each actuarial assumption is exactly realized. Therefore, method C is not a reasonable funding method.

Example (4). Assume that a plan, using funding method D, bases benefits on final average pay. Under method D, the past service liability on any date equals the present value of the accrued benefit on that date based on compensation as of that date. The normal cost for any year equals the present value of a certain amount. That amount is the excess of the projected accrued benefit as of the end of the year over the actual accrued benefit at the beginning of the year. Accrued benefits, projected as of the end of a year, reflect a 1-year salary projection. Under paragraph (c)(4) of this section, salary scales reflected in projected benefits must project salaries to the salary on which benefits would be based under the plan at the age when the receipt of benefits under the plan is expected to begin. Because the plan is not a career average pay plan and compensation is projected only 1 year, method D is not a reasonable funding method. (Under paragraph (c)(4) of this section, the use of a salary scale assumption could be required with a unit credit method if, without the use of a salary scale, assumptions in the aggregate are unreasonable.)

Example (5). Assume that a plan, using method E, a unit credit funding method, calculates a participant's accrued benefit according to the following formula: 2 percent of final salary for the first 10 years of service and 1 percent of final salary for the years of service in excess of 10. Under the plan, no employee may be credited with more than 25 years of service. The actuarial assumptions for the valuation include a salary scale of 5 percent per year. For a participant at age 40 with 15 years of service, a current salary of $20,000 and a normal retirement age of 65, the accrued liability for the retirement benefit is the present value of an annuity of $16,932 per year, commencing at age 65. The $16,932 is calculated as follows:

$$\$20{,}000 \times 3.3864 \times 35\% \times \frac{(10 \times 2) + (5 \times 1)}{(10 \times 2) - (15 \times 1) + (15 \times 0)}$$

(3.3864 is 1.05 raised to the 25th power; the 25th power reflects the difference between normal retirement age and attained age (65–40).)

Salary under this method is projected to the age when the receipt of benefits is expected to begin. Therefore, method E meets the requirement of paragraph (c)(4) of this section. Also, the allocation of benefits under method E between past and future years of service meets the requirements of paragraph (e)(3) of this section.

Example (6). Assume that a plan that has two participants and that previously used the unit credit cost method wishes to change the funding method at the beginning of the plan year to funding method F, a modification of the aggregate cost method. The modification involves determining normal cost for each of the two participants under the plan. Therefore, it requires an allocation of assets to each participant for valuation purposes. The actuary proposes to allocate the assets on hand at the beginning of the plan

year of the change in funding method in proportion to the accrued liabilities calculated under the unit credit cost method. The relevant results of the calculations are shown below:

	Employees		Totals
	M	N	
Accrued Liabilities (unit credit method):			
Dollar amount	15,670	906	16,576
Per cent of total	94.53	5.47	100.00
Assets:			
Dollar amount	7,835	453	8,288
per cent of total	94.53	5.47	100.00

The proposed allocation in proportion to the accrued liabilities under the unit credit cost method satisfies the requirements of paragraph (c)(5) of this section at the beginning of the first plan year for which the new method is used.

Example (7). The facts are the same as in Example (6). However, the actuary proposes to allocate all the assets to employee M, the older employee. Method F, under these facts, is not an acceptable funding method because the allocation is not in proportion to related liabilities as required under paragraph (c)(5) of this section.

[T.D. 7746, 45 FR 86430, Dec. 31, 1980]

§ 1.412(c)(3)–2 Effective dates and transitional rules relating to reasonable funding methods.

(a) *Introduction.* This section prescribes effective dates for rules relating to reasonable funding methods, under section 412(c)(3) and § 1.412(c)(3)–1. Also, this section sets forth rules concerning adjustments to a plan's funding standard account that are necessitated by a change in funding method, and a provision setting forth procedural requirements for use of an optional phase-in of required changes.

(b) *Effective date*—(1) *General rule.* Except as otherwise provided by subparagraph (2) of this paragraph, § 1.412(c)(3)–1 applies to any valuation of a plan's liabilities (within the meaning of section 412(c)(9)) as of a date after April 30, 1981.

(2) *Exception.* If a collective bargaining agreement which determines contributions to a plan is in effect on April 30, 1981, then § 1.412(c)(3)–1 applies to any valuation of that plan's liabilities as of a date after the earlier of the date on which the last such collective bargaining agreement expires or April 30, 1984.

(3) *Transitional rule.* The reasonableness of a funding method used in making a valuation of a plan's liability as of a date before the effective date determined under subparagraph (1) or (2) of this paragraph is determined on the basis of such published guidance as was available on the date as of which the valuation was made.

(c) *Change of funding method without approval*—(1) *In general.* A plan that is required to change its funding method to comply with § 1.412(c)(3)–1 is not required to submit the change of funding method for approval as otherwise required by section 412(c)(5). However, this change must be described on Form 5500, Schedule B for the plan year with respect to which the change is first effective.

(2) *Amortization base.* An amortization base must be established in the plan year of the change in method equal to the change in the unfunded liability due to the change (where both unfunded liabilities are based on the same actuarial assumptions). Such a base must be amortized over 30 years in determining the charges or credits to the funding standard account, unless the Commissioner upon application permits amortization over a shorter period.

(d) *Phase-in of additional funding required by new method*—(1) *In general.* A plan that is required to change its funding method to comply with § 1.412(c)(3)–1 may elect to charge and credit the funding standard account as provided in this paragraph. An election under this paragraph shall be irrevocable.

(2) *Credit in year of change.* In the plan year of the change in method the funding standard account may be credited with an amount not in excess of 0.8 multiplied by the excess (if any) of—

(i) The normal cost under the new method plus the amortization charge (or minus the amortization credit) computed as described in § 1.412(c)(3)–2(c)(2), over

(ii) The normal cost under the prior method, for the plan year of the change in method.

(3) *Credits in the next three years.* In the three years following the year of the change the funding standard account may be credited with an amount

not in excess of 0.6, 0.4, and 0.2 respectively in the first, second, and third years, multiplied by either of the following amounts, computed as of the last day of the year of credit—

(i) The excess described in §1.412(c)(3)–2(d)(2) multiplied by a fraction (not greater than 1), the numerator of which is the number of participants in the year of the credit and the denominator of which is the number of participants in the year of the change, or, at the option of the plan,

(ii) The excess (if any) in the year of credit of—

(A) The net charge to the funding standard account based on the new method, over

(B) The net charge to the funding standing account based on the prior method.

(4) *Computational rules.* For purposes of the calculation described in §1.412(c)(3)–2(d)(3)(ii), the net charge is the excess of charges under section 412(b)(2) (A) and (B) over the credits under section 412(b)(3)(B) (including the charge or credit described in §1.412(c)(3)–2(c)) which would be required using the actuarial assumptions and plan benefit structure in effect on the last day of the plan year of change.

(5) *Fifteen-year amortization of credits.* The funding standard account shall be charged with 15-year amortization of each credit described in §1.412(c)(3)–2(d)(2) and (3) beginning in the year following each such credit.

(6) *Manner of election.* An election under this paragraph shall be made by the claiming of the credits described in §1.412(c)(3)–2(d) (2) and (3) on Schedule B to Form 5500 and by filing such other information as may be required by the Commissioner.

(e) *Effect on shortfall method.* The charges and credits described in this section apply in the shortfall method to the annual computation charge described in §1.412(c)(1)–2(d). The amounts described in §1.412(c)(3)–2(d) shall be determined before the application of the shortfall method.

(Sec. 3(31) of the Employee Retirement Income Security Act of 1974 (88 Stat. 837; 29 U.S.C. 1002) and sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7746, 45 FR 86432, Dec. 31, 1980]

§1.412(i)–1 Certain insurance contract plans.

(a) *In general.* Under section 412(h)(2) of the Internal Revenue Code of 1954, as added by section 1013(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 914) (hereinafter referred to as ''the Act''), an insurance contract plan described in section 412(i) for a plan year is not subject to the minimum funding requirements of section 412 for that plan year. Consequently, if an individual or group insurance contract plan satisfies all of the requirements of paragraph (b)(2) or (c)(2) of this section, whichever are applicable, for the plan year, the plan is not subject to the requirements of section 412 for that plan year. The effective date for section 412 of the Code is determined under section 1017 of the Act. In general, in the case of a plan which was not in existence on January 1, 1974, this section applies for plan years beginning after September 2, 1974, and in the case of a plan in existence on January 1, 1974, to plan years beginning after December 31, 1975.

(b) *Individual insurance contract plans.* (1) An individual insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of paragraph (b)(2) of this section for the plan year.

(2) The requirements of this paragraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies (licensed under the law of a State or the District of Columbia to do business with the plan) of individual annuity or individual insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of individual annuity or individual insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (relating to accrued benefit from employee contributions).

(ii) 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 became 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 annual 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 normal retirement age, 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.

(iii) The benefits provided by the plan for each individual participant must be equal to the benefits provided under his individual contracts at his normal retirement age under the plan provisions.

(iv) The benefits provided by the plan for each individual participant must be guaranteed by the life insurance company, described in paragraph (b)(2)(i) of this section, issuing the individual contracts to the extent premiums have been paid.

(v) Except as provided in the following sentence, all premiums payable for the plan year, and for all prior plan years, under the insurance or annuity contracts must have been paid before lapse. If the lapse has occurred during the plan year, the requirements of this subdivision will be considered to have been met if reinstatement of the insurance policy, under which the individual insurance contracts are issued, occurs during the year of the lapse and before distribution is made or benefits commence to any participant whose benefits are reduced because of the lapse.

(vi) No rights under the individual contracts may have been subject to a security interest at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the security interest is created after the date of distribution.

(vii) No policy loans, including loans to individual participants, on any of the individual contracts may be outstanding at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the loan is made after the date of distribution. An application of funds by the issuer to pay premiums due under the contracts shall be deemed not to be a policy loan if the amount of the funds so applied, and interest thereon, is repaid during the plan year in which the funds are applied and before distribution is made or benefits commence to any participant whose benefits are reduced because of such application.

(c) *Group insurance contract plans.* (1) A group insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of subparagraph (2) for the plan year.

(2) The requirements of this subparagraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies, described in paragraph (b)(2)(i) of this section, of group annuity or group insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of group annuity or group insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411 (c)(2) (relating to accrued benefit derived from employee contributions).

(ii) In the case of a plan funded by a group insurance contract or a group annuity contract the requirements of paragraph (b)(2)(ii) of this section must be satisfied by the group contract issued under the plan. Thus, for example, each individual participant's benefits under the group contract must be provided for by level annual, or more frequent, payments equivalent to the payments required to satisfy such paragraph. The requirements of this subdivision will not be satisfied if benefits for any individual are not provided for by level payments made on his behalf under the group contract.

(iii) The group annuity or group insurance contract must satisfy the requirements of clauses (iii), (iv), (v), (vi), and (vii) of paragraph (b)(2). Thus, for example, each participant's benefits provided by the plan must be equal to his benefits provided under the group contract at his normal retirement age.

(iv)(A) If the plan is funded by a group annuity contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual annuity contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(B) If the plan is funded by a group insurance contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participate under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual insurance contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(v) Under the group annuity or group insurance contract, premiums or other consideration received by the insurance company (and, if a custodial account or trust is used, the custodian or trustee thereof) must be allocated to purchase individual benefits for participants under the plan. A plan which maintains unallocated funds in an auxiliary trust fund or which provides that an insurance company will maintain unallocated funds in a separate account, such as a group deposit administration contract, does not satisfy the requirements of this subdivision.

(d) *Combination of plans*. A plan which is funded by a combination of individual contracts and a group contract shall be treated as a plan described in section 412 (i) for the plan year if the combination, in the aggregate, satisfies the requirements of this section for the plan year.

[T.D. 7746, 45 FR 47676, July 16, 1980; 45 FR 50563, July 30, 1980]0

§ 1.413–1 Special rules for collectively bargained plans.

(a) *Application of section 413(b) to certain collectively bargained plans*—(1) *In general*. Section 413(b) sets forth special rules applicable to certain pension, profit-sharing, and stock bonus plans (and each trust which is a part of such a plan), hereinafter referred to as ''section 413(b) plans'', described in paragraph (a)(2) of this section. Notwithstanding any other provision of the Code, a section 413(b) plan is subject to the special rules of section 413(b) (1) through (8) and paragraphs (b) through (i) of this section.

(2) *Requirements*. Section 413(b) applies to a plan (and each trust which is a part of such plan) if the plan is a single plan which is maintained pursuant to one or more agreements which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers. A plan which provides benefits for employees of more than one employer is considered a single plan subject to the requirements of section 413(b) and this section if the plan is considered a single plan for purposes of applying section 414(l) (see § 1.414(l)–1(b)(1)). For purposes of determining whether one or more plans (or agreements) are a single plan, under sections 413(a) and 414(l), it is irrelevant that there are in form two or more separate plans (or agreements). For example, a single plan will be considered to exist

where agreements are entered into separately by a national labor organization (or one or more local units of such organization), on one hand, and individual employers, on the other hand, if the plan is considered a single plan for purposes of applying section 414(*l*).

(3) *Additional rules and effective dates.* (i) If a plan is a section 413(b) plan at a relevant time, the rules of section 413(b) and this section apply, and the rules of section 413(c) and §1.413–2 do not apply to the plan.

(ii) The qualification of a section 413(b) plan, at any relevant time, under section 401(a), 403(a), or 405(a), as modified by sections 413(b) and this section, is determined with respect to all employers maintaining the plan. Consequently, the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the plan for all employers maintaining the plan.

(iii) Except as otherwise provided, section 413 (a) and (b) and this section apply to a plan for plan years beginning after December 31, 1953.

(b) *Participation.* Section 410 and the regulations thereunder shall be applied as if all employees of each of the employers who are parties to the collective-bargaining agreement and all such employees who are subject to the same benefit computation formula under the plan were employed by a single employer.

(c) *Discrimination, etc.*—(1) *General rule.* Section 401(a)(4) (relating to prohibited discrimination) and section 411(d)(3) (relating to vesting required on termination, partial termination, or discontinuance of contributions) shall be applied as if all the participants in the plan, who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement, are employed by a single employer.

(2) *Application of discrimination rules.* Under section 401(a)(4) and the regulations thereunder a plan is not qualified unless the contributions or benefits provided under the plan do not discriminate in favor of officers, shareholders or highly compensated employees (hereinafter referred to collectively as ''the prohibited group''). The presence or absence of such discrimination under a plan to which this section applies at any time shall not be determined on an employer-by-employer basis, but rather by testing separately each group of employees who are subject to the same benefit computation formula to determine if there is discrimination within such group. Consequently, discrimination in contributions or benefits among two or more different groups or among employees in different groups covered by the plan may be present without causing the plan to be disqualified. However, the presence of prohibited discrimination within one such group will result in the disqualification of the plan for all groups. Section 401(a)(4) and the regulations thereunder provide rules relating to the determination of which employees are members of the prohibited group and to the determination of discrimination in contributions or benefits which are applicable to a plan to which this section applies. The determination of whether or not an individual employee is a highly compensated employee shall be based on the relationship of the compensation of the employee to the compensation of all the other employees of all employers who are maintaining the plan and have employees covered under the same benefit computation formula, whether or not such other employees are covered by the plan or are covered under the same benefit computation formula, rather than to the compensation of all the other employees of the employer of such individual employee.

(3) *Application of termination, etc. rules.* Section 411(d)(3) and the regulations thereunder (relating to vesting required in the case of a termination, partial termination, or complete discontinuance of contributions) apply to a plan subject to the provisions of this section. The requirements of section 411(d)(3) shall be applied as if all participants in the plan who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement are employed by a single employer. The determination of whether or not there is a termination,

partial termination, or complete discontinuance of contributions shall be made separately for each such group of participants who are treated as employed by a single employer. Consequently, if there are two or more groups of participants, a termination, partial termination, or complete discontinuance can take place under a plan with respect to one group of participants but not with respect to another such group of participants or for the entire plan. See §1.411(d)–2 for rules prescribed under section 411(d)(3).

(4) *Effective dates and transitional rules.* (i) Section 413(b)(2) and this paragraph apply to a plan for plan years beginning after December 31, 1953.

(ii) In applying the rules of this paragraph to a plan for plan years to which section 411 does not apply, section 401(a)(7) (as in effect on September 1, 1974) shall be substituted for section 411(d)(3). See §1.401–6 for rules prescribed under section 401(a)(7) as in effect on September 1, 1974. See §1.411(a)–2 for the effective dates of section 411.

(5) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A is a defined benefit plan subject to the provisions of this section and covers two groups of participants, local unions 1 and 2. Each local union has negotiated its own bargaining agreement with employers X, Y, and Z to provide its own benefit computation formula. The following table indicates the composition of the plan A participants:

	Employer X	Employer Y	Employer Z	Total
Local union 1	20	10	70	100
Local union 2	30	70	100	200

Under the rules of subparagraph (2) of this paragraph, the determination of whether contributions or benefits provided under the plan discriminate in favor of the prohibited group is made by applying the rules of section 401(a)(4) separately to participants who are members of local union 1 and local union 2. Thus, plan A will satisfy the qualification requirements of section 401(a)(4) if, within local union 1 and local union 2, respectively, plan benefits do not discriminate in favor of participants who are prohibited group employees within local union 1 and local union 2. Under the rules of subparagraph (2) of this paragraph, the determination under section 401(a)(4) of whether or not any individual employee, included within the 300 participants in plan A, is a highly compensated employee is based on the relationship of the compensation of such individual employee to the compensation of all the employees of Employers X, Y, and Z, whether or not such employees are participants in plan A. Thus, if there are 20 participants who are prohibited group employees within the 100 participants of local union 1, discrimination is determined by comparing the benefits of the 20 prohibited group participants to the benefits of the other 80 participants within local union 1. The same comparison would have to be made for the local union 2 participants between the prohibited group participants and the other participants in local union 2. Discrimination in benefits, if any, between the participants in local union 1 and local union 2, or among the employees of X, Y, or Z, would not affect the qualification of plan A under section 401(a)(4).

Example (2). Assume the same facts as in example (1). Employer X withdraws from the plan. Under subparagraph (3) of this paragraph, whether or not as a result of the withdrawal there is a partial termination under section 411(d)(3) is to be determined by applying the requirements of such section separately to the local union 1 and local union 2 participants. See §1.411(d)–2 for the requirements relating to partial terminations. The application of such requirements raises the following possibilities with respect to the plan: (1) A partial termination as to local union 1, (2) a partial termination as to local union 2, (3) a partial termination as to both local unions 1 and 2, or (4) no partial termination for either local union.

Example (3). Assume the same facts as in example (1). Plan A is amended to cease future benefit accruals under the plan for local union 1 participants. Under subparagraph (3) of the paragraph, whether or not as a result of the cessation there is a partial termination under section 411(d)(3) is to be determined by applying the requirements of such section separately to the local union 1 and local union 2 participants.

Example (4). Plan A is a defined benefit plan that provides for two normal retirement benefits, X and 2X. A participant receives benefit X if the collective bargaining agreement covering his employment provides for a contribution rate, M. If such agreement provides for a contribution rate of N, the participant receives benefit 2X. Benefit X and benefit 2X constitute separate benefit computation formulas.

Example (5). Plan B is a defined benefit plan that provides for a normal retirement benefit, X. Benefit X is provided for all plan participants even though there are two collective bargaining agreements providing for different contribution rates, M and N. Plan B has a single benefit computation formula,

even though there are two contribution rates.

(d) *Exclusive benefit.* Under section 401(a), a plan is not qualified unless the plan is for the exclusive benefit of the employees (and their beneficiaries) of the employer establishing and maintaining the plan. Other qualification requirements under section 401(a) require the application of the exclusive benefit rule (for example, section 401(a)(2), which precludes diversion of plan assets). For purposes of applying the requirements of section 401(a) in determining whether a plan subject to this section is, with respect to each employer establishing and maintaining the plan, for the exclusive benefit of its employees (and their beneficiaries), all of the employees participating in the plan shall be treated as employees of each such employer. Thus, for example, contributions by employer A to a plan subject to this section could be allocated to employees of other employers maintaining the plan without violating the requirements of section 401(a)(2), because all the employees participating in the plan are deemed to be employees of A.

(e) *Vesting.* Section 411 (other than section 411(d)(3) relating to termination or partial termination; discontinuance of contributions) and the regulations thereunder shall be applied as if all employers who have been parties to the collective-bargaining agreement constituted a single employer. The application of any rules with respect to breaks in service under section 411 shall be made under regulations prescribed by the Secretary of Labor. Thus, for example, all the hours which an employee worked for each employer in a collectively-bargained plan would be aggregated in computing the employee's hours of service under the plan. See also 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans.)

(f)–(h) [Reserved]

(i) *Employees of labor unions*—(1) *General rule.* For purposes of section 413(b) and this section, employees of employee representatives shall be treated as employees of an employer establishing and maintaining a plan to which section 413(b) and this section apply if, with respect to the employees of such representatives, the plan satisfies the nondiscrimination requirements of section 401(a)(4) (determined without regard to section 413(b)(2)) and the minimum participation and coverage requirements of section 410 (determined without regard to section 413(b)(1)). For purposes of the preceding sentence, the plan and any affiliated employee health or welfare plan shall be deemed to be an employee representative. If employees of employee representatives, the plan, or an affiliated employee health or welfare plan are covered by the plan and are not treated as employees of an employer establishing and maintaining the plan under the provisions of this paragraph, the plan fails to satisfy the qualification requirements of section 401(a). In addition, in order for such a plan to be qualified, the plan must satisfy the requirements of section 413(b) (1) and (2), relating to participation and discrimination, respectively; see paragraphs (b) and (c) of this section. For purposes of this paragraph, an affiliated health or welfare plan is a health or welfare plan that is maintained under the same collective bargaining agreement or agreements, and that covers the same membership.

(2) *Effective dates and transitional rules.* (i) Section 413(b)(8) and this paragraph apply to a plan for plan years beginning after December 31, 1953.

(ii) In applying the rules of this paragraph to a plan for plan years to which section 410 does not apply, section 401(a)(3) (as in effect on September 1, 1974) shall be substituted for section 410. See §1.401–3 for rules prescribed under section 401(a)(3) as in effect on September 1, 1974. See §1.410(a)–2 for the effective dates of section 410.

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A is a defined benefit plan, maintained pursuant to a collective bargaining agreement between employers, X, Y, and Z and labor union, L, which covers members of L employed by X, Y, and Z. In 1978, plan A is amended to cover, under the same benefit formula, all five employees of L who have satisfied the minimum age and service requirements of the plans (age 25 and

1 year of service). Assume that plan A is subject to section 413(b) and satisfies the requirements of section 413(b) (1) and (2). Assume further that with respect to employees of L, plan A (i) satisfies the nondiscrimination requirements of section 401(a)(4), (ii) meets the minimum participation requirements of section 410(a), and (iii) meets the minimum coverage requirements of section 410(b)(1)(A). Under the rules of subparagraph (1) of this paragraph, because such requirements are all satisfied, the employees of L are treated as employees of an employer establishing and maintaining plan A.

Example (2). Assume the same facts as example (1), except that plan A is amended to cover only one of the five employees of L, none of whom is covered by any other plan. Assume further that, under plan A, L does not satisfy the minimum percentage coverage requirement of section 410(b)(1)(A) with respect to employees of L. Assume further that the compensation of the one L employee who is covered by the plan is such that he is highly compensated relative to the four employees of L not covered by the plan. Consequently, L does not satisfy the minimum coverage requirements of section 410(b)(1)(B), with respect to employees of L. Under the rules of subparagraph (1) of this paragraph, the employees of L cannot be treated as employees of an employer establishing and maintaining the A plan because such coverage requirements are not satisfied by L. Consequently, the A plan fails to satisfy the qualification requirements of section 401(a).

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by 42 FR 47198, Sept. 20, 1977; T.D. 7654, 44 FR 65063, Nov. 9, 1979]

§ 1.413–2 Special rules for plans maintained by more than one employer.

(a) *Application of section 413(c)*—(1) *In general.* Section 413(c) describes certain plans (and each trust which is a part of any such plan) hereinafter referred to as ''section 413(c) plans.'' A plan (and each trust which is a part of such plan) is deemed to be a section 413(c) plan if it is described in subparagraph (2) of this paragraph. Notwithstanding any other provision of the code (not specifically in conflict with the special rules hereinafter mentioned), a section 413(c) plan is subject to the special rules of section 413(c) (1) through (6) and paragraphs (b) through (g) of this section.

(2) *Section 413(c) plan.* A plan (and each trust which is a part of such plan) is a section 413(c) plan if—

(i) The plan is a single plan, within the meaning of section 413(a) and § 1.413–1(a)(2), and

(ii) The plan is maintained by more than one employer.

For purposes of subdivision (ii) of this subparagraph, the number of employers maintaining the plan is determined by treating any employers described in section 414(b) (relating to a controlled group of corporations) or any employers described in section 414(c) (relating to trades or businesses under common control), whichever is applicable, as if such employers are a single employer. See § 1.411(a)–5(b)(3) for rules relating to the time when an employer maintains a plan. A master or prototype plan is not a section 413(c) plan unless such a plan is described in this subparagraph. Similarly, the mere fact that a plan, or plans, utilizes a common trust fund or otherwise pools plan assets for investment purposes does not, by itself, result in a particular plan being treated as a section 413(c) plan.

(3) *Additional rules.* (i) If a plan is a collectively bargained plan described in § 1.413–1(a), the rules of section 413(c) and this section do not apply, and the rules of section 413(b) and § 1.413–1 do apply to the plan.

(ii) The special rules of section 413(b)(1) and § 1.413–1(b) relating to the application of section 410, other than the rules of section 410(a), do not apply to a section 413(c) plan. Thus, for example, the minimum coverage requirements of section 410(b) are generally applied to a section 413(c) plan on an employer-by-employer basis, taking into account the generally applicable rules such as section 401(a)(5) and section 414 (b) and (c).

(iii) The special rules of section 413(b)(2) and § 1.413–1(c) (relating to (A) section 401(a)(4) and prohibited discrimination, and (B) 411(d)(3) and vesting required on termination, partial termination, or discontinuance of contributions) do not apply to a section 413(c) plan. Thus, for example, the determination of whether or not there is a termination, within the meaning of section 411(d)(3), of a section 413(c) plan is made solely by reference to the rules of sections 411(d)(3) and 413(c)(3).

(iv) The qualification of a section 413(c) plan, at any relevant time, under section 401(a), 403(a) or 405(a), as modified by section 413(c) and this section, is determined with respect to all employers maintaining the section 413(c) plan. Consequently, the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the section 413(c) plan for all employers maintaining the plan.

(4) *Effective dates.* Except as otherwise provided, section 413(c) and this section apply to a plan for plan years beginning after December 31, 1953.

(b) *Participation.* Section 410(a) and the regulations thereunder shall be applied as if all employees of each of the employers who maintain the plan were employed by a single employer.

(c) *Exclusive benefit.* In the case of a plan subject to this section, the exclusive benefit requirements of section 401(a) shall be applied to the plan in the same manner as under section 413(b)(3) and § 1.413–1(d).

(d) *Vesting.* Section 411 and the regulations thereunder shall be applied as if all employers who maintain the plan constituted a single employer. The application of any rules with respect to breaks in service under section 411 shall be made under regulations prescribed by the Secretary of Labor. Thus, for example, all the hours which an employee worked for each employer maintaining the plan would be aggregated in computing the employee's hours of service under the plan. See also 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by 42 FR 47198, Sept. 20, 1977; T.D. 7654, 44 FR 65065, Nov. 9, 1979]

§ 1.414(b)–1 Controlled group of corporations.

(a) *Defintion of controlled group of corporations.* For purposes of this section, the term ''controlled group of corporations'' has the same meaning as is assigned to the term in section 1563(a) and the regulations thereunder, except that (1) the term ''controlled group of corporations'' shall not include an ''insurance group'' described in section 1563(a)(4), and (2) section 1563(e)(3)(C) (relating to stock owned by certain employees' trusts) shall not apply. For purposes of this section, the term ''members of a controlled group'' means two or more corporations connected through stock ownership described in section 1563(a) (1), (2), or (3), whether or not such corporations are ''component members of a controlled group'' within the meaning of section 1563(b). Two or more corporations are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph). For purposes of this section, if a corporation is a member of more than one controlled group of corporations, such corporation shall be treated as a member of each controlled group.

(b) *Single plan adopted by two or more members.* If two or more members of a controlled group of corporations adopt a single plan for a plan year, then the minimum funding standard provided in section 412, the tax imposed by section 4971, and the applicable limitations provided by section 404(a) shall be determined as if such members were a single employer. In such a case, the amount of such items and the allocable portion attributable to each member shall be determined in the manner provided in regulations under sections 412, 4971, and 404(a).

(c) *Cross reference.* For rules relating to the application of sections 401, 408(k), 410, 411, 415, and 416 with respect to two or more trades or businesses which are under common control, see section 414(c) and the regulations thereunder.

[T.D. 8179, 53 FR 6605, Mar. 2, 1988]

§ 1.414(c)–1 Commonly controlled trades or businesses.

For purposes of applying the provisions of sections 401 (relating to qualified pension, profit-sharing, and stock bonus plans), 408(k) (relating to simplified employee pensions), 410 (relating to minimum participation standards), 411 (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 416 (relating to

top-heavy plans), all employees of two or more trades or businesses under common control within the meaning of § 1.414(c)–2 for any period shall be treated as employed by a single employer. See sections 401, 408(k), 410, 411, 415, and 416 and the regulations thereunder for rules relating to employees of trades or businesses which are under common control. See § 1.414(c)–5 for effective date.

[T.D. 8179, 53 FR 6606, Mar. 2, 1988]

§ 1.414(c)–2 Two or more trades or businesses under common control.

(a) *In general.* For purposes of this section, the term ''two or more trades or businesses under common control'' means any group of trades or businesses which is either a ''parent-subsidiary group of trades or businesses under common control'' as defined in paragraph (b) of this section, a ''brother-sister group of trades or businesses under common control'' as defined in paragraph (c) of this section, or a ''combined group of trades or businesses under common control'' as defined in paragraph (d) of this section. For purposes of this section and §§ 1.414(c)–3 and 1.414(c)–4, the term ''organization'' means a sole proprietorship, a partnership (as defined in section 7701(a)(2)), a trust, an estate, or a corporation.

(b) *Parent-subsidiary group of trades or businesses under common control*—(1) *In general.* The term ''parent-subsidiary group of trades or businesses under common control'' means one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of § 1.414(c)–4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of § 1.414(c)–4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations.

(2) *Controlling interest defined*—(i) *Controlling interest.* For purposes of paragraphs (b) and (c) of this section, the phrase ''controlling interest'' means:

(A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;

(B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;

(C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and

(D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

(ii) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary. The factors and methods prescribed in § 20.2031–7 or, for certain prior periods, § 20.2031–7A (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest.

(c) *Brother-sister group of trades or businesses under common control*—(1) *In general.* The term ''brother-sister group of trades or businesses under common control'' means two or more organizations conducting trades or businesses if (i) the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)–4) a controlling interest in each organization, and (ii) taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization. The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same

persons whose ownership is considered for purposes of the effective control requirement.

(2) *Effective control defined.* For purposes of this paragraph, persons are in ''effective control'' of an organization if—

(i) In the case of an organization which is a corporation, such persons own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of such corporation;

(ii) In the case of an organization which is a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;

(iii) In the case of an organization which is a partnership, such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership; and

(iv) In the case of an organization which is a sole proprietorship, one of such persons owns such sole proprietorship.

(d) *Combined group of trades or businesses under common control.* The term ''combined group of trades or businesses under common control'' means any group of three or more organizations, if (1) each such organization is a member of either a parent-subsidiary group of trades or businesses under common control or a brother-sister group of trades or businesses under common control, and (2) at least one such organization is the common parent organization of a parent-subsidiary group of trades or businesses under common control and is also a member of a brother-sister group of trades or businesses under common control.

(e) *Examples.* The definitions of parent-subsidiary group of trades or businesses under common control, brother-sister group of trades or businesses under common control, and combined group of trades or businesses under common control may be illustrated by the following examples.

Example (1). (a) The ABC partnership owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to voting of S corporation. ABC partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC partnership and S Corporation.

(b) Assume the same facts as in (a) and assume further that S owns 80 percent of the profits interest in the DEF Partnership. The ABC Partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, S Corporation, and the DEF Partnership. The result would be the same if the ABC Partnership, rather than S, owned 80 percent of the profits interest in the DEF Partnership.

Example (2). L Corporation owns 80 percent of the only class of stock of T Corporation, and T, in turn, owns 40 percent of the capital interest in the GHI Partnership. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the capital interest in the GHI Partnership. L is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of L Corporation, T Corporation, N Corporation, and the GHI Partnership.

Example (3). ABC Partnership owns 75 percent of the only class of stock of X and Y Corporations; X owns all the remaining stock of Y, and Y owns all the remaining stock of X. Since interorganization ownership is excluded (that is, treated as not outstanding) for purposes of determining whether ABC owns a controlling interest of at least one of the other organizations, ABC is treated as the owner of stock possessing 100 percent of the voting power and value of all classes of stock of X and of Y for purposes of paragraph (b)(1)(ii) of this section. Therefore, ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, X Corporation, and Y Corporation.

Example (4). Unrelated individuals A, B, C, D, E, and F own an interest in sole proprietorship A, a capital interest in the GHI Partnership, and stock of corporations M, W, X, Y, and Z (each of which has only one class of stock outstanding) in the following proportions:

ORGANIZATIONS

Individuals	A	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B	—	40%	—	15%	40%	50%	30%
C	—	—	—	—	10%	10%	10%
D	—	—	—	25%	—	20%	—

ORGANIZATIONS—Continued

Individuals	A	GHI	M	W	X	Y	Z
E	—	10%	—	—	10%	—	—
	100%	100%	100%	100%	100%	100%	100%

Under these facts the following four brother-sister groups of trades or businesses under common control exist: GHI, X and Z; X, Y and Z; W and Y; A and M. In the case of GHI, X, and Z, for example, A and B together have effective control of each organization because their combined identical ownership of GHI, X and Z is greater than 50%. (A's identical ownership of GHI, X and Z is 40% because A owns at least a 40% interest in each organization. B's identical ownership of GHI, X and Z is 30% because B owns at least a 30% interest in each organization.) A and B (the persons whose ownership is considered for purposes of the effective control requirement) together own a controlling interest in each organization because they own at least 80% of the capital interest of partnership GHI and at least 80% of the total combined voting power of corporations X and Z. Therefore, GHI, X and Z comprise a brother-sister group of trades or businesses under common control. Y is not a member of this group because neither the effective control requirement nor the 80% controlling interest requirement are met. (The effective control requirement is not met because A's and B's combined identical ownership in GHI, X, Y and Z (20% for A and 30% for B) does not exceed 50%. The 80% controlling interest test is not met because A and B together only own 70% of the total combined voting power of the stock of Y.) A and M are not members of this group because B owns no interest in either organization and A's ownership of GHI, X and Z, considered alone, is less than 80%.

Example (5). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

CORPORATIONS

Individuals	U	V
	(percent)	(percent)
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13
	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of a brother-sister group of trades or businesses under common control because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (6). A, an individual, owns a controlling interest in ABC Partnership and DEF Partnership. ABC, in turn, owns a controlling interest in X Corporation. Since ABC, DEF, and X are each members of either a parent-subsidiary group or a brother-sister group of trades or businesses under common control, and ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC and X, and also a member of a brother-sister group of trades or businesses under common control consisting of ABC and DEF, ABC Partnership, DEF Partnership, and X Corporation are members of the same combined group of trades or businesses under common control.

[T.D. 8179, 53 FR 6606, Mar. 2, 1988, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.414(c)–3 Exclusion of certain interests or stock in determining control.

(a) *In general.* For purposes of § 1.414(c)–2 (b)(2)(i) and (c)(2), the term ''interest'' and the term ''stock'' do not include an interest which is treated as not outstanding under paragraph (b) of this section in the case of a parent-subsidiary group of trades or businesses under common control or under paragraph (c) of this section in the case of a brother-sister group of trades or businesses under common control. In addition, the term ''stock'' does not include treasury stock or nonvoting stock which is limited and preferred as to dividends. For definitions of certain terms used in this section, see paragraph (d) of this section.

(b) *Parent-subsidiary group of trades or businesses under common control*—(1) *In general.* If an organization (hereinafter in this section referred to as ''parent organization'') owns (within the meaning of paragraph (b)(2) of this section)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of §1.414(c)–2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether the parent organization or such other organization (hereinafter in this section referred to as ''subsidiary organization'') is a member of a parent-subsidiary group of trades or businesses under common control, an interest in such subsidiary organization excluded under paragraph (b) (3), (4), (5), or (6) of this section shall be treated as not outstanding.

(2) *Ownership.* For purposes of paragraph (b)(1) of this section, a parent organization shall be considered to own an interest in or stock of another organization which it owns directly or indirectly with the application of §1.414(c)–4(b)(1) and—

(i) In the case of a parent organization which is a partnership, a trust, or an estate, with the application of paragraphs (b) (2), (3), and (4) of §1.414(c)–4, and

(ii) In the case of a parent organization which is a corporation, with the application of §1.414(c)–4(b)(4).

(3) *Plan of deferred compensation.* An interest which is an interest in or stock of the subsidiary organization held by a trust which is part of a plan of deferred compensation (within the meaning of section 406(a)(3) and the regulations thereunder) for the benefit of the employees of the parent organization or the subsidiary organization shall be excluded.

(4) *Principal owners, officers, etc.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of §1.414(c)–4) by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization shall be excluded.

(5) *Employees.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of §1.414(c)–4) by an employee of the subsidiary organization shall be excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.

(6) *Controlled exempt organization.* An interest which is an interest in or stock of the subsidiary organization shall be excluded if owned (directly and with the application of §1.414(c)–4) by an organization (other than the parent organization):

(i) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof.

(c) *Brother-sister group of trades or businesses under common control*—(1) *In general.* If five or fewer persons (hereinafter in this section referred to as ''common owners'') who are individuals, estates, or trusts own (directly and with the application of §1.414(c)–4)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock or such corporation,

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of §1.414(c)–2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether such organization is a member of a

brother-sister group of trades or businesses under common control, an interest in such organization excluded under paragraph (c) (2), (3), or (4) of this section shall be treated as not outstanding.

(2) *Exempt employees' trust.* An interest which is an interest in or stock of such organization held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be excluded if such trust is for the benefit of the employees of such organization.

(3) *Employees.* An interest which is an interest in or stock of such organization owned (directly and with the application of § 1.414(c)–4) by an employee of such organization shall be excluded if such interest or stock is subject to conditions which run in favor of a common owner of such organization or in favor of such organization and which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or stock, the direct or record owner's right) to dispose of such interest or stock.

(4) *Controlled exempt organization.* An interest which is an interest in or stock of such organization shall be excluded if owned (directly and with the application of § 1.414(c)–4) by an organization:

(i) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or fiduciary of such organization, or by any combination thereof.

(d) *Definitions*—(1) *Employee.* For purposes of this section, the term ''employee'' has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act).

(2) *Principal owner.* For purposes of this section, the term ''principal owner'' means a person who owns (directly and with the application of § 1.414(c)–4)—

(i) In the case of a corporation, 5 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation or 5 percent of more of the total value of shares of all classes of stock of such corporation;

(ii) In the case of a trust or estate, an actuarial interest of 5 percent or more of such trust or estate; or

(iii) In the case of a partnership, 5 percent or more of the profits or capital interest of such partnership.

(3) *Officer.* For purposes of this section, the term ''officer'' includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(4) *Partner.* For purposes of this section, the term ''partner'' means any person defined in section 7701(a)(2) (relating to definitions of partner).

(5) *Fiduciary.* For purposes of this section and § 1.414(c)–4, the term ''fiduciary'' has the same meaning as such term is given in section 7701(a)(6) and the regulations thereunder.

(6) *Substantial conditions.* (i) *In general.* For purposes of this section, an interest in or stock of an organization is subject to conditions which substantially restrict or limit the right to dispose of such interest or stock and which run in favor of another person if the condition extends directly or indirectly to such person preferential rights with respect to the acquisition of the direct owner's (or the record owner's) interest or stock. For a condition to be in favor of another person it is not necessary that such person be extended a discriminatory concession with respect to price. A right of first refusal with respect to an interest or stock in favor of another person is a condition which substantially restricts or limits the direct or record owner's right of disposition which runs in favor of such person. Further, any legally enforceable condition which prohibits the direct or record owner from disposing of his or her interest or stock without the consent of another person will be considered to be a substantial limitation running in favor of such person.

(ii) *Special rule.* For purposes of paragraph (c)(3) of this section only, if a condition which restricts or limits an employee's right (or direct or record owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bonafide reciprocal purchase arrangement, such condition shall not be treated as a substantial limitation or restriction. An example of a reciprocal purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(7) *Control.* For purposes of paragraphs (b)(6) and (c)(4) of this section, the term ''control'' means control in fact. The determination of whether there exists control in fact will depend upon all of the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). ABC Partnership owns 70 percent of the capital interest and of the profits interest in the DEF Partnership. The remaining capital interest and profits interest in DEF is owned as follows: 4 percent by A (a general partner in ABC), and 26 percent by D (a limited partner in ABC). ABC satisfies the 50-percent capital interest or profits interest ownership requirement of paragraph (b)(1)(iii) of this section with respect to DEF. Since A and D are partners of ABC, under paragraph (b)(4) of this section the capital and profits interests in DEF owned by A and D are treated as not outstanding for purposes of determining whether ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control under § 1.414 (c)–2(b). Thus, ABC is considered to own 100 percent (70÷70) of the capital interest and profits interest in DEF. Accordingly, ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control.

Example (2). Assume the same facts as in example (1) and assume further that A owns 15 shares of the 100 shares of the only class of stock of S Corporation and DEF Partnership owns 75 shares of such stock. ABC satisfies the 50 percent stock requirement of paragraph (b)(1)(i) of this section with respect to S since ABC is considered as owning 52.5 percent (70 percent×75 percent) of the S stock with the application of § 1.414 (c)–4(b)(2). Since A is a partner of ABC, the S stock owned by A is treated as not outstanding for purposes of determining whether S is a member of a parent-subsidiary group of trades or businesses under common control. Thus, DEF Partnership is considered to own stock possessing 88.2 percent (75÷85) of the voting power and value of the S stock. Accordingly, ABC Partnership, DEF Partnership, and S Corporation are members of a parent-subsidiary group of trades or businesses under common control.

Example (3). ABC Partnership owns 60 percent of the only class of stock of Corporation Y. D, the president of Y, owns the remaining 40 percent of the stock of Y. D has agreed that if she offers her stock in Y for sale she will first offer the stock to ABC at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since D is an employee of Y within the meaning of section 3306(i) of the Code and her stock in Y is subject to a condition which substantially restricts or limits her right to dispose of such stock and runs in favor of ABC Partnership, under paragraph (b)(5) of this section such stock is treated as not outstanding for purposes of determining whether ABC and Y are members of a parent-subsidiary group of trades or businesses under common control. Thus, ABC Partnership is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, ABC Partnership and Y Corporation are members of a parent-subsidiary group of trades or businesses under common control. The result would be the same if D's husband, instead of D, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of ABC Partnership.

(f) *Exception*—(1) *In general.* If an interest in an organization (including stock of a corporation) is owned by a person directly or with the application of the rules of paragraph (b) of § 1.414 (c)–4 and such ownership results in the membership of that organization in a group of two or more trades or businesses under common control for any period, then the interest will not be treated as an excluded interest under

paragraph (b) or (c) of this section if the result of applying such provisions is that the organization is not a member of a group of two or more trades or businesses under common control for the period.

(2) *Example*. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. A, an officer of P, owns directly 30 shares of S stock which P has an option to acquire. If, under paragraph (b)(4) of this section, the 30 shares owned directly by A are treated as not outstanding, P would be treated as owning stock possessing only 71 percent (50/70) of the total voting power and value of S stock, and S should not be a member of a parent-subsidiary group of trades or businesses under common control. However, because the 30 shares owned by A that P has an option to purchase are considered as owned by P under paragraph (b)(2) of this section, and that ownership plus P's direct ownership of 50 shares result in S's membership in a parent-subsidiary group of trades or businesses under common control for 1985, the provisions of this paragraph apply. Therefore, A's stock is not treated as an excluded interest and S is a member of a parent-subsidiary group consisting of P and S.

[T.D. 8179, 53 FR 6607, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988]

§ 1.414(c)–4 Rules for determining ownership.

(a) *In general*. In determining the ownership of an interest in an organization for purposes of § 1.414(c)–2 and § 1.414(c)–3, the constructive ownership rules of paragraph (b) of this section shall apply, subject to the operating rules contained in paragraph (c). For purposes of this section the term ''interest'' means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest; in the case of a partnership, an interest in the profits or capital; and in the case of a sole proprietorship, the proprietorship.

(b) *Constructive ownership*—(1) *Options*. If a person has an option to acquire any outstanding interest in an organization, such interest shall be considered as owned by such person. For this purpose, an option to acquire an option, and each one of a series of such options shall be considered as an option to acquire such interest.

(2) *Attribution from partnerships*—(i) *General*. An interest owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater.

(ii) *Example*. The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following example:

Example. A, B, and C, unrelated individuals, are partners in the ABC Partnership. The partners' interest in the capital and profits of ABC are as follows:

(IN PERCENT)

Partner	Capital	Profits
A	36	25
B	60	71
C	4	4

The ABC Partnership owns the entire outstanding stock (100 shares) of X Corporation. Under paragraph (b)(2)(i) of this section, A is considered to own the stock of X owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is greater. Therefore, A is considered to own 36 shares of X stock. Since B has a greater interest in the profits of the partnership than in the capital, B is considered to own X stock in proportion to his interest in such profits. Therefore, B is considered to own 71 shares of X stock. Since C does not have an interest of 5 percent or more in either the capital or profits of ABC, he is not considered to own any shares of X stock.

(3) *Attribution from estates and trusts*—(i) *In general*. An interest in an organization (hereinafter called an ''organization interest'') owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or more in such organization interest, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion

by the fiduciary in favor of such beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. A beneficiary of an estate or trust who cannot under any circumstances receive any part of an organization interest held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such organization interest. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate has been specifically bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in § 20.2031–7 or, for certain prior periods, § 20.2031–7A (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in an organization interest owned directly or indirectly by or for an estate or trust.

(ii) *Special rules for estates.* (A) For purposes of this paragraph (b)(3) with respect to an estate, property of a decedent shall be considered as owned by his or her estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death.

(B) For purposes of this paragraph (b)(3) with respect to an estate, the term ''beneficiary'' includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution.

(C) For purposes of this paragraph (b)(3) with respect to an estate, a person shall no longer be considered a beneficiary of an estate when all the property to which he or she is entitled has been received by him or her, when he or she no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property from him or her or to seek payment from him or her by contribution or otherwise to satisfy claims against the estate or expenses of administration.

(iii) *Grantor trusts, etc.* An interest owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E, part I, subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(4) *Attribution from corporations*—(i) *General.* An interest owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (directly and, in the case of a parent-subsidiary group of trades or businesses under common control, with the application of paragraph (b)(1) of this section, or in the case of a brother-sister group of trades or business under common control, with the application of this section), 5 percent or more in value of the stock in that proportion which the value of the stock which such person so owns bears to the total value of all the stock in such corporation.

(ii) *Example.* The provisions of paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. B, an individual, owns 60 of the 100 shares of the only class of outstanding stock of corporation P. C, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, B is considered to own 30 shares of the S stock (60/100×50), and X is considered to own 18 shares of S stock (36/100×50). Since C does not own 5 percent or more in the value of P stock, he is not considered as owning any of the S stock owned by P. If in this

example, C's wife had owned directly 1 share of the P stock, C and his wife would each be considered as owning 5 shares of the P stock, and therefore C and his wife would be considered as owning 2.5 shares of the S stock (5/100×50).

(5) *Spouse*—(i) *General rule*. Except as provided in paragraph (b)(5)(ii) of this section, an individual shall be considered to own an interest owned, directly or indirectly, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) *Exception*. An individual shall not be considered to own an interest in an organization owned, directly or indirectly, by or for his or her spouse on any day of a taxable year of such organization, provided that each of the following conditions are satisfied with respect to such taxable year:

(A) Such individual does not, at any time during such taxable year, own directly any interest in such organization;

(B) Such individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;

(C) Not more than 50 percent of such organization's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

(D) Such interest in such organization is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years. The principles of § 1.414(c)–3(d)(6)(i) shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) *Definitions*. For purposes of paragraph (b)(5)(ii)(C) of this section, the gross income of an organization shall be determined under section 61 and the regulations thereunder. The terms ''interest'', ''royalties'', ''rents'', ''dividends'', and ''annuities'' shall have the same meaning such terms are given for purposes of section 1244(c) and § 1.1244(c)–1(e)(1).

(6) *Children, grandchildren, parents, and grandparents*—(i) *Children and parents*. An individual shall be considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

(ii) *Children, grandchildren, parents, and grandparents*. If an individual is in effective control (within the meaning of § 1.414(c)–2(c)(2)), directly and with the application of the rules of this paragraph without regard to this subdivision, of an organization, then such individual shall be considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

(iii) *Adopted children*. For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual.

(iv) *Example*. The provisions of this subparagraph (6) may be illustrated by the following example:

Example: (A) *Facts*. Individual F owns directly 40 percent of the profits interest of the DEF Partnership. His son, M, 20 years of age, owns directly 30 percent of the profits interest of DEF, and his son, A, 30 years of age, owns directly 20 percent of the profits interest of DEF. The 10 percent remaining of the profits interest and 100 percent of the capital interest of DEF is owned by an unrelated person.

(B) *F's ownership*. F owns 40 percent of the profits interest in DEF directly and is considered to own the 30 percent profits interest owned directly by M. Since, for purposes of the effective control test contained in paragraph (b)(6)(ii) of this section, F is treated as owning 70 percent of the profits interest of DEF, F is also considered as owning the 20 percent profits interest of DEF owned by his adult son, A. Accordingly, F is considered as owning a total of 90 percent of the profits interest in DEF.

(C) *M's ownership*. Minor son, M. owns 30 percent of the profits interest in DEF directly, and is considered to own the 40 percent profits interest owned directly by his father, F. However, M is not considered to own the 20 percent profits interest of DEF

owned directly by his brother, A, and constructively by F, because an interest constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such interest. (See paragraph (c)(2) of this section.) Accordingly, M is considered as owning a total of 70 percent of the profits interest of the DEF Partnership.

(D) *A's ownership.* Adult son, A, owns 20 percent of the profits interest in DEF directly. Since, for purposes of determining whether A effectively controls DEF under paragraph (b)(6)(ii) of this section, A is treated as owning only the percentage of profits interest he owns directly, he does not satisfy the condition precedent for the attribution of the DEF profits interest from his father. Accordingly, A is considered as owning only the 20 percent profits interest in DEF which he owns directly.

(c) *Operating rules*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, an interest constructively owned by a person by reason of the application of paragraph (b) (1), (2), (3), (4), (5), or (6) of this section shall, for the purposes of applying such paragraph, be treated as actually owned by such person.

(2) *Members of family.* An interest constructively owned by an individual by reason of the application of paragraph (b) (5) or (6) of this section shall not be treated as owned by such individual for purposes of again applying such subparagraphs in order to make another the constructive owner of such interest.

(3) *Precedence of option attribution.* For purposes of this section, if an interest may be considered as owned under paragraph (b)(1) of this section (relating to option attribution) and under any other subparagraph of paragraph (b) of this section, such interest shall be considered as owned by such person under paragraph (b)(1) of this section.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, 30 years of age, has a 90 percent interest in the capital and profits of DEF Partnership. DEF owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under paragraph (c)(1) of this section, the 60 shares of Y constructively owned by DEF by reason of paragraph (b)(4) of this section are treated as actually owned by DEF for purposes of applying paragraph (b)(2) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under paragraph (c)(2) of this section such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts as in example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in paragraph (c)(2) of this section does not prevent the reattribution of such 40 shares to A because, under paragraph (c)(3) of this section, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A is in effective control of Y under paragraph (b)(6)(ii) of this section, the 40 shares of Y stock constructively owned by C are reattributed to A. A is considered as owning a total of 94 shares of Y stock.

[T.D. 8179, 53 FR 6609, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.414(c)–5 Effective date.

(a) *General rule.* Except as provided in paragraph (b), (c), (e), or (f) of this section, the provisions of § 1.414(b)–1 and §§ 1.414(c)–1 through 1.414 (c)–4 shall apply for plan years beginning after September 2, 1974.

(b) *Existing plans.* In the case of a plan in existence on January 1, 1974, unless paragraph (c) of this section applies, the provisions of ''§ 1.414 (b)–1 and §§ 1.414(c)–1 through 1.414(c)–4 shall apply for plan years beginning after December 31, 1975. For definition of the term ''existing plan'', see § 1.410(a)–2(c).

(c) *Existing plans electing new provisions.* In the case of a plan in existence on January 1, 1974, for which the plan administrator makes an election under § 1.410 (a)–2(d), the provisions of § 1.414(b)–1 and §§ 1.414 (c)–1 through 1.414(c)–4 shall apply to the plan years elected under § 1.410 (a)–2 (d).

(d) *Application.* For purposes of the Employee Retirement Income Security Act of 1974, the provisions of § 1.414(b)–1 and §§ 1.414(c)–1 through 1.414(c)–4 do

not apply for any period of time before the plan years described in paragraph (a), (b), or (c) of this section, whichever is applicable.

(e) *Special rule.* Notwithstanding paragraph (a), (b), or (c) of this section, § 1.414(c)–3 (f) is effective April 1, 1988.

(f) *Transitional rule*—(1) *In general.* The amendments made by T.D. 8179 apply to the plan years or period described in paragraphs (a), (b), or (c) of this section, whichever is applicable.

(2) *Exception.* In the case of a plan year or period beginning before March 2, 1988, if an organization—

(i) Is a member of a brother-sister group of trades or businesses under common control under § 11.414(c)–2(c), as in effect before removal by T.D. 8179 (''old group''), for such plan year or period, and

(ii) Is not such a member for such plan year or period because of the amendments made by such Treasury decision,

such member (whether or not a corporation) nevertheless will be treated as a member of such old group for purposes of section 414(c) for that plan year or period to the extent provided in § 1.1563–1 (d)(2). Also, such member will be treated as a member of an old group for all purposes of the Code for such plan year or period if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of §1.1563–1 (d)(3) with respect to such plan year or period.

[T.D. 8179, 53 FR 6611, Mar. 2, 1988]

§ 1.414(e)–1 Definition of church plan.

(a) *General rule.* For the purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, the term ''church plan'' means a plan established and at all times maintained for its employees by a church or by a convention or association of churches (hereinafter included within the term ''church'') which is exempt from tax under section 501(a), provided that such plan meets the requirements of paragraphs (b) and (if applicable) (c) of this section. If at any time during its existence a plan is not a church plan because of a failure to meet the requirements set forth in this section, it cannot thereafter become a church plan.

(b) *Unrelated businesses*—(1) *In general.* A plan is not a church plan unless it is established and maintained primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses (within the meaning of section 513).

(2) *Establishment or maintenance of a plan primarily for persons not employed in connection with one or more unrelated trades or businesses.* (i) (A) A plan, other than a plan in existence on September 2, 1974, is established primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses if on the date the plan is established the number of employees employed in connection with the unrelated trades or businesses eligible to participate in the plan is less than 50 percent of the total number of employees of the church eligible to participate in the plan.

(B) A plan in existence on September 2, 1974, is to be considered established as a plan primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses if it meets the requirements of both paragraphs (b)(2)(ii) (A) and (B) (if applicable) in either of its first 2 plan years ending after September 2, 1974.

(ii) For plan years ending after September 2, 1974, a plan will be considered maintained primarily for the benefit of employees of a church who are not employed in connection with one or more unrelated trades or businesses if in 4 out of 5 of its most recently completed plan years—

(A) Less than 50 percent of the persons participating in the plan (at any time during the plan year) consist of and in the same year

(B) Less than 50 percent of the total compensation paid by the employer during the plan year (if benefits or contributions are a function of compensation) to employees participating in the plan is paid to,

employees employed in connection with an unrelated trade or business. The determination that the plan is not a church plan will apply to the second

year (within a 5 year period) for which the plan fails to meet paragraph (b)(2)(ii) (A) or (B) (if applicable) and to all plan years thereafter unless, taking into consideration all of the facts and circumstances as described in paragraph (b)(2)(iii) of this section, the plan is still considered to be a church plan. A plan that has not completed 5 plan years ending after September 2, 1974, shall be considered maintained primarily for the benefit of employees not employed in connection with an unrelated trade or business unless it fails to meet paragraphs (b)(2)(ii) (A) and (B) in at least 2 such plan years.

(iii) Even though a plan does not meet the provisions of paragraph (b)(2)(ii) of this section, it nonetheless will be considered maintained primarily for the benefit of employees who are not employed in connection with one or more unrelated trades or businesses if the church maintaining the plan can demonstrate that based on all of the facts and circumstances such is the case. Among the facts and circumstances to be considered in evaluating each case are:

(A) The margin by which the plan fails to meet the provisions of paragraph (b)(2)(ii) of this section, and

(B) Whether the failure to meet such provisions was due to a reasonable mistake as to what constituted an unrelated trade or business or whether a particular person or group of persons were employed in connection with one or more unrelated trades or businesses.

(iv) For purposes of this section, an employee will be considered eligible to participate in a plan if such employee is a participant in the plan or could be a participant in the plan upon making mandatory employee contributions to the plan.

(3) *Employment in connection with one or more unrelated trades or businesses.* An employee is employed in connection with one or more unrelated trades or businesses of a church if a majority of such employee's duties and responsibilities in the employ of the church are directly or indirectly related to the carrying on of such trades or businesses. Although an employee's duties and responsibilities may be insignificant with respect to any one unrelated trade or business, such employee will nonetheless be considered as employed in connection with one or more unrelated trades or businesses if such employee's duties and responsibilities with respect to all of the unrelated trades or businesses of the church represent a majority of the total of such person's duties and responsibilities in the employ of the church.

(c) *Plans of two or more employers.* The term ''church plan'' does not include a plan which, during the plan year, is maintained by two or more employers unless—

(1) Each of the employers is a church that is exempt from tax under section 501(a), and

(2) With respect to the employees of each employer, the plan meets the provisions of paragraph (b)(2)(ii) of this section or would be determined to be a church plan based on all the facts and circumstances described in paragraph (b)(2)(iii) of this section.

Thus, if with respect to a single employer the plan fails to meet any provision of this paragraph, the entire plan ceases to be a church plan unless that employer ceases maintaining the plan for all plan years beginning after the plan year in which it receives a final notification from the Internal Revenue Service that it does not meet the provisions of this paragraph. If the employer does cease maintaining the plan in accordance with this paragraph, the fact that the employer formerly did maintain the plan will not prevent the plan from being a church plan for prior years.

(d) *Special rule.* (1) Notwithstanding paragraph (c)(1) of this section, a plan maintained by a church and one or more agencies of such church for the employees of such church and of such agency or agencies, that is in existence on January 1, 1974, shall be treated as a church plan for plan years ending after September 2, 1974, and beginning before January 1, 1983, provided that the plan is described in paragraph (c) of this section without regard to paragraph (c)(1) of this section, and the plan is not maintained by an agency which did not maintain the plan on January 1, 1974.

(2) For the purposes of section 414(e) and this section, an agency of a church means an organization which is exempt

from tax under section 501 and which is either controlled by, or associated with, a church. For example, an organization, a majority of whose officers or directors are appointed by a church's governing board or by officials of a church, is controlled by a church within the meaning of this paragraph. An organization is associated with a church if it shares common religious bonds and convictions with that church.

(e) *Religious orders and religious organizations.* For the purpose of this section the term ''church'' includes a religious order or a religious organization if such order or organization (1) is an integral part of a church, and (2) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise.

(f) *Separately incorporated fiduciaries.* A plan which otherwise meets the provisions of this section shall not lose its status as a church plan because of the fact that it is administered by a separately incorporated fiduciary such as a pension board or a bank.

(g) *Cross reference.* (1) For rules relating to treatment of church plans, see section 410(c), 411(e), 412(h), 4975(g), and the regulations thereunder.

(2) For rules relating to church plan elections, see section 410(d) and the regulations thereunder.

[T.D. 7688, 45 FR 20797, Mar. 31, 1980]

§ 1.414(f)–1 Definition of multiemployer plan.

(a) *General rule.* For purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, a plan is a multiemployer plan for a plan year if all of the following requirements are satisfied:

(1) *Number of contributing employers.* More than one employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for the plan year.

(2) *Collective bargaining agreement.* The plan is maintained for the plan year pursuant to one or more collective bargaining agreements between employee representatives and more than one employer.

(3) *Amount of contributions.* Except as provided by paragraph (c) of this section (relating to the special rule for contributions exceeding 50 percent), the amount of contributions made under the plan for the plan year by or on behalf of each employer is less than 50 percent of the total amount of contributions made under the plan for such plan year by or on behalf of all employers.

(4) *Benefits.* The plan provides that the amount of benefits payable with respect to each employee participating in the plan is determined without regard to whether or not his employer continues as a member of the plan. If benefits accrued as a result of the participant's service with his employer during a period before such employer was a member of the plan, this requirement does not apply to the amount of those benefits, except that this requirement does apply to the amount of those benefits (i) which are accrued benefits derived from employee contributions, or (ii) which are accrued under a plan maintained by an employer prior to the time such employer became a member of the plan to which the requirements of this paragraph (a) are applied.

(5) *Other requirements.* The plan satisfies such other requirements as the Secretary of Labor by regulations prescribes under the authority of section 414(f)(1)(E) of the Code and section 3(37) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 839). See 29 CFR 2510.3–37.

(b) *Special rules*—(1) *Amount of contributions.* For purposes of paragraphs (a)(3) and (c) of this section, the amount of contributions made under the plan for the plan year by or on behalf of each employer shall be the sum of such contributions made on or before the last day of the plan year. For purposes of determining whether contributions are made on or before the last day of the plan year, the rule of section 412(c)(10) and the regulations thereunder (relating to the treatment of certain contributions made after the last day of the plan year as made on such last day) shall apply.

(2) *Benefits.* (i) For purposes of paragraph (a)(4) of this section, certain benefit amounts are treated as accrued as a result of the participant's service with an employer during a period before such employer was a member of

the plan. The amount of such a benefit so treated is the difference (if any) between two calculated amounts. The first calculated amount is the participant's total accrued benefit calculated under the plan as of the date the employer ceased to be a member of the plan. The second calculated amount is the participant's accrued benefit calculated without regard to his service with such employer during the period before such employer was a member of the plan. However, under a special limitation, this difference may not exceed the benefit a participant accrued from service before his employer became a member of the plan. For purposes of this limitation, this benefit is the benefit accrued as of the date the employer ceases to be a member of the plan. An employer shall be deemed to be a member of the plan in a plan year if the employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for such plan year or if an employee of the employer accrues a benefit, on account of service with the employer during such plan year, under the plan for that plan year.

(ii) The provisions of paragraphs (a)(4) and (b)(2)(i) of this section are illustrated by the following example:

Example. On January 1, 1976, employer W became a member of the noncontributory XYZ pension plan which uses the calendar year as the plan year. W did not maintain any plan prior to that date. The plan provided for benefits of $4 per month per year of service (including service with W before January 1, 1976). On January 1, 1980, following adoption of a new collective bargaining agreement, the benefits were increased to $12 per month per year of service for all years of service (including service with W before January 1, 1976). On January 1, 1991, W ceased to be a member of the plan.

A, an employee of W, had 15 years of service before January 1, 1976, 4 years of service between January 1, 1976, and December 31, 1979, and 11 years of service between January 1, 1980, and December 31, 1990. On December 31, 1990, A's accrued benefit was $360 per month ($12 per month x 30). On January 1, 1991, the portion of A's accrued benefit retained and the portion forfeited under the terms of the XYZ pension plan were determined as follows:

Years	Monthly accrued benefit retained	Monthly accrued benefit forfeited
Before Jan. 1, 1976		$12×15 years=$180
Jan. 1, 1976 to Dec. 31, 1979	$4×4 years=$16	$8×4 years=$32
Jan. 1, 1980 to Dec. 31, 1990	$12×11 years=$132	
Total	$148	$212

The XYZ plan does not satisfy the requirements of paragraphs (a)(4) and (b)(2)(i) of this section because no benefit can be forfeited with respect to service after W began participating in the plan. Thus, the maximum accrued benefit that may be forfeited is $180 per month (the accrued benefit with respect to A's service prior to January 1, 1976). Therefore, in order for the plan to meet the requirements of paragraphs (a)(4) and (b)(2)(i) of this section, the plan must provide for A's accrued benefit after W ceased to be a member of the plan to be at least $180 per month ($360 per month total accrued benefit less $180 per month benefit accrued for service prior to W's membership in the plan).

(iii) For purposes of paragraphs (a)(4) and (b)(2) of this section, if an employer for a period employs two or more individuals who, solely by reason of their employment, are participants in the plan and who do not belong to the same collective bargaining unit, the dates on which the employer became and ceased to be a member of the plan shall be determined separately on a class basis for individuals who belong to separate collective bargaining units, as separate classes, and for individuals who do not belong to a collective bargaining unit, as a further single separate class. Thus, such dates shall be determined with respect to individuals as a class who belong to the same collective bargaining unit (or who do not belong to a collective bargaining unit) without consideration of the employment by the employer of, or the participation in the plan by, other individuals (who do not belong to such collective bargaining unit and who may belong to another collective bargaining unit) or whether the employer is a member of the plan with respect to such other individuals. In no event,

however, may service not attributable to service with a particular collective bargaining unit be disregarded under paragaphs (a)(4) and (b)(2) of this section merely because the employer ceases to maintain the plan with respect to such unit. Thus, for example, paragraphs (a)(4) and (b)(2) of this section do not permit the disregard of a period of service of an individual belonging to a collective bargaining unit prior to the time the employer became a member of the plan with respect to such unit to the extent that, during such period of service, the individual belonged to another collective bargaining unit with respect to which the employer was a member of the plan.

(3) *Controlled groups*. For purposes of section 414(f) and this section, all corporations which are members of a controlled group of corporations (within the meaning of section 1563(a) and the regulations thereunder, but determined without regard to section 1563(e)(3)(C) and the regulations thereunder) are deemed to be one employer.

(c) *Contributions exceeding 50 percent*. If a plan was a multiemployer plan as defined in this section for any plan year (including plan years ending prior to September 3, 1974), ''75 percent'' shall be substituted for ''50 percent'' in applying paragraph (a)(3) of this section for subsequent plan years until the first plan year following a plan year in which the amount contributed by or on behalf of one employer is 75 percent or more of the total amount of contributions made under the plan for that plan year by or on behalf of all of the employers making contributions. In such case ''75 percent'' shall not again be substituted for ''50 percent'' until the plan has met the requirements of paragraph (a) of this section (determined without regard to this paragraph) for one plan year.

(d) *Examples*. The application of this section is illustrated by the following examples. For purposes of these examples, assume that the plan meets the requirements of paragraphs (a) (1), (2), (4), and (5) of this section for each plan year.

Example (1). On January 1, 1970, U, V, and W, three employers none of which is a member of a controlled group of corporations with any of the other two employers, establish a plan with a plan year corresponding to the calendar year. U, V, and W each contribute less than one-half of the total contributions made under the plan for each of the years 1970, 1971, and 1972. For the years 1973, 1974, and 1975, U contributes 70 percent and V and W each contribute 15 percent of the total contributions made under the plan for each year. The plan is a multiemployer plan under section 414(f) and this section for 1975 because no employer has contributed 75 percent or more of the total amount contributed for each of the plan years subsequent to 1972.

Example (2). (i) *First plan year*. On January 1, 1975, X, Y, and Z, three employers none of which is a member of a controlled group of corporations with any of the other two employers, establish a plan with a plan year corresponding to the calendar year. X, Y, and Z each contribute less than one-half of the total contributions made under the plan for 1975. The plan is a multiemployer plan for 1975 because it meets the 50 percent contribution requirement of paragraph (a)(3) of this section.

(ii) *Second plan year*. For the second plan year, 1976, X contributes 70 percent and Y and Z each contribute 15 percent of the total contributions made under the plan. The plan is a multiemployer plan for 1976 because it was a multiemployer plan for the preceding plan year and satisfies the 75 percent contribution requirement of paragraph (c) of this section.

(iii) *Third plan year*. For the third plan year, 1977, X contributes 80 percent and Y and Z each contribute 10 percent of the total contributions made under the plan. The plan is not a multiemployer plan for 1977 because it fails to satisfy the 75 percent contribution requirement of paragraph (c) of this section.

(iv) *Fourth plan year*. For the fourth plan year, 1978, Y contributes 60 percent and X and Z each contribute 20 percent of the total contributions made under the plan. The 75 percent contribution requirement of paragraph (c) of this section does not apply. The plan is not a multiemployer plan for 1978 because it fails to satisfy the 50 percent contribution requirement of paragraph (a)(3) of this section.

(v) *Fifth plan year*. For the fifth plan year, 1979, X, Y, and Z each contribute less than one-half of the total contributions made under the plan. The 75 percent contribution requirement of paragraph (c) of this section does not apply. The plan is a multiemployer plan for 1979 because it again meets the 50 percent contribution requirement of paragraph (a)(3) of this section.

(vi) *Sixth plan year*. For the sixth plan year, 1980, the plan will continue to be a multiemployer plan, provided that no employer contributes 75 percent or more of the total amount of contributions made under the plan for the plan year.

(e) *Retention of records.* (1) For plan years ending prior to September 3, 1974, a plan may be required to furnish proof that it met the requirements of section 414(f) and this section for each plan year ending prior to that date to the extent necessary to show the applicability of the 75 percent test provided in paragraph (c) of this section.

(2) For plan years ending after September 2, 1974, a plan may be required to furnish proof that it met the requirements of section 414(f) and this section for 6 immediately preceding plan years.

(Secs. 414(f) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 927, 26 U.S.C. 414(f); 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7552, 43 FR 29940, July 12, 1978]

§ 1.414(g)–1 Definition of plan administrator.

(a) *In general.* For purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, if the instrument under which the plan is operated for a plan year specifically designates a person or a group of persons as plan administrator, the person or group of persons collectively is the plan administrator for the plan year. The instrument may specifically designate a plan administrator—

(1) By name,

(2) By reference to the person or group of persons holding a named position or positions,

(3) By reference to a procedure established under the terms of the instrument pursuant to which a plan administrator is designated, or

(4) By reference to the person or group of persons charged with specific responsibilities of plan administrator. Consistent with the provisions of section 405 (c) (1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1105 (c) (1)), a plan may provide for the allocation of specific responsibilities of plan administrator among named persons and for named persons to designate others to carry out such responsibilities. A person or group of persons may be designated as plan administrator in accordance with the rules of this paragraph even though the person or group of persons does not carry the specific title ''plan administrator''. In the absence of a person or group of persons designated as the plan administrator (individually, collectively, or by designation of different specific administrative responsibilities), the plan administrator for the plan year is the person or group of persons specified in paragraph (b) of this section.

(b) *Plan administrator not specifically designated.* If no person or group of persons is specifically designated as the plan administrator for a plan year by the instrument under which the plan is operated, the plan administrator for such year is the person or group of persons determined under the following rules:

(1) *Single employer.* In the case of a plan maintained by a single employer, the employer is the plan administrator. If the employer is a corporation, the corporation is the plan administrator. However, the corporation's board of directors may authorize a person or group of persons to fulfill responsibilities of the corporation as plan administrator. In the absence of such authorization, any corporate officer authorized under law, corporate by-laws, or resolution of the board of directors to act on behalf of the corporation with respect to contracts of a value equivalent to the fair market value of the assets of the plan shall be presumed to have authority to fulfill responsibilities of the corporation as plan administrator. For purposes of this paragraph (b) (1), ''employer'' means the ''employer'' as defined in section 3 (5) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1003 (5)).

(2) *Employee organization.* In the case of a plan maintained by an employee organization, the employee organization is the plan administrator.

(3) *Group representing the parties.* In the case of a plan maintained by two or more employers, or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who maintain the plan, as the case may be, is the plan administrator. For purposes of this subparagraph (3), a plan shall be considered maintained by two or more employers or jointly by one or more employers

and one or more employee organizations only if none of the parties has the express power, under the terms of the instrument under which the plan is operated, to terminate the plan unilaterally.

(4) *Person in control of assets.* In any case where a plan administrator may not be determined by application of paragraphs (a) and (b), (1), (2), and (3) of this section, the plan administrator is the person or persons actually responsible, whether or not under the terms of the plan, for the control, disposition, or management of the cash or property received by or contributed to the plan, irrespective of whether such control, disposition, or management is exercised directly by such person or persons or indirectly through an agent or trustee designated by such person or persons.

(Secs. 414(g) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 927, 68A Stat 917; 26 U.S.C. 414(g), 7805))

[T.D. 7618, 44 FR 27657, May 11, 1979]

§ 1.414(l)–1 Mergers and consolidations of plans or transfers of plan assets.

(a) *In general*—(1) *Scope of the regulations.* Sections 401(a)(12) and 414(l) apply only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, these sections do not apply to a governmental plan within the meaning of section 414(d); a church plan, within the meaning of section 414(e), for which there has not been made the election under section 410(d) to have the participation, vesting, funding, etc. requirements apply; or a plan which at no time after September 2, 1974, provided for employer contributions.

(2) *General rule.* Under section 414(l),

(i) A trust which forms a part of a plan will not constitute a qualified trust under section 401, and

(ii) A plan will not be treated as being qualified under section 403 (a) and 405 (a), unless, in the case of a merger or consolidation (as defined in paragraph (b)(2) of this section), or a transfer of assets or liabilities (as defined in paragraph (b)(3) of this section), the following condition is satisfied. This condition requires that each participant receive benefits on a termination basis (as defined in paragraph (b)(5) of this section) from the plan immediately after the merger, consolidation or transfer which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation, or transfer.

(b) *Definitions.* For purposes of this section:

(1) *Single plan.* A plan is a ''single plan'' if and only if, on an ongoing basis, all of the plan assets are available to pay benefits to employees who are covered by the plan and their beneficiaries. For purposes of the preceding sentence, all the assets of a plan will not fail to be available to provide all the benefits of a plan merely because the plan is funded in part or in whole with allocated insurance instruments. A plan will not fail to be a single plan merely because of the following:

(i) The plan has several distinct benefit structures which apply either to the same or different participants,

(ii) The plan has several plan documents,

(iii) Several employers, whether or not affiliated, contribute to the plan,

(iv) The assets of the plan are invested in several trusts or annuity contracts, or

(v) Separate accounting is maintained for purposes of cost allocation but not for purposes of providing benefits under the plan.

However, more than one plan will exist if a portion of the plan assets is not available to pay some of the benefits. This will be so even if each plan has the same benefit structure or plan document, or if all or part of the assets are invested in one trust with separate accounting with respect to each plan.

(2) *Merger or consolidation.* The terms ''merger'' or ''consolidation'' means the combining of two or more plans into a single plan. A merger or consolidation will not occur merely because one or more corporations undergo a reorganization (whether or not taxable). Furthermore, a merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan.

(3) *Transfer of assets or liabilities.* A ''transfer of assets or liabilities'' occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumption of these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding media used for a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities.

(4) *Spinoff.* The term ''spinoff'' means the splitting of a single plan into two or more plans.

(5) *Benefits on a termination basis.* (i) The term ''benefits on a termination basis'' means the benefits that would be provided exclusively by the plan assets pursuant to section 4044 of the Employee Retirement Income Security Act of 1974 (''ERISA'') and the regulations thereunder if the plan terminated. Thus, the term does not include benefits that are guaranteed by the Pension Benefit Guaranty Corporation, but not provided by the plan assets.

(ii) For purposes of determining the benefits on a termination basis, the allocation of assets to various priority categories under section 4044 of ERISA must be made on the basis of reasonable actuarial assumptions. The assumptions used by the Pension Benefit Guaranty Corporation as of the date of the merger or spinoff are deemed reasonable for this purpose.

(iii) If a change in the benefit structure of a plan in conjunction with a merger, consolidation, or transfer of assets or liabilities alters the benefits on a termination basis, the change should be designated, at the time the merger, consolidation, or transfer occurs, to be effective either immediately before or immediately after that occurrence. In the event that no designation is made, the change in the benefit structure will be deemed to occur immediately after the merger, consolidation, or transfer of assets or liabilities.

(6) *Lower funded plan.* (i) The term ''lower funded plan'' generally means the plan which, immediately prior to the merger, would have its assets exhausted in a higher priority category than the other plan.

(ii) Where two plans, immediately prior to the merger, would have their assets exhausted in the same priority category of section 4044 of ERISA in the event of termination, the lower funded plan is the one in which the assets would satisfy a lesser proportion of the liability allocated to that priority category.

(7) *Priority category.* The term ''priority category'' means the category of benefits described in each paragraph of section 4044(a) of ERISA. References to higher or highest priority categories refer to those priority categories which receive the first allocation of asserts, i.e. the lowest paragraph numbers in section 4044(a).

(8) *Separate accounting of assets.* The term ''separate accounting of assets'' means the maintenance of an asset account with respect to a given group of participants which is:

(i) Credited with contributions made to the plan on behalf of the participants and with its allocable share of investment income, if any, and

(ii) Charged with benefits paid to the participants, and with its allocable share of investment losses or expenses.

(9) *Present value of accrued benefit.* For purposes of this section, the present value of an accrued benefit must be determined on the basis of reasonable actuarial assumptions. For this purpose, the assumptions used by the Pension Benefit Guaranty Corporation as of the date of the merger or spinoff are deemed reasonable.

(10) *Valuation of plan assets.* In determining the value of a plan's assets, the standards set forth in regulations prescribed by the Pension Benefit Guaranty Corporation (29 CFR Part 2611) shall be applied.

(11) *Date of merger or spinoff.* The actual date of a merger or spinoff shall be determined on the basis of the facts and circumstances of the particular situation. For purposes of this determination, the following factors, none of which is necessarily controlling, are relevant:

(i) The date on which the affected employees stop accruing benefits under

one plan and begin coverage and benefit accruals under another plan.

(ii) The date as of which the amount of assets to be eventually transferred is calculated.

(iii) If the merger or spinoff agreement provides that interest is to accrue from a certain date to the date of actual transfer, the date from which such interest will accrue.

(c) *Application of section 414(l)*—(1) *Two or more plans.* (i) Section 414(l) does not apply unless more than a single plan is involved. It also does not apply unless at least a single plan assumes liabilities from another plan or obtains assets from another plan (as in a merger or spinoff). For purposes of section 414(l), a transfer of assets or liabilities will not be deemed to occur merely because a defined contribution plan is amended to become a defined benefit plan. This rule will apply even if, under the facts and circumstances of a particular case, a termination of the defined contribution plan will be considered to have occurred for purposes of other provisions of the Code.

(ii) The requirements of this subparagraph may be illustrated as follows:

Example. After acquiring Corporation B, Corporation A amends Corporation B's defined benefit plan (Plan B) to provide the same benefits as Corporation A's defined benefit plan (Plan A). The assets of Plan B are transferred to the trust containing the assets of Plan A in such a manner that the assets of each plan: (1) are separately accounted for, and (2) are not available to pay benefits of the other plan. Because of condition (2) there are still two plans and, therefore, a merger did not occur. As a result, section 414(l) does not apply. If at some later date Corporation A were to sell Corporation B and transfer the assets of Plan B that were separately accounted for to another trust or to an annuity contract solely for the purpose of providing Plan B's benefits, this transfer would also not involve section 414(l). This is so because Plan B was a separate plan before the entire transaction and because no plan assumed liabilities or obtained assets from another plan. If, on the other hand, Corporation A merged Plan A and Plan B at the time of the acquisition of Corporation B by deleting condition (2) above, then section 414(l) would apply both to the merger of Plan A and Plan B and to the spinoff of Plan B from the merged plan. The spinoff would have to satisfy the requirements of paragraph (n) of this section, even if the assets attributable to Plan A and Plan B were separately accounted for in order to allocate funding costs.

(2) *Multiemployer plans.* Except to the extent provided by regulations of the Pension Benefit Guaranty Corporation, section 114(l) does not apply to any transaction to the extent that participants either before or after that transaction are covered under a multiemployer plan within the meaning of section 414(f). Until these regulations are issued, section 414(l) does not apply to any of the following situations:

(i) A multiemployer plan is split into two or more plans, one or more of which are not multiemployer plans, or

(ii) A single employer plan is merged into a multiemployer plan.

Therefore, if some (but not all) of the participants in a single employer plan become participants in a multiemployer plan under an agreement in which the multiemployer plan assumes all the liabilities of the single employer plan with respect to these participants and in which some or all of the assets of the single employer plan are transferred to the multiemployer plan, section 414(l) applies, but only with respect to the participants in the single employer plan who did not transfer to the multiemployer plan.

(d) *Merger of defined contribution plans.* In the case of a merger of two or more defined contribution plans, the requirements of section 414(l) will be satisfied if all of the following conditions are met:

(1) The sum of the account balances in each plan equals the fair market value (determined as of the date of the merger) of the entire plan assets.

(2) The assets of each plan are combined to form the assets of the plan as merged.

(3) Immediately after the merger, each participant in the plan as merged has an account balance equal to the sum of the account balances the participant had in the plans immediately prior to merger.

(e) *Merger of defined benefit plans*—(1) *General rule.* Section 414(l) compares the benefits on a termination basis before and after the merger. If the sum of the assets of all plans is not less than the sum of the present values of the accrued benefit (whether or not vested) of all plans, the requirements of section

414(l) will be satisfied merely by combining the assets and preserving each participant's accrued benefits. This is so because all the accrued benefits of the plan as merged are provided on a termination basis by the plan as merged. However, if the sum of the assets of all plans is less than the sum of the present values of the accrued benefits (whether or not vested) in all plans, the accrued benefits in the plan as merged are not provided on a termination basis.

(2) *Special schedule of benefits.* Generally, for some participants, the benefits provided on a termination basis for the plan as merged would be different from the benefits provided on a termination basis in the plans prior to merger if the assets were merely combined and if each participant retained his accrued benefit. Some participants would, therefore, receive greater benefits on a termination basis as a result of the merger and some other participants would receive smaller benefits. Accordingly, the requirements of section 414(l) would not be satisfied unless the distribution on termination were modified in some manner to prevent any participant from receiving smaller benefits on a termination basis as a result of the merger. This is accomplished through modifying the application of section 4044 of ERISA by inserting a special schedule of benefits.

(f) *Operational rules for the special schedule.* The application of section 4044 of ERISA as modified by the schedule of benefits is accomplished by the following steps:

(1) Section 4044 is applied in the plan as merged through the priority categories fully satisfied by the assets of the lower funded plan immediately prior to the merger.

(2) The assets in the plan as merged are then allocated to the next priority category as a percentage of the value of the benefits that would otherwise be allocated to that priority category. That percentage is the ratio of (i) the assets allocated to the first priority category not fully satisfied by the lower funded plan immediately prior to the merger to (ii) the assets that would have been allocated had that priority category been fully satisfied.

(3) A schedule of benefits is formed listing participants and scheduled accrued benefits. The scheduled accrued benefit is the excess of the benefits provided on a termination basis with respect to any participant from the plans immediately prior to the merger, over the benefits provided on a termination basis in subparagraphs (1) and (2) of this paragraph immediately after the merger. After allocating the assets in accordance with subparagraph (2) of this paragraph, the assets are allocated to the schedule of benefits as follows:

(i) First the assets are allocated to the scheduled benefits to the extent that the participant would have benefits provided in subparagraph (4) of this paragraph if there were no scheduled benefits.

(ii) Then the assets are allocated to the scheduled benefits to the extent that the participant would have benefits provided pursuant to subparagraph (5) of this paragraph if there were no scheduled benefits.

These assets should be allocated first to those scheduled benefits that are in the highest priority category under section 4044.

(4) The assets are then allocated to those benefits in the priority category described in subparagraph (2) of this paragraph with respect to which assets were not allocated. This allocation is made to the extent that these benefits are not associated with benefits in the schedule.

(5) Finally, the assets are allocated in accordance with section 4044 with respect to priority categories lower than the priority category described in subparagraph (4) of this paragraph. This allocation is made to the extent that these benefits are not associated with benefits in the schedule.

(g) *Successive mergers*—(1) *In general.* In the case of a current merger of a defined benefit plan with another defined benefit plan which as a result of a previous merger has a special schedule, the rules of paragraphs (e) and (f) of this section apply as if the schedule were considered a category described in section 4044 of ERISA. Thus, a second schedule may be formed as a result of

the current merger. The second schedule will be inserted in the priority category of section 4044 described in paragraph (f)(2) of this section as of the date of the current merger. This priority category may be higher, lower, or within the schedule of benefits existing on account of a previous merger. If this priority schedule is inserted within a schedule of benefits, a new single schedule of benefits replacing the old schedule of benefits would in effect be created.

(2) *Allocation of assets*. Assets in the new schedule of benefits are allocated as follows:

(i) First to the benefits remaining in the old schedule to the extent that there are assets immediately prior to the second merger to satisfy the original benefits,

(ii) Then to the benefits provided on a termination basis from the plans immediately prior to the second merger to the extent that they are not provided before the schedule after the second merger or in subdivision (i) of this subparagraph,

(iii) Then to benefits remaining in the original schedule not included in subdivision (i) of this subparagraph.

(h) *De minimis rule for merger of defined benefit plan*—(1) *In general*. In the case of a merger of a defined benefit plan (''smaller plan'') whose liabilities (*i.e.*, the present value of accrued benefits, whether or not vested) are less than 3 percent of the assets of another defined benefit plan (''larger plan'') as of at least one day in the larger plan's plan year in which the merger of the two plans occurs, section 414(l) will be deemed to be satisfied if the following condition is met. The condition requires that a special schedule of benefits (consisting of all the benefits that would be provided by the smaller plan on a termination basis just prior to the merger) be payable in a priority category higher than the highest priority category in section 4044 of ERISA. Assets will be allocated to that schedule in accordance with the allocation of assets to scheduled benefits in paragraph (f)(3) of this section.

(2) *Application to a series of mergers*. In the case of a series of such mergers in a given plan year of the larger plan, the rule described in subparagraph (1) of this paragraph will apply only if the sum of the liabilities (whether or not vested) assumed by the larger plan are less than 3 percent of the assets of the larger plan as of at least one day in the plan year of the larger plan in which the mergers occurred.

(3) *Application to a merger occurring over more than one plan year*. In the case of a merger of a smaller plan or a portion thereof with a larger plan designed to occur in steps over more than one plan year of the larger plan, the entire transaction will be deemed to occur in the plan year of the larger plan which contains the first of these steps.

(4) *Liabilities of the smaller plan*. For purposes of subparagraphs (2) and (3) of this paragraph, mergers satisfying paragraphs (e), (f) or (g) of this section will be ignored in determining the sum of the liabilities assumed by the larger plan.

(i) *Data maintenance*—(1) *Alternative to the special schedule*. In the case of a merger which would require the creation of a special schedule in order to satisfy section 414(l), the schedule need not be created at the time of the merger if data sufficient to create the schedule is maintained. The schedule would only have to be created in the event of a subsequent plan termination or a subsequent spinoff. In that case the schedule must be determined as of the date of the merger.

(2) *Required data*. The data that must be maintained depends on the plan, and care should be taken to ensure that all necessary data is maintained. Furthermore, in order to take advantage of the data maintenance alternative provided in this paragraph, an enrolled actuary must certify to the plan administrator that each element of data necessary to determine the schedule as of the date of the merger is maintained. This certification must be based either upon the enrolled actuary's independent examination of the data, or upon his reliance, which under the circumstances of the particular situation must be reasonable, upon a written statement of the plan administrator concerning what data is actually being maintained.

(j) *Five year rule*—(1) *Limitation on the required use of the special schedule*. A

plan will not fail to satisfy the requirements of section 414(l) merely because the effects of the special schedule created pursuant to paragraphs (e)(2) or (h) of this section are ignored 5 years after the date of a merger. Furthermore, the date maintained pursuant to paragraph (i) of this section need not be maintained for more than 5 years after the merger, if the plan does not have a spinoff or a termination within 5 years.

(2) *Illustration*. If Plans A and B merge to form Plan AB and if Plan AB merges with Plan C 3 years later to form Plan ABC and if Plan ABC terminates 4 years later, the data relating to the merger of Plans A and B need not be maintained for more than 5 years after the merger of Plans A and B. In addition, after 5 years have elapsed after the merger of Plans A and B, the effect of any special schedule created by the merger of Plans A and B on the schedule created by the merger of Plans AB and C may be ignored in determining the later schedule.

(k) *Examples*. The provisions of paragraphs (e) through (j) of this section may be illustrated by the following examples:

Example (*1*). Plan A, whose assets are $220,000, is to be merged with Plan B, whose assets are $200,000. Plan A has three employees. Plan B has two employees. If Plans A and B were to terminate just prior to the merger, the benefits provided on a termination basis would be as follows:

PLAN A

Priority category of section 4044 of ERISA	(1)—Annual accrued benefits			(2)—Present value of accrued benefits			(3)—Fair market value of assets allocated to priority category	(4)—Benefits on a termination basis		
	EE_1	EE_2	EE_3	EE_1	EE_2	EE_3		EE_1	EE_2	EE_3
3	$10,000	.....	.....	$120,000	.....	.....	$120,000	$10,000	.....	.....
4	2,000	$4,000	.....	24,000	$44,000	.....	68,000	2,000	$4,000	.....
5	.....	3,000	$4,000	.....	33,000	$40,000	32,000	.....	[1] 1,315	[2] $1,753
6	.....	.....	1,000	.....	.....	10,000	.....	.....	.....	.....
Total	.....	.....	.....	.....	.....	.....	220,000	12,000	5,315	1,753

[1] $3,000 × $32,000 ÷ $73,000 i.e. accrued benefit × assets available for priority category 5—Total present value of accrued benefits in category 5.
[2] $4,000 × $32,000 ÷ $73,000.

PLAN B

Priority category of section 4044 of ERISA	(1)—Annual accrued benefits					(2)—Present value of accrued benefits					(3)—Fair market value of assets allocated to priority category	(4)—Benefits on a termination basis				
	EE_1	EE_2	EE_3	EE_4	EE_5	EE_1	EE_2	EE_3	EE_4	EE_5		EE_1	EE_2	EE_3	EE_4	EE_5
3	.....	.....	.....	$15,000	.....	.....	.....	.....	$195,000	.....	$195,000	.....	.....	.....	$15,000	.....
4	.....	.....	.....	.....	$5,000	.....	.....	.....	.....	$50,000	5,000	.....	.....	.....	.....	[1] $500
5	.....	.....	.....	.....	8,000	.....	.....	.....	.....	80,000	.....	.....	.....	.....	.....	.....
Total	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	200,000	.....	.....	.....	15,000	500

[1] $5,000 ÷ $5,000 × $50,000.

Because Plan B's assets are exhausted in a higher priority category than Plan A's assets, Plan B is the lower funded plan. A schedule will, therefore, be inserted in Priority Category 4 of the plan as merged after providing 10% of the benefits provided in category 4, i.e. the ratio of $5,000 assets in Plan B allocated to category 4 to the $50,000 liability in category 4. The schedule would be constructed as follows:

EE	(1)—Benefits on a termination basis before merger	(2)—Benefits provided from priority categories higher than Category 4	(3)—10% of benefits provided in priority Category 4	(4)—Benefits provided before schedule (2) + (3)	(5)—Schedule of benefits (1) − (4)
1	$12,000	$10,000	$200	$10,200	$1,800
2	5,315	.....	400	400	4,915
3	1,753	.....	.....	.....	1,753
4	15,000	15,000	.....	15,000	.....
5	500	.....	500	500	.....

Example (2). The facts are the same as in Example (1). The plan, however, terminates one year later. Furthermore, no employee has accrued additional benefits during the year except that the $2,000 benefit for EE_1, that was originally in category 4 is now in category 3. The assets would be allocated to the priority categories to the extent that there are assets to cover the following benefits.

Priority termination category	EE_1	EE_2	EE_3	EE_4	EE_5
3	$12,000	.....	.....	$15,000	.....
10% of 4	.....	$400	.....	.....	$500
Schedule of benefits included in balance of Category 4	.....	3,600	.....	.....	.....
Schedule of benefits included in Category 5	.....	1,315	$1,753	.....	.....
Schedule of benefits included in Category 6	.....	.....	.....	.....	.....
Balance of Category 4 not included in schedule	.....	.....	.....	.....	4,500
Balance of Category 5 not included in schedule	.....	1,685	2,247	.....	8,000
Balance of Category 6 not included in schedule	.....	.....	1,000	.....	.....

(l) *Merger of defined benefit and defined contribution plan.* In the case of a merger of a defined benefit plan with a defined contribution plan, one of the plans before the merger should be converted into the other type of plan (*i.e.*, the defined benefit converted into a defined contribution or the defined contribution converted into a defined benefit) and either paragraph (d) or paragraphs (e) through (j) of this section, whichever is appropriate, should be applied.

(m) *Spinoff of a defined contribution plan.* In the case of a spinoff of a defined contribution plan, the requirements of section 414(l) will be satisfied if after the spinoff—

(1) The sum of the account balances for each of the participants in the resulting plans equals the account balance of the participant in the plan before the spinoff, and

(2) The assets in each of the plans immediately after the spinoff equals the sum of the account balances for all participants in that plan.

(n) *Spinoff of a defined benefit plan*—(1) *General rule.* In the case of a spinoff of a defined benefit plan, the requirements of section 414(l) will be satisfied if—

(i) All of the accrued benefits of each participant are allocated to only one of the spun off plans, and

(ii) The value of the assets allocated to each of the spun off plans is not less than the sum of the present value of the benefits on a termination basis in the plan before the spin off for all participants in that spun off plan.

(2) *De minimis rule.* In the case of a spin off the requirements of section 414(l) will be deemed to be satisfied if the value of the assets spun off—

(i) Equals the present value of the accrued benefits spun off (whether or not vested), and

(ii) In conjunction with other assets spun off during the plan year in which the spinoff occurs in accordance with this subparagraph, is less than 3 percent of the assets as of at least one day in that year.

Spinoffs occurring in previous or subsequent plan years are ignored if they are not part of a single spinoff designed to occur in steps over more than one plan year.

(3) *Special temporary rule*. In the case of a defined benefit plan maintained for different groups of employees, which is a single plan (as defined in paragraph (b)(l) of this section) and under which there has been separate accounting of assets for each group, a spinoff of the plan on or before July 1, 1978, into a separate plan for each group will be deemed to satisfy section 414 (l) if—

(i) All the liabilities with respect to each group of employees are allocated to a separate plan for that group of employees, and

(ii) The assets that are separately accounted for with respect to each group of employees are allocated to the separate plan for that group of employees.

For purposes of this subparagraph, a separate accounting of assets will not be considered to have occurred to the extent that the assets allocated to each single plan are determined by an historical re-creation of benefits, contributions, investment gains, etc.

(o) *Transfers of assets or liabilities*. Any transfer of assets or liabilities will for purposes of section 414 (l) be considered as a combination of separate mergers and spinoffs using the rules of paragraphs (d), (e) through (j), (l), (m), or (n) of this section, whichever is appropriate. Thus, for example, if in accordance with the transfer of one or more employees, a block of assets and liabilities are transferred from Plan A to Plan B, each of which is a defined benefit plan, the transaction will be considered as a spinoff from Plan A and a merger of one of the spinoff plans with Plan B. The spinoff and merger described in the previous sentence would be subject to the requirements of paragraphs (n) and (e) through (j) of this section respectively.

[T.D. 7638, 44 FR 48195, Aug. 17, 1979]

§ 1.414(q)–1 Highly compensated employee.

Q&A–1—Q&A–8: [Reserved]. See § 1.414(q)–1T, Q&A–1 through Q&A–8 for further guidance.

Q–9: How is the top-paid group determined?

A–9: (a) [Reserved]. See § 1.414(q)–1T, Q&A–9(a) for further guidance.

(b) *Number of employees in the top-paid group*—(1) *Exclusions*. The number of employees who are in the top-paid group for a year is equal to 20 percent of the total number of active employees of the employer for such year. However, solely for purposes of determining the total number of active employees in the top-paid group for a year, the employees described in § 1.414(q)–1T, A–9(b)(1) (i), (ii) and (iii)(B) are disregarded. Paragraph (g) of this A–9 provides rules for determining those employees who are excluded for purposes of applying section 414(r)(2)(A), relating to the 50-employee requirement applicable to a qualified separate line of business.

(i)–(iii) [Reserved]. See § 1.414(q)–1T, Q&A–9(b)(1) (i) through (iii) for further guidance.

(2) *Alternative exclusion provisions*—(i)–(ii) [Reserved]. See § 1.414(q)–1T, Q&A–9(b)(2) (i) and (ii) for further guidance.

(iii) *Method of election*. The elections in this paragraph (b)(2) must be provided for in all plans of the employer and must be uniform and consistent with respect to all situations in which the section 414(q) definition is applicable to the employer. Thus, with respect to all plan years beginning in the same calendar year, the employer must apply the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans. If either election is changed during the determination year, no recalculation of the look-back year based on the new election is required, provided the change in election does not result in discrimination in operation.

(c)–(f) [Reserved]. See § 1.414(q)–1T, Q&A–9 (c) through (f) for further guidance.

(g) *Excluded employees under section 414(r)(2)(A)*—(1) *In general*. This paragraph (g) provides the rules for determining which employees are excluded employees for purposes of applying section 414(r)(2)(A), relating to the 50-employee requirement applicable to a qualified separate line of business.

(2) *Excluded employees*—(i) *Age and service exclusion*. All employees are excluded who are described in §1.414(q)–1T, A–9(b)(1)(i) (relating to exclusions based on age or service). For this purpose, the rules in §1.414(q)–1T, A–9 (e) and (f) (relating respectively to the 17½-hour rule and the 6-month rule) apply. However, the election in §1.414(q)–1T, A–9(b)(2)(i) (permitting the employer to elect reduced minimum age or service requirements) does not apply.

(ii) *Nonresident alien exclusion*. All employees are excluded who are described in §1.414(q)–1T, A–9(b)(1)(ii) (relating to the exclusion of nonresident aliens with no U.S.- source income from the employer).

(iii) *Inclusion of employees covered under a collective bargaining agreement*. All employees are included who are described in §1.414(q)–1T, A–9(b)(1)(iii)(A) (relating to employees covered under a collective bargaining agreement) and who are not otherwise described in paragraph (g)(2) (i) or (ii) of this A–9. For this purpose, the exclusion in §1.414(q)–1T, A– 9(b)(1)(iii)(B) and the related election in §1.414(q)–1T, A–9(b)(2)(ii) do not apply.

(3) *Applicable period*. The determination of which employees are excluded employees is made on the basis of the testing year specified in the regulations under section 414(r) and not on the basis of the determination year or the look-back year under section 414(q).

(h) *Effective date*. The provisions of this A–9 apply to plan years and testing years beginning on or after January 1, 1994.

Q&A–10 through Q&A–15: [Reserved]. See §1.414(q)–1T, Q&A–10 through Q&A–15 for further guidance.

[T.D. 8548, 59 FR 32915, June 27, 1994]

§1.414(q)–1T Highly compensated employee (temporary).

The following questions and answers relate to the definition of ''highly compensated employee'' provided in section 414(q). The definitions and rules provided in these questions and answers are provided solely for purposes of determining the group of highly compensated employees.

TABLE OF CONTENTS.

Q&A–1 General applicability of section 414(q).
Q&A–2 Definition of highly compensated employees.
Q&A–3 Definition of highly compensated active employees.
Q&A–4 Definition of highly compensated former employees.
Q&A–5 Definition of separation year.
Q&A–6 Definition of employer.
Q&A–7 Definition of employee.
Q&A–8 Definition of 5-percent owner.
Q&A–9 Definition of top-paid group.
Q&A–10 Definition of officer and rules on inclusion of officers in highly compensated group.
Q&A–11 Rules with respect to family aggregation.
Q&A–12 Definition of family member.
Q&A–13 Definition of compensation.
Q&A–14 Rules with respect to the relevant determination periods.
Q&A–15 Transition rule applicable to plan years beginning in 1987 and 1988 for certain employers that have plans that must comply with the provisions of section 401(k)(3) or 401(m)(2).

Q–1: To what employee benefit plans and statutory provisions is the definition of highly compensated employee contained in section 414(q) applicable?

A–1: (a) *In general*. This definition is applicable to statutory provisions that incorporate the definition by reference.

(b) *Qualified retirement plans*—(1) *In general*. Generally, this definition is incorporated in many of the nondiscrimination requirements applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). *See, e.g.*, the nondiscrimination provisions of sections 401(a) (4) and (5), 401(k)(3), 401(l), 401(m), 406(b), 407(b), 408(k), 410(b) and 411(d)(1). The definition is also incorporated by certain other provisions with respect to such plans, including the aggregation rules of section 414(m) and section 4975 (tax on prohibited transactions).

(2) *Not applicable where not incorporated by reference*. This definition is not applicable to qualified plan provisions that do not incorporate it. *See, e.g.*, section 415 (limitations on contributions and benefits), with the exception of section 415(c)(3)(C) and 415(c)(6) (special rules for permanent and total disability and employee stock ownership plans respectively).

(c) *Other employee benefit plans or arrangements.* This definition is incorporated by various sections relating to employee benefit provisions. *See, e.g.*, section 89 (certain other employee benefit plans), section 106 (accident and health plans), 117(d) (qualified tuition reduction), section 125 (cafeteria plans), section 129 (dependent care assistance programs), section 132 (certain fringe benefits), section 274 (certain entertainment, etc. expenses), section 423(b) (employee stock purchase plan provisions), section 501(c) (17) and (18) (certain exempt trusts providing benefits to employees), and section 505 (certain exempt organizations or trusts providing benefits to individuals). See the respective sections for the applicable effective dates.

(d) *ERISA.* This definition is not determinative with respect to any provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), unless it is explicitly incorporated by reference (e.g., section 408(b)(1)(B)).

Q–2: Who is a highly compensated employee?

A–2: The group of employees (including former employees) who are highly compensated employees consists of both highly compensated active employees (see A–3 of this §1.414(q)–1T) and highly compensated former employees (see A–4 of this §1.414(q)–1T). In many circumstances, highly compensated active employees and highly compensated former employees are considered separately in applying the provisions for which the definition of highly compensated employees in section 414(q) is applicable. Specific rules with respect to the treatment of highly compensated active employees and highly compensated former employees will be provided in the regulations with respect to the sections to which the definition of highly compensated employees is applicable.

Q–3: Who is a highly compensated active employee?

A–3: (a) *General rule.* For purposes of the year for which the determination is being made (the determination year), a highly compensated active employee is any employee who, with respect to the employer, performs services during the determination year and is described in any one or more of the following groups applicable with respect to the look-back year calculation and/or determination year calculation for such determination year. See A–14 for rules relating to the periods for which the look-back year calculation and determination year calculation are to be made.

(1) *Look-back year calculation.*

(i) *5-percent owner.* The employee is a 5-percent owner at any time during the look-back year (i.e., generally, the 12-month period immediately preceding the determination year; see A–14. (See A–8 of this §1.414(q)–1T.)

(ii) *Compensation above $75,000.* The employee receives compensation in excess of $75,000 during the look-back year.

(iii) *Compensation above $50,000 and top-paid group.* The employee receives compensation in excess of $50,000 during the look-back year and is a member of the top-paid group for the look-back year. (See A–9 of this §1.414(q)–1T.)

(iv) *Officer.* The employee is an ''includible officer'' during the look-back year. (See A–10 of this §1.414(q)–1T.)

(2) *Determination year calculation.*

(i) *5-percent owner.* The employee is a 5-percent owner at any time during the determination year. (See A–8 of this §1.414(q)–1T.)

(ii) *Top-100 employees.* The employee is both (A) described in paragraph (a)(1)(i), (ii) and/or (iv) of this A–3, when such paragraphs are modified to substitute the determination year for the look-back year, and (B) one of the 100 employees who receive the most compensation from the employer during the determination year.

(b) *Rounding and tie-breaking rules.* In making the look-back year and determination year calculations for a determination year, it may be necessary for an employer to adopt a rule for rounding calculations (e.g., in determining the number of employees in the top-paid group). In addition, it may be necessary to adopt a rule breaking ties among two or more employees (e.g., in identifying those particular employees who are in the top-paid group or who are among the 100 most highly compensated employees). In such cases, the employer may adopt any rounding or tie-breaking rules it desires, so long as

such rules are reasonable, nondiscriminatory, and uniformly and consistently applied.

(c) *Adjustments to dollar thresholds*—(1) *Indexing of dollar thresholds.* The dollar amounts in paragraph (a)(1) (i) and (ii) of this A–3 are indexed at the same time and in the same manner as the section 415(b)(1)(A) dollar limitation for defined benefit plans.

(2) *Applicable dollar threshold.* The applicable dollar amount for a particular determination year or look-back year is the dollar amount for the calendar year in which such determination year or look-back year begins. Thus, the dollar amount for purposes of determining the highly compensated active employees for a particular look-back year is based on the calendar year in which such look-back year begins, not the calendar year in which such look-back year ends or in which the determination year with respect to such look-back year begins.

(d) *Employees described in more than one group.* An individual who is a highly compensated active employee for a determination year, by reason of being described in one group in paragraph (a) of this A–3, under either the look-back year calculation or the determination year calculation, is not disregarded in determining whether another individual is a highly compensated active employee by reason of being described in another group under paragraph (a). For example, an individual who is a highly compensated active employee for a determination year, by reason of being a 5-percent owner during such year, who receives compensation in excess of $50,000 during both the look-back year and the determination year, is taken into account in determining the group of employees who are highly compensated active employees for such determination year by reason of receiving more than $50,000, and being in the top-paid group under either or both the look-back year calculation or determination year calculation for such determination year.

(e) *Examples.* The following examples, in which the determination year and look-back year are the calendar year, are illustrative of the rules in paragraph (a) of this A–3. For purposes of these examples, the threshold dollar amounts in paragraph (a)(1) (ii) and (iii) of this A–3 are not increased pursuant to paragraph (c) of this A–3.

Example (1). Employee A, who is not at any time a 5-percent owner, an officer, or a member of the top-100 within the meaning of paragraph (a)(1) (i), or (iv), or (a)(2) (i) or (ii), but who was a member of the top-paid group for each year, is included in or excluded from the highly compensated groups as specified below for the following years:

Year	Compensation	Status	Comments
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitutes the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	80,000	Excl	Excluded because A was not an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1986).
1988	80,000	Incl	Included because A was an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1987).
1989	45,000	Incl	Included because A was an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1988).
1990	45,000	Excl	Excluded because A was not an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1989).

Example (2). Assuming the same facts as those given in *Example (1)*, except that A is a member of the top-100 employees within the meaning of paragraph (a)(2)(ii) of this A–3 for the 1987 year and 1990 year, the results are as follows:

Year	Compensation	Status	Comments
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitutes the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the determination year (1987) and was described in paragraph (a)(2)(ii) of this A–3 in that year.

Year	Compensation	Status	Comments
1988	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1987).
1989	45,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1988).
1990	45,000	Excl	Excluded even though in top-100 employees during 1990 determination year because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1989) or for the determination year (1990).

A–4: Who is a highly compensated former employee?

Q–4: (a) *General rule*. Except to the extent provided in paragraph (d) of this A–4, a highly compensated former employee for a determination year is any former employee who, with respect to the employer, had a separation year (as defined in A–5 of this §1.414(q)–1T) prior to the determination year and was a highly compensated active employee as defined in A–3 of this §1.414(q)–1T for either such employee's separation year or any determination year ending on or after the employee's 55th birthday. Thus, for example, an employee who is a highly compensated active employee for such employee's separation year, by reason of receiving over $75,000 during the look-back year, is a highly compensated former employee for determination years after such employee's separation year.

(b) *Special rule for employees who perform no services for the employer in the determination year*. For purposes of this rule, employees who perform no services for an employer during a determination year are treated as former employees. Thus, for example, an employee who performed no services for the employer during a determination year, by reason of a leave of absence during such year, is treated as a former employee for such year.

(c) *Dollar amounts for pre-1987 determination years*. For determination years beginning before January 1, 1987, the dollar amounts in paragraph (a)(1)(B) and (C) of A–2 of this §1.414(q)–1T are $75,000 and $50,000 respectively.

(d) *Special rule for employees who separated from service before January 1, 1987*—(1) *Election of special rule*. Employers may elect to apply paragraph (d)(2) of this A–4 in lieu of paragraph (a) of this A–4 in determining whether former employees who separated from service prior to January 1, 1987, are highly compensated former employees. If this election is made with respect to any qualified plan, it must be provided for in the plan. If the employer makes this election with respect to any employee benefit plan, such election must be used uniformly for all purposes for which the section 414(q) definition is applicable. The election, once made, cannot be changed without the consent of the Commissioner.

(2) *Special definition of highly compensated former employee*. A highly compensated former employee includes any former employee who separated from service with the employer prior to January 1, 1987, and was described in any one or more of the following groups during either the employee's separation year (or the year preceding such separation year) or any year ending on or after such individual's 55th birthday (or the last year ending before such employee's 55th birthday):

(i) *5-percent owner*. The employee was a 5-percent owner of the employer at any time during the year.

(ii) *Compensation amount*. The employee received compensation is excess of $50,000 during the year.

The determinations provided for in this paragraph (b)(2) may be made on the basis of the calendar year, the plan year, or any other twelve month period selected by the employer and applied on a reasonable and consistent basis.

(e) *Rules with respect to former employees*—(1) *In general*. For specific provisions with respect to the treatment of former employees and of highly compensated former employees, refer to the rules with respect to which the section 414(q) definition of highly compensated employee is applicable.

(2) *Former employees excluded in determining top-paid group, top-100 employees and includible officers*. Former employees are not included in the top-paid group, the group of the top-100 employees, or the group of includible officers for purposes of applying section 414(q)

to active employees. In addition, former employees are not counted as employees for purposes of determining the number of employees in the top-paid group.

Q–5: What is a separation year for purposes of section 414(q)?

A–5: (a) *Separation year*—(1) *In general*. The separation year generally is the determination year during which the employee separates from service with the employer. For purposes of this rule, an employee who performs no services for the employer during a determination year will be treated as having separated from service with the employer in the year in which such employee last performed services for the employer. Thus, for example, an employee who performs no services for the employer by reason of being on a leave of absence throughout the determination year is considered to have separated from service with the employer in the year in which such employee last performed services prior to beginning the leave of absence.

(2) *Deemed separation*. An employee who performs services for the employer during a determination year may be deemed to have separated from service with the employer during such year pursuant to the rules in paragraph (a)(3) of this A–5. Such deemed separation year is relevant for purposes of determining whether such employee is a highly compensated former employee after such employee actually separates from service, not for purposes of identifying such employee as either an active or former employee. Because employees to whom the provisions of paragraph (a)(2) of this A–5 apply are still performing services for the employer during the determination year, they are treated as active employees. Thus, for example, an employee who has a deemed separation year in 1989, a year during which he was a highly compensated employee, who continues to work for the employer until he retires from employment in 1995, is an active employee of the employer until 1995 and is either highly compensated or not highly compensated for any determination year during such period based on the rules with respect to highly compensated active employees. For determination years after the year of such employee's retirement, such employee is a highly compensated former employee because such employee was a highly compensated active employee for the deemed separation year.

(3) *Deemed separation year*. An employee will be deemed to have a separation year if, in a determination year prior to attainment of age 55, the employee receives compensation in an amount less than 50% of the employee's average annual compensation for the three consecutive calendar years preceding such determination year during which the employee received the greatest amount of compensation from the employer (or the total period of the employee's service with the employer, if less).

(4) *Leave of absence*. The deemed separation rules contained in paragraph (a)(2) and (3) of this A–5 apply without regard to whether the reduction in compensation occurs on account of a leave of absence.

(b) *Deemed resumption of employment*. An employee who is treated as having a deemed separation year by reason of the provisions of paragraph (a) of this A–5 will not be treated as a highly compensated former employee (by reason of such deemed separation year) after such employee actually separates from service with the employer if, after such deemed separation year, and before the year of actual separation, such employee's services for and compensation from the employer for a determination year increase significantly so that such employee is treated as having a deemed resumption of employment. The determination of whether an employee who has incurred a deemed separation year has an increase in services and compensation sufficient to result in a deemed resumption of employment will be made on the basis of all the surrounding facts and circumstances pertaining to each individual case. At a minimum, there must be an increase in compensation from the employer to the extent that such compensation would not result in a deemed separation year under the tests in paragraph (a)(2) of this A–5 using the same three-year period taken into account in such paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this A–5 are illustrated by the following examples based on calendar years. For purposes of these examples the threshold dollar amounts in A–5(a) of this §1.414(q)–1T have not been increased pursuant to A–5(b) of this §1.414(q)–1T.

Example (1). Assume that in 1990 A is a highly compensated employee of X by reason of having earned more than $75,000 during the 1989 look-back year. In 1987, 1988 and 1989, A's years of greatest compensation received from X, A received $76,000, $80,000 and $79,000 respectively. In February of 1990, A received $30,000 in compensation. Because A's compensation during the 1990 determination year is less than 50% of A's average annual compensation from X during A's high three prior determination years, A is deemed to have a separation year during the 1990 determination year pursuant to the provisions of paragraph (a) of this A–5. Since A is a highly compensated employee for X in 1990, A's deemed separation year, A will be treated as a highly compensated former employee after A actually separates from service with the employer unless A experiences a deemed resumption of employment within the meaning of paragraph (b) of this A–5.

Example (2). Assume that in 1990 A is a highly compensated employee by reason of having been an officer (with annual compensation in excess of the section 415(c)(1)(A) dollar limitation) during the 1989 look-back year. A's compensation from X during 1990 is $37,000. A's average compensation from X for the three-year period ending with or within January, 1990, was $60,000. A's compensation during the 1990 determination year is not less than 50% of the compensation earned during the test period. Therefore, A is not deemed to have a separation year under paragraph (a)(2)(i) of this A–5.

Example (3). Assume that in 1990 C is 35 and a highly compensated employee of Z for the reasons given in *Example (1)* with the same compensation set forth in that example. During 1990, C leaves C's 40 hour a week position as director of the actuarial division of Z and starts working as an actuary for the same division, producing actuarial reports approximately 15 to 20 hours a week, approximately half of these hours at home. C contemplates returning to full-time employment with Z when C's child enters school. During the 1990 determination year, C's compensation is less than 50% of C's compensation during her high three preceding determination years. Therefore, C has a deemed separation year during the 1990 determination year. In 1991 C commences working 32 hours a week for X at X's place of business and receives compensation in an amount equal to 80 percent of her average annual compensation during her high three prior determination years. The C's increased compensation, considered in conjunction with the reasons for the reduction in service, the nature and extent of the services performed before and after the reduction in services, and the lack of proximity of C's age to age 55 at the time of the reduction are sufficient to establish that C has a deemed resumption of employment within the meaning of paragraph (b) of this A–5. Therefore, when C separates from service with the employer, C will not be treated as a highly compensated former employee by reason of C's deemed separation year in 1990.

Q–6: Who is the employer?

A–6: (a) *Aggregation of certain entities.* The employer is the entity employing the employees and includes all other entities aggregated with such employing entity under the aggregation requirements of section 414(b), (c), (m) and (o). Thus, the following entities must be taken into account as a single employer for purposes of determining the employees who are ''highly compensated employees'' within the meaning of section 414(q):

(1) All corporations that are members of a controlled group of corporations (as defined in section 414(b)) that includes the employing entity.

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) which group includes the employing entity.

(3) All organizations (whether or not incorporated) that are members of an affiliated service group (as defined in section 414(m)) that includes the employing entity.

(4) Any other entities required to be aggregated with the employing entity pursuant to section 414(o) and the regulations thereunder.

(b) *Priority of aggregation provisions.* The aggregation requirements of paragraph (a) of this A–6 and of A–7(b) of this section with respect to leased employees are applied before the application of any of the other provisions of section 414(q) and this section.

(c) *Line of business rules.* The section 414(r) rules with respect to separate lines of business are not applicable in determining the group of highly compensated employees.

Q–7: Who is an employee for purposes of section 414(q)?

A–7: (a) *General rule.* Except as provided in paragraph (b) of this A–7, the term ''employee'' for purposes of section 414(q) refers to individuals who perform services for the employer and are either common-law employees of the employer or self-employed individuals who are treated as employees pursuant to section 401(c)(1). This rule with respect to the inclusion of certain self-employed individuals in the group of highly compensated employees is applicable whether or not such individuals are eligible to participate in the plan or benefit arrangement being tested.

(b) *Leased employees*—(1) *In general.* The term ''employee'' includes a leased employee who is treated as an employee of the recipient pursuant to the provisions of section 414(n)(2) or 414(o)(2). Employees that an employer treats as leased employees under section 414(n), pursuant to the requirements of section 414(o), are considered to be leased employees for purposes of this rule.

(2) *Safe-harbor exception.* For purposes of qualified retirement plans, if an employee who would be a leased employee within the meaning of section 414(n)(2) is covered in a safe-harbor plan described in section 414(n)(5) (a qualified money purchase pension plan maintained by the leasing organization), and not otherwise covered under a qualified retirement plan of the employer, then such employee is excluded from the term ''employee'' unless the employer elects to include such employee pursuant to the provisions of paragraph (4) of this paragraph (b).

(3) *Other employee benefit plans.* The exception in paragraph (b)(2) of this A–7 is not applicable to the determination of the highly compensated employee group for purposes of the sections enumerated in section 414(n)(3)(C). Thus, for example, a leased employee covered by a safe-harbor plan is considered to be an employee in applying the nondiscrimination provisions of section 89 to statutory benefit plans. Consequently, an employer with leased employees covered in a safe-harbor plan may have 2 groups of highly compensated employees, one with respect to its retirement plans and another with respect to its statutory benefit plans.

(4) *Election with respect to leased employee exclusion.* An employer may elect to include the employees excepted under the provisions of paragraph (b)(2) of this A–7 in determining the highly compensated group with respect to an employer's retirement plans. Thus, for example, by electing to forego the exception in paragraph (b)(2) of this A–7, an employer may achieve more uniform highly compensated employee groups for purposes of its retirement plans and welfare benefit plans. The election to include such employees must be made on a reasonable and consistent basis and must be provided for in the plan.

Q–8: Who is a 5-percent owner of the employer?

A–8: An employee is a 5-percent owner of the employer for a particular year if, at any time during such year, such employee is a 5-percent owner as defined in section 416(i)(B)(i) and §1.416–1 A T–17&18. Thus, if the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner. Thus, for example, an individual who is a 5-percent owner of a subsidiary corporation that is part of a controlled group of corporations within the meaning of section 414(b) is treated as a 5-percent owner for purposes of these rules.

Q–9: How is the ''top-paid group'' determined?

A–9: (a) *General rule.* An employee is in the top-paid group of employees for a particular year if such employee is in the group consisting of the top 20 percent of the employer's employees when ranked on the basis of compensation received from the employer during such year. The identification of the

particular employees who are in the top-paid group for a year involves a two-step procedure:

(1) The determination of the number of employees that corresponds to 20 percent of the employer's employees, and

(2) The identification of the particular employees who are among the number of employees who receive the most compensation during this year.

Employees who perform no services for the employer during a year are not included in making either of these determinations for such year.

(b) *Number of employees in the top-paid group*—(1) *Exclusions.* [Reserved]. See §1.414(q)–1, Q&A–9(b)(1) for further information.

(i) *Age and service exclusion.* The following employees are excluded on the basis of age or service absent an election by the employer pursuant to the rules in paragraph (b)(2) of this A–9:

(A) Employees who have not completed 6 months of service by the end of such year. For purposes of this paragraph (A), an employee's service in the immediately preceding year is added to service in the current year in determining whether the exclusion is applicable with respect to a particular employee in the current year. For example, given a plan with a calendar determination year, if employee A commences work August 1, 1989, and terminates employment May 31, 1990, A may be excluded under this paragraph (b)(1)(i)(A) in 1989 because A completed only 5 months of service by December 31, 1989. However, A cannot be excluded pursuant to this rule in 1990 because A has completed 10 months of service, for purposes of this rule, by the end of 1990.

(B) Employees who normally work less than 17½ hours per week as defined in paragraph (d) of this A–9 for such year.

(C) Employees who normally work during less than 6 months during any year as defined in paragraph (e) of this A–9 for such year.

(D) Employees who have not had their 21st birthdays by the end of such year.

(ii) *Nonresident alien exclusion.* Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) are excluded.

(iii) *Collective bargaining exclusion*—(A) *In general.* Except as provided in paragraph (B) of this paragraph (b)(1)(iii), employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer, which agreement satisfies section 7701(a)(46) and §301.7701–17T (Temporary), are included in determining the number of employees in the top-paid group.

(B) *Percentage exclusion provision.* If 90 percent or more of the employees of the employer are covered under collective bargaining agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and the employer, which agreements satisfy section 7701(a)(46) and §301.7701–17T (Temporary), and the plan being tested covers only employees who are not covered under such agreements, then the employees who are covered under such collective bargaining agreements are not counted in determining the number of noncollective bargaining employees who will be included in the top-paid group for purposes of testing such plan. In addition, such employees are not included in the top-paid group for such purposes. Thus, if the conditions of this paragraph (b)(1)(iii)(B) are satisfied, a separate calculation is required to determine the number and identity of noncollective bargaining employees who will be highly compensated employees by reason of receiving over $50,000 and being in the top-paid group of employees for purposes of testing those plans that cover only noncollective bargaining employees.

(2) *Alternative exclusion provisions*—(i) *Age and service exclusion election.* An employer may elect, on a consistent and uniform basis, to modify the permissible exclusions set forth in paragraph (b)(1)(i) (A), (B), (C), and (D) of this A–9 by substituting any shorter period of service or lower age than that specified in such paragraph. These exclusions may be modified to substitute a zero service or age requirement.

(ii) *Election not to apply percentage exclusion provision.* An employer may elect not to exclude employees under the rules in paragraph (b)(1)(iii)(B) of this A–9.

(iii) *Method of election.* [Reserved]. See §1.414(q)–1, Q&A–9(b)(2)(iii) for further information.

(c) *Identification of top-paid group members.* With the exception of the paragraph (b)(1)(iii) of this A–9 exclusion for certain employees covered by collective bargaining agreements, the exclusions in paragraph (b)(1) of this A–9 are not applicable for purposes of identifying the particular employees in the top-paid group. Thus, for example, even if an employee who normally works for less than 17½ hours is excluded in determining the number of employees in the top-paid group such employee may be a member of the top-paid group. Similarly, if during a determination year, employee A receives over $75,000 and is one of the top-100 employees ranked by compensation, then employee A is a highly compensated active employee for such determination year. This is true even though employee A has worked less than six months and thus may be excluded in determining the number of persons in the top-paid group for the determination year.

(d) *Example.* Paragraphs (b) and (c) of this A–9 are illustrated by the following example:

Example. Employer X has 200 active employees during the 1989 determination year, 100 of whom normally work less than 17½ hours per week during such year and 80 of whom normally work less than 15 hours per week during such year. X elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group. Thus, X excludes 80 employees in determining the number of employees in the top-paid group. X's top-paid group for the 1989 determination year consists of 20% of 120 or 24 employees. All 200 of X's employees must then be ranked in order by compensation received during the year, and the 24 employees X paid the greatest amount of compensation during the year are top-paid employees with respect to X for the 1989 determination year.

(e) *17½ hour rule*—(1) *In general.* The determination of whether an employee normally works less than 17½ hours per week is made independently for each year based on the rules in paragraph (e)(2) and (3) of this A–9. In making this determination, weeks during which the employee did not work for the employer are not considered. Thus, for example, if an employee normally works twenty hours a week for twenty-five weeks during the fall and winter school quarters, 10 hours a week for the 12 week spring quarter, and does not work for the employer during the three-month summer quarter, such employee is treated as normally working more than 17½ hours per week under the rule of this paragraph (e).

(2) *Deemed above 17½.* An employee who works 17½ hours a week or more, for more than fifty percent of the total weeks worked by such employee during the year, is deemed to normally work more than 17½ hours a week for purposes of this rule.

(3) *Deemed below 17½.* An employee who works less than 17½ hours a week for fifty percent or more of the total weeks worked by such employee during the year is deemed to normally work less than 17½ hours a week for purposes of this rule.

(4) *Application.* The determination provided for in paragraph (e)(1), (2), and (3) of this A–9 may be made separately with respect to each employee, or on the basis of groups of employees who fall within particular job categories as established by the employer on a reasonable basis. For example, under the rule of this paragraph (e)(4) an employer may exclude all office cleaning personnel if, for the year in question, the employees performing this function normally work less than 17½ hours a week. This is true even though one or more employees within this group normally work in excess of 17½ hours. The election to make this determination on the basis of individuals or groups is operational and does not require a plan provision.

(5) *Application based on groups.* (i) Groups of employees who perform the same job are not required to be considered as one category for purposes of the rule in paragraph (e)(4) of this A–9. Thus, for example, an employer supermarket may determine its highly compensated employees by excluding part-time grocery checkers if such personnel normally work less than 17½

hours a week while continuing to include full-time personnel performing this function. In general, 80 percent of the positions within a particular job category must be filled by employees who normally work less than 17½ hours a week before any employees may be excluded under this rule on the basis of their membership in that job category.

(ii) Alternatively, an employer may exclude employees who are members of a particular job category if the median number of hours of service credited to employees in that category during a determination or look-back year is 500 or less.

(f) *6-month rule*—(1) *In general*. The determination of whether employees normally work during not more than 6 months in any year is made on the basis of the facts and circumstances of the particular employer as evidenced by the employer's customary experience in the years preceding the determination year. An employee who works on one day during a month is deemed to have worked during that month.

(2) *Application of prior year experience*. In making the determination under this paragraph (f), the experience for years immediately preceding the determination year will generally be weighed more heavily than that of earlier years. However, this emphasis on more recent years is not appropriate if the data for a particular year reflects unusual circumstances. For example, if fishermen working for employer X worked 9 months in 1987 and 1988, 8 months in 1989, and then, because of abnormal ice conditions, worked only 5 months in 1990, such fishermen could not be excluded under this rule in 1990. Furthermore, the data with respect to 1990 would not be weighed more heavily in making a determination with respect to subsequent years.

(3) *Individual or group basis*. This determination may be made separately with respect to each employee or on the basis of groups of employees who fall within particular job categories in the manner set forth in paragraph (e)(4) of this A–8.

Q–10. For purposes of determining the group of highly compensated employees, which employees are officers and which officers must be included in the highly compensated group?

A–10: (a) *In general*. Subject to the limitations set forth in paragraph (b) of this A–10 and the top-100 employee rule set forth in A–2, an employee is an includible officer for purposes of this section and is a member of the group of highly compensated employees if such employee is an officer of the employer (within the meaning of section 416(i) and §1.416–1 A–T 13 & A–T 15) at any time during the determination year or look-back year and receives compensation during such year that is greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the determination or look-back year begins. In addition, an officer who does not meet the 415(c)(1)(A) dollar limitation requirement may be an includible officer based on the minimum inclusion rules set forth in paragraph (c) of this A–10.

(b) *Maximum limitation*—(1) *In general*. Nor more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees without regard to any exclusions) shall be treated as officers for purposes of this provision in determining the group of highly compensated employees for any determination year or look-back year.

(2) *Total number of employees*. The total number of employees for purposes of the limitation in this paragraph (b) is the number of employees the employer has during the particular determination year or look-back year. For purposes of this A–10, employees include only those individuals who perform services for the employer during the determination or look-back year. The exclusions applicable for purposes of determining the number of employees in the top-paid group are not applicable for purposes of the limitations in this paragraph (b).

(3) *Inclusion ranking*. If the number of the employer's officers who satisfy paragraph (a) of this A–10 during either the determination year or the look-back year exceeds the limitation under this paragraph (b), then the officers who will be considered as includible officers for purposes of this rule are those who receive the greatest compensation from the employer during such determination or look-back year.

The definition of compensation in A–13 is to be used for this purpose.

(c) *Minimum inclusion rule.* This paragraph (c) is applicable when no officer of the employer satisfies the compensation requirements of paragraph (a) of this A–10 during either a determination year or look-back year. In such case, the highest paid officer of the employer for such year is treated as a highly compensated employee by reason of being an officer, without regard to the amount of compensation paid to such officer in relation to the section 415(c)(1)(A) dollar amount for the year. This is true whether or not such employee is also a highly compensated employee on any other basis. Thus, for example, if no officer of employer X meets the compensation requirements of paragraph (a) of this A–10 during the 1989 look-back year, and employee A is both the highest paid officer during such year and a 5-percent owner, employee A is treated as an includible officer satisfying the minimum inclusion rules of this paragraph.

(d) *Separate application.* The maximum and minimum officer inclusion rules of paragraphs (b) and (c) of this A–10 apply separately with respect to the determination year calculation and the look-back year calculation. Thus, for example, if no officer of employer X receives compensation above the threshold amount in paragraph (a) of this A–10 during either the determination year or look-back year, application of the minimum inclusion rule would result in the officer of employer X who received the greatest compensation during the look-back year being treated as a highly compensated employee and, in addition, the officer of employer X who receives the most compensation during the determination year would be included in the highly compensated group if such officer is also in the top-100 employees of employer X for such year. Thus, two officers may be treated as highly compensated active employees for a determination year by reason of the provisions of the minimum inclusion rule.

Q–11: To what extent must family members who are employed by the same employer be aggregated for purposes of section 414(q)?

A–11: (a) *Family aggregation*—(1) *In general.* Aggregation is required with respect to an employee who is, during a particular determination year or look-back year, a family member (as defined in A–12) of either (i) a 5-percent owner who is an active or former employee or (ii) a highly compensated employee who is one of the ten most highly compensated employees ranked on the basis of compensation paid by the employer during such year.

(2) *Aggregation of contributions or benefits.* As prescribed in regulations under the provisions to which section 414(q) is applicable, a family member and a 5-percent owner or top-10 highly compensated employee aggregated under this rule are generally treated as a single employee receiving an amount of compensation and a plan contribution or benefit that is based on the compensation, contributions, and benefits of such family member and 5-percent owner or top-10 highly compensated employee.

(b) *Exclusion status irrelevant.* Family members are subject to this aggregation rule whether or not they fall within the categories of employees that may be excluded for purposes of determining the number of employees in the top-paid group and whether or not they are highly compensated employees when considered separately.

(c) *Order of determination*—(1) *Determination of highly compensated employees.* The determination of which employees are highly compensated employees and which highly compensated employees are among the ten most highly compensated employees in making the look-back year calculation or the determination year calculation for a determination year will be made prior to the application of the rules in paragraph (a) of this A–11.

(2) *Determination of top-paid group and top-100 employees.* The determination of the number and identity of employees in the top-paid group under the look-back year calculation or the determination year calculation for a determination year and the identity of individuals in the top-100 employees under the determination year calculation for a determination year is made prior to application of the rules in paragraph (a) of this A–11.

(d) *Determination period*. The rules under paragraph (a) of this A–11 apply separately to the determination year and the look-back year. Thus, assuming there are no 5-percent owners, if employees A, B, C, D, E, F, G, H, I and J are the top 10 highly compensated employees in the 1988 look-back year, and employees F, G, H, I, J, K, L, M, N and O are the top 10 highly compensated employees in the 1989 determination year, then family aggregation would be required with respect to all fifteen of such employees (i.e. employees A, B, C, D, E, F, G, H, I, J, K, L, M, N, and O).

Q–12: Which individuals are family members for purposes of the aggregation rules in section 414(a)(6)(A) and A–11?

A–12: (a) *Definition of family member*. Individuals who are family members for purposes of these provisions include, with respect to any employee or former employee, such employee's or former employee's spouse and lineal ascendants or descendants and the spouses of such lineal ascendants and descendants. In determining whether an individual is a family member with respect to an employee or former employee, legal adoptions shall be taken into account.

(b) *Test period*. If an individual is a family member with respect to an employee or former employee on any day during the year, such individual is treated as a family member for the entire year. Thus, for example, if an individual is a family member with respect to an employee on the first day of a year, such individual continues to be a family member with respect to such employee throughout the year even though their relationship changes as a result of death or divorce.

Q–13: How is ''compensation'' determined for purposes of determining the group of ''highly compensated employees.''

A–13: (a) *In general*. For purposes of section 414(q), the term ''compensation'' means compensation within the meaning of section 415(c)(3) without regard to sections 125, 402(a)(8), and 402(h)(1)(B) and, in the case of employer contributions made pursuant to a salary reduction agreement, without regard to section 403(b). Thus, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity.

(b) *Determination period*. For purposes of determining the group of highly compensated employees, compensation must be calculated on the basis of the applicable period for the determination year and look-back year respectively.

(c) *Compensation taken into account*. Only compensation received by an employee during the determination year or during the look-back year is considered in determining whether such employee is a highly compensated active employee under either the look-back year calculation or determination year calculation for such determination year. Thus, compensation is not annualized for purposes of determining an employee' compensation in the determination year or the look-back year in applying the rules of paragraph (a) of this A–13.

Q–14: What periods must be used for determining who is a highly compensated employee for a determination year?

A–14: (a) *Determination year and look-back year*—(1) *In general*. For purposes of determining the group of highly compensated employees for a determination year, the determination year calculation is made on the basis of the applicable year of the plan or other entity for which a determination is being made and the look-back year calculation is made on the basis of the twelve month period immediately preceding such year. Thus, in testing plans X and Y of an employer, if plan X has a calendar year plan year and plan Y has a July 1 to June 30 plan year, the determination year calculation and look-back year calculation for plan X must be made on the basis of the calendar year. Similarly, the determination year calculation and look-back year calculation for plan Y must be made on the basis of the July 1 to June 30 year.

(2) *Applicable year*. For purposes of this A–14, the applicable year is the plan year of the qualified plan or other employee benefit arrangement to which the definition of highly compensated employees is applicable as defined in the written plan document or

otherwise identified in regulations pursuant to sections to which the definition of highly compensated employees is applicable. To the extent that the definition of highly compensated employees is applicable to entities of other arrangements that do not have an otherwise identified plan year, then either the calendar year of the employer's fiscal year may be treated as the plan year.

(3) *Look-back year*. The look-back year is never less than a twelve month period.

(b) *Calendar year calculation election*—(1) *In general*. An employer may elect to make the look-back year calculation for a determination year on the basis of the calendar year ending with or within the applicable determination year (or, in the case of a determination year that is shorter than twelve months, the calendar year ending with or within the twelve-month period ending with the end of the applicable determination year). In such case, the employer must make the determination year calculation for the determination year on the basis of the period (if any) by which the applicable determination year extends beyond such calendar year (i.e., the lag period). If the applicable year for which the determination is being made is the calendar year, the employer still may elect to make the calendar year calculation election under this A–14(b). In such case, the look-back year calculation is made on the basis of the calendar year determination year and, because there is no lag period, a separate determination year calculation under A–3(a)(2) of this §1.414(q)–1 is not required.

(2) *Lag period calculation*. In making the determination year calculation under A–3(a)(2) of this §1.414(q)–1 on the basis of the lag period, the dollar amounts applicable under A–3(a)(1) (B) and (C) of this §1.414(q)–1 are to be adjusted by multiplying such dollar amounts by a fraction, the numerator of which is the number of calendar months that are included in the lag period and the denominator of which is twelve.

(3) *Determination of active employees*. An employee will be considered an active employee for purposes of a determination year for which the calendar year calculation election is in effect so long as such employee performs services for the employer during the applicable year for which the determination is being made. This is the case even if such employee does not perform services for the employer during the lag-period for such determination year.

(4) *Election requirement*. If the employer elects to make the calendar year calculation election with respect to one plan, entity, or arrangement, such election must apply with respect to all plans, entities, and arrangements of the employer. In addition, such election must be provided for in the plan.

(c) *Change in applicable years*. Where there is a change in the applicable year for which a determination is being made with respect to a plan entity, or other arrangement that is not subject to the calendar year calculation election, the look-back year calculation for the short applicable year is to be made on the basis of the twelve month period preceding the short applicable year (i.e., generally, the old applicable year) and the determination year calculation for the short applicable year is to be made on the basis of the short applicable year. In addition, the dollar amounts under A–3(a)(1) (B) and (C) are to be adjusted for such determination year calculation as if the short applicable year were a lag period under paragraph (b)(2) of this A–14.

(d) *Example*. The following examples illustrates the rules of this A–14:

Example 1. Employer X has a single plan (Plan A) with an April 1 to March 31 plan year. Employer X makes no election to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1989 to March 31, 1990 plan year, the determination year is the plan year ending March 31, 1990 and the look-back year is the plan year ending March 31, 1989.

Example 2. Assume the same facts given above. With respect to the plan year beginning in 1990, employer X elects to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1990 to March 31, 1991 plan year, the lag-period determination year is the period from January 1, 1991, through March 31, 1991, and the applicable look-back year is the 1990 calendar year.

Example 3. Employer Y has a single plan (Plan B) with a calendar plan year. With respect to the plan year beginning in 1990, employer Y elects to make the look-back year calculation for the 1990 determination year on the basis of the calendar year ending with or within the 1990 determination year. Because employer Y's determination year is the 1990 calendar year there is no lag period and employer Y determines the group of highly compensated employees for purposes of the 1990 calendar plan year on the basis of such plan year alone.

Q–15: Is there any transition rule in determining the group of highly compensated employees for 1987 and 1988?

A–15: (a) *In general.* Solely for purposes of section 401(k)(3) and (m)(2) and solely for twelve-month plan years beginning in 1987 and 1988, an eligible employer may elect to define the group of highly compensated employees as the group consisting of 5-percent owners of the employer at any time during the plan year and employees who receive compensation in excess of $50,000 during the plan year. This rule would apply in lieu of the look-back year calculation and determination year calculation otherwise applicable under A–3(a) of this § 1.44(q)–1. In addition, an eligible employer may elect to make the determinations permitted under this transition rule on the basis of the calendar year ending in the plan year and the period by which such plan year extends beyond such calendar year, in accordance with the rules of A–14(b), in lieu of making the determinations under this transition rule on the basis of the plan year for which the determinations are being made.

(b) *Eligible employers.* An employer is an eligible employer under this A–15 if such employer satisfies both of the following requirements:

(1) The employer does not maintain any top-heavy plan within the meaning of section 416 at any time during 1987 and 1988; and

(2) Under each plan of the employer to which section 401(k)(3) or 401(m)(2) is applicable, the group of eligible employees that comprises the highest 25% of eligible employees ranked on the basis of compensation includes at least one employee whose compensation is $50,000 or below. This requirement must be met separately with respect to each such plan of the employer.

(c) *Uniformity requirement.* An eligible employer may not make the election under paragraph (a) of this A–15 unless the election applies to all of the plans maintained by the employer to which section 401(k)(3) or 401(m)(2) applies.

(d) *Election requirements.* This election is operational and does not require a plan provision.

[T.D. 8173, 53 FR 4967, Feb. 19, 1988, as amended by T.D. 8334, 56 FR 3977, Feb. 1, 1991; T.D. 8548, 59 FR 32916, June 27, 1994]

§ 1.414(r)–0 Table of contents.

(a) *In general.* Sections 1.414(r)–1 through 1.414(r)–11 provide rules for determining whether an employer is treated as operating qualified separate lines of business under section 414(r) of the Internal Revenue Code of 1986 as added to the Code by section 1115(a) of the Tax Reform Act of 1986 (Pub. L. No. 99–514), as well as rules for applying the requirements of sections 410(b), 401(a)(26), and 129(d)(8) separately with respect to the employees of each qualified separate line of business of an employer. Paragraph (b) of this section contains a listing of the headings of §§ 1.414(r)–1 through 1.414(r)–11. Paragraph (c) of this section provides a flowchart showing how the major provisions of §§ 1.414(r)–1 through 1.414(r)–6 are applied.

(b) *Table of contents.* The following is a listing of the headings of §§ 1.414(r)–1 through 1.414(r)–11.

§ 1.414(r)–1 Requirements applicable to qualified separate lines of business.

(a) In general.
(b) Conditions under which an employer is treated as operating qualified separate lines of business.
(1) In general.
(2) Qualified separate line of business.
(i) In general.
(ii) Line of business.
(iii) Separate line of business.
(iv) Qualified separate line of business.
(A) In general.
(B) Fifty-employee requirement.
(C) Notice requirement.
(D) Requirement of administrative scrutiny.
(3) Determining the employees of a qualified separate line of business.
(c) Separate application of certain Code requirements to employees of a qualified separate line of business.
(1) In general.
(2) Separate application of section 410(b).

(i) General rule.
(ii) Special rule for employer-wide plans.
(3) Separate application of section 401(a)(26).
(i) General rule.
(ii) Special rule for employer-wide plans.
(4) Separate application of section 129(d)(8). [Reserved]
(5) Separate application of other Code requirements.
(d) Application of requirements.
(1) In general.
(2) Interpretation.
(3) Separate operating units.
(4) Certain mergers and acquisitions.
(5) Governmental and tax-exempt employers.
(i) General rule.
(ii) Additional rules. [Reserved]
(6) Testing year basis of application.
(i) Section 414(r).
(ii) Sections 410(b), 401(a)(26), and 129(d)(8).
(7) Averaging rules.
(8) Definitions.
(9) Effective dates.
(i) General rule.
(ii) Reasonable compliance.
(A) In general.
(B) Determination of reasonable compliance.
(C) Effect on other plans.
(e) Additional rules.

§ 1.414(r)–2 Line of business.

(a) General rule.
(b) Employer determination of its lines of business.
(1) In general.
(2) Property and services provided to customers.
(i) In general.
(ii) Timing of provision of property or services.
(3) Employer designation.
(i) In general.
(ii) Ability to combine unrelated types of property or services in a single line of business.
(iii) Ability to separate related types of property or services into two or more lines of business.
(iv) Affiliated service groups.
(c) Examples.
(1) In general.
(2) Examples illustrating employer designation.
(3) Examples illustrating property and services provided to customers.

§ 1.414(r)–3 Separate line of business.

(a) General rule.
(b) Separate organization and operation.
(1) In general.
(2) Separate organizational unit.
(3) Separate financial accountability.
(4) Separate employee workforce.
(5) Separate management.
(c) Supplementary rules.
(1) In general.
(2) Determination of separate employee workforce.
(3) Determination of separate management.
(4) Employees taken into account.
(5) Services taken into account.
(i) Provision of services to a separate line of business.
(ii) Period for which services are provided.
(iii) Optional rule for employees who change status.
(A) In general.
(B) Change in employee's status.
(6) Examples of the separate employee workforce requirement.
(7) Examples of the separate management requirement.
(d) Optional rule for vertically integrated lines of business.
(1) In general.
(2) Requirements.
(3) Optional rule.
(i) Treatment of employees.
(ii) Purposes for which optional rule applies.
(4) Examples.

§ 1.414(r)–4 Qualified separate line of business—fifty-employee and notice requirements.

(a) In general.
(b) Fifty-employee requirement.
(c) Notice requirement.
(1) General rule.
(2) Effect of notice.

§ 1.414(r)–5 Qualified separate line of business—administrative scrutiny requirement—safe harbors.

(a) In general.
(b) Statutory safe harbor.
(1) General rule.
(2) Highly compensated employee percentage ratio.
(3) Employees taken into account.
(4) Ten-percent exception.
(5) Determination based on preceding testing year.
(6) Examples.
(c) Safe harbor for separate lines of business in different industries.
(1) In general.
(2) Optional rule for foreign operations.
(3) Establishment of industry categories.
(4) Examples.
(d) Safe harbor for separate lines of business that are acquired through certain mergers and acquisitions.
(1) General rule.
(2) Employees taken into account.
(3) Transition period.
(4) Examples.
(e) Safe harbor for separate lines of business reported as industry segments.

(1) In general.
(2) Reported as an industry segment in conformity with Form 10–K or Form 20–F.
(3) Timely filing of Form 10–K or 20–F.
(4) Examples.
(f) Safe harbor for separate lines of business that provide same average benefits as other separate lines of business.
(1) General rule.
(2) Separate lines of business benefiting disproportionate number of nonhighly compensated employees.
(i) Applicability of safe harbor.
(ii) Requirement.
(3) Separate lines of business benefiting disproportionate number of highly compensated employees.
(i) Applicability of safe harbor.
(ii) Requirement.
(4) Employees taken into account.
(5) Example.
(g) Safe harbor for separate lines of business that provide minimum or maximum benefits.
(1) In general.
(2) Minimum benefit required.
(i) Applicability.
(ii) Requirement.
(iii) Defined benefit minimum.
(A) In general.
(B) Normal form and equivalent benefits.
(C) Compensation definition.
(D) Average compensation requirement.
(E) Special rules.
(iv) Defined contribution minimum.
(A) In general.
(B) Modified allocation definition for averaging.
(3) Maximum benefit permitted.
(i) Applicability.
(ii) Requirement.
(iii) Defined benefit maximum.
(A) In general.
(B) Determination of defined benefit maximum.
(C) Adjustment for different compensation definitions.
(D) Adjustment for certain subsidies.
(iv) Defined contribution maximum.
(4) Duplication of benefits or contributions.
(i) Plans of the same type.
(ii) Plans of different types.
(iii) Special rule for floor-offset arrangements.
(5) Certain contingency provisions ignored.
(6) Employees taken into account.

§ 1.414(r)–6 Qualified separate line of business—administrative scrutiny requirement—individual determinations.

(a) In general.
(b) Authority to establish procedures.

§ 1.414(r)–7 Determination of the employees of an employer's qualified separate lines of business.

(a) Introduction.
(1) In general.
(2) Purposes for which this section applies.
(b) Assignment procedure.
(1) In general.
(2) Assignment for the first testing day.
(3) Assignment of new employees for subsequent testing days.
(4) Special rule for employers using annual option under section 410(b).
(c) Assignment and allocation of residual shared employees.
(1) In general.
(2) Dominant line of business method of allocation.
(i) In general.
(ii) Dominant line of business.
(iii) Employee assignment percentage.
(A) Determination of percentage.
(B) Employees taken into account.
(iv) Option to apply reduced percentage.
(v) Examples.
(3) Pro-rata method of allocation.
(i) In general.
(ii) Allocation procedure.
(iii) Examples.
(4) HCE percentage ratio method of allocation.
(i) In general.
(ii) Highly compensated employee percentage assignment ratio.
(iii) Allocation procedure.
(5) Small group method.
(i) In general.
(ii) Size of group.
(iii) Composition of qualified separate line of business.
(iv) Reasonable allocation.

§ 1.414(r)–8 Separate application of section 410(b).

(a) General rule.
(b) Rules of separate application.
(1) In general.
(2) Satisfaction of section 410(b)(5)(B) on an employer-wide basis.
(i) General rule.
(ii) Application of facts and circumstances requirements under nondiscriminatory classification test.
(iii) Modification of unsafe harbor percentage for plans satisfying ratio percentage test at 90 percent level.
(A) General Rule.
(B) Facts and circumstances alternative.
(3) Satisfaction of section 410(b) on a qualified-separate-line-of-business basis.
(4) Examples.
(c) Coordination of section 401(a)(4) with section 410(b).
(1) General rule.
(2) Examples.
(d) Supplementary rules.

(1) In general.
(2) Definition of plan.
(3) Employees of a qualified separate line of business.
(4) Consequences of failure.

§ 1.414(r)–9 Separate application of section 401(a)(26).

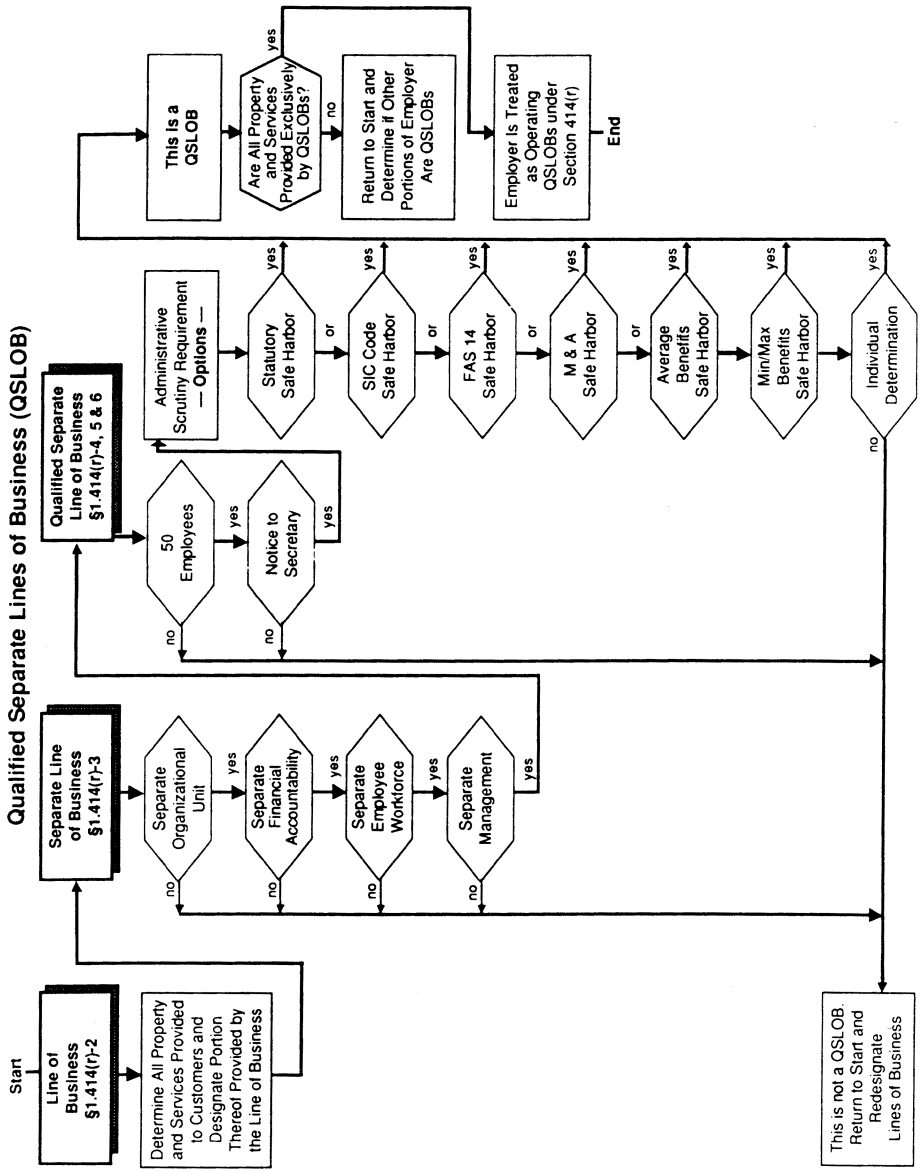
(a) General rule.
(b) Requirements applicable to a plan.
(c) Supplementary rules.
(1) In general.
(2) Definition of plan.
(3) Employees of a qualified separate line of business.
(4) Consequences of failure.

§ 1.414(r)–10 Separate application of section 129(d)(8). [Reserved]

§ 1.414(r)–11 Definitions and special rules.

(a) In general.
(b) Definitions.
(1) In general.
(2) Substantial-service employee.
(3) Top-paid employee.
(4) Residual shared employee.
(5) Testing year.
(6) Testing day.
(7) First testing day.
(8) Section 401(a)(26) testing day.
(c) Averaging rules.
(1) In general.
(2) Specified provisions.
(3) Averaging of large fluctuations not permitted.
(4) Consistency requirements.

(c) *Flowchart.* The following is a flowchart showing how the major provisions of §§1.414(r)–1 through 1.414(r)–6 are applied.



[T.D. 8376, 56 FR 63434, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32916, June 27, 1994]

§ 1.414(r)–1 Requirements applicable to qualified separate lines of business.

(a) *In general.* Section 414(r) prescribes the conditions under which an employer is treated as operating qualified separate lines of business. If an employer is treated as operating qualified separate lines of business under section 414(r), certain requirements under the Code may be applied separately with respect to the employees of

each qualified separate line of business. These requirements are limited to the minimum coverage requirements of section 410(b) (including the nondiscrimination requirements of section 401(a)(4)), the minimum participation requirements of section 401(a)(26), and the 55-percent average benefits test of section 129(d)(8). This section provides the exclusive rules for determining whether an employer is treated as operating qualified separate lines of business under section 414(r), as well as rules for applying the requirements of sections 410(b), 401(a)(26), and 129(d)(8) separately with respect to the employees of a qualified separate line of business.

(b) *Conditions under which an employer is treated as operating qualified separate lines of business*—(1) *In general.* An employer is treated as operating qualified separate lines of business under section 414(r) only if all property and services provided by the employer to its customers are provided exclusively by qualified separate lines of business. Thus, once an employer has determined its qualified separate lines of business under paragraph (b)(2) of this section, no portion of the employer may remain that is not included in a qualified separate line of business. In addition, once the employer has determined the employees of its qualified separate lines of business under paragraph (b)(3) of this section, every employee must be treated as an employee of a qualified separate line of business, and no employee may be treated as an employee of more than one qualified separate line of business.

(2) *Qualified separate line of business*—(i) *In general.* A qualified separate line of business is a portion of the employer that is a line of business within the meaning of paragraph (b)(2)(ii) of this section, that is also a separate line of business within the meaning of paragraph (b)(2)(iii) of this section, and, finally, that satisfies the requirements of section 414(r)(2) in accordance with paragraph (b)(2)(iv) of this section.

(ii) *Line of business.* A line of business is a portion of an employer that is identified by the property or services it provides to customers of the employer. For this purpose, the employer is permitted to determine the lines of business it operates by designating the property and services that each of its lines of business provides to customers of the employer. Rules for determining an employer's lines of business are provided in § 1.414(r)–2.

(iii) *Separate line of business.* A separate line of business is a line of business that is organized and operated separately from the remainder of the employer. The determination of whether a line of business is organized and operated separately from the remainder of the employer is made on the basis of objective criteria. These criteria generally require that the line of business be organized into one or more separate organizational units (e.g., corporations, partnerships, or divisions), that the line of business constitute one or more distinct profit centers within the employer, and that no more than a moderate overlap exist between the employee workforce and management employed by the line of business and those employed by the remainder of the employer. Rules for determining whether a line of business is organized and operated separately from the remainder of the employer and thus constitutes a separate line of business are provided in § 1.414(r)–3. These rules include an optional rule for vertically integrated lines of business.

(iv) *Qualified separate line of business*—(A) *In general.* A qualified separate line of business must satisfy the three statutory requirements in section 414(r)(2). A separate line of business that satisfies these three statutory requirements in accordance with paragraphs (b)(2)(iv)(B) through (b)(2)(iv)(D) of this section constitutes a qualified separate line of business.

(B) *Fifty-employee requirement.* Under section 414(r)(2)(A), a separate line of business must have at least 50 employees. Rules for determining whether this requirement is satisfied are provided in § 1.414(r)–4(b).

(C) *Notice requirement.* Under section 414(r)(2)(B), the employer must notify the Secretary that it treats itself as operating qualified separate lines of business under section 414(r) for purposes of applying the requirements of section 410(b), 401(a)(26), or 129(d)(8) separately with respect to the employees of the separate line of business.

Rules and procedures for complying with this requirement are provided in § 1.414(r)–4(c).

(D) *Requirement of administrative scrutiny*. Under section 414(r)(2)(C), a separate line of business must pass administrative scrutiny. A separate line of business may satisfy this requirement in one of two ways. First, a separate line of business that satisfies any of the safe harbors in § 1.414(r)–5 satisfies the requirement of administrative scrutiny. These safe harbors implement the statutory safe harbor of section 414(r)(3) as well as the guidelines prescribed under section 414(r)(2)(C). Second, a separate line of business that does not satisfy any of the safe harbors in § 1.414(r)–5 nonetheless satisfies the requirement of administrative scrutiny if the employer requests and receives an individual determination from the Commissioner that the separate line of business satisfies the requirement of administrative scrutiny. Rules and procedures applicable to requesting and receiving an individual determination are provided in § 1.414(r)–6. A separate line of business is permitted to satisfy the requirement of administrative scrutiny in any manner permitted under this paragraph (b)(2)(iv)(D), regardless of how any other separate line of business of the employer satisfies the requirement.

(3) *Determining the employees of a qualified separate line of business*. In order to apply certain provisions under these regulations, it is necessary to determine the employees of a qualified separate line of business. For these purposes, the employees of a qualified separate line of business consist of all employees who are substantial-service employees with respect to the qualified separate line of business, and all other employees who are assigned to the qualified separate line of business. Rules for making these determinations are provided in § 1.414(r)–7. These rules apply solely for the purposes specified in these regulations (see § 1.414(r)–7(a)(2) for a comprehensive listing of these purposes). These rules do not apply for any other purpose (e.g., the determination under § 1.414(r)–3 of whether a line of business is organized and operated separately from the remainder of the employer).

(c) *Separate application of certain Code requirements to employees of a qualified separate line of business*—(1) *In general*. If an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with paragraph (b) of this section, the requirements of sections 410(b), 401(a)(26), and 129(d)(8) may be applied separately with respect to the employees of each qualified separate line of business. Paragraphs (c)(2) through (c)(4) of this section provide for the separate application of these requirements. In general, the requirements of a Code section are applied separately with respect to the employees of a qualified separate line of business by treating those employees as if they were the only employees of the employer. Paragraph (c)(5) of this section prescribes the limited conditions under which other Code requirements may be applied separately with respect to the employees of a qualified separate line of business.

(2) *Separate application of section 410(b)*—(i) *General rule*. Except as provided in paragraph (c)(2)(ii) of this section, an employer is permitted to apply the requirements of section 410(b) separately with respect to the employees of each qualified separate line of business operated by the employer only if the employer does so with respect to all its plans, all its employees, and all its qualified separate lines of business. For this purpose, the requirements of section 410(b) encompass the requirements of section 401(a)(4) (including, but not limited to, the permitted disparity rules of section 401(*l*), the actual deferral percentage test of section 401(k)(3) and the actual contribution percentage test of section 401(m)(2)). Rules for applying section 410(b) separately with respect to the employees of a qualified separate line of business are provided in § 1.414(r)–8. An employer may apply the rules of section 414(r) for purposes of section 410(b) even if it does not apply the rules of section 414(r) for purposes of section 401(a)(26).

(ii) *Special rule for employer-wide plans*. Notwithstanding paragraph (c)(2)(i) of this section, an employer that is treated as operating qualified

separate lines of business for purposes of section 410(b) in accordance with paragraph (b) of this section may apply the requirements of section 410(b) on an employer-wide rather than a qualified-separate-line-of-business basis with respect to any plan (within the meaning of §1.414(r)–8(d)(2), but without regard to the mandatory disaggregation rule of §1.410(b)–7(c)(4) for portions of a plan that benefit employees of different qualified separate lines of business) that benefits a group of employees that satisfies the percentage test of section 410(b)(1)(A) (i.e., benefits at least 70 percent of the employer's nonexcludable nonhighly compensated employees). If section 401(a)(4) requires that a group of employees under the plan described in the preceding sentence satisfy section 410(b) for purposes of satisfying section 401(a)(4), the percentage test of section 410(b)(1)(A) must be satisfied by each such group of employees. See §1.414(r)–8(c). The rules of this paragraph (c)(2)(ii) are illustrated by the following example.

Example. Employer A maintains a single profit-sharing plan, Plan W, and three pension plans, Plans X, Y and Z, each benefiting employees of a different one of Employer A's three qualified separate lines of business. Contributions to the profit-sharing plan are made pursuant to a cash or deferred arrangement in which all employees of Employer A are eligible to participate. Assume that, as a result, Plan W satisfies the requirements to be tested under this paragraph (c)(2)(ii). None of the pension plans benefits more than 70 percent of the nonexcludable nonhighly compensated employees of Employer A. Employer A is treated as operating qualified separate lines of business for purposes of applying section 410(b) to its qualified plans. The requirements of sections 410(b) and 401(a)(4) must therefore be applied to Plans X, Y and Z separately with respect to the employees of each of the three qualified separate line of business operated by Employer A. Since Plan W benefits at least 70 percent of the nonexcludable nonhighly compensated employees of Employer A, however, the requirements of sections 410(b) and 401(a)(4) (including section 401(k)) may be applied to Plan W on an employer-wide basis.

(3) *Separate application of section 401(a)(26)*—(i) *General rule*. Except as provided in paragraph (c)(3)(ii) of this section, an employer is permitted to apply the requirements of section 401(a)(26) separately with respect to the employees of each qualified separate line of business operated by the employer only if the employer does so with respect to all its plans, all its employees, and all its qualified separate lines of business. Rules for applying the requirements of section 401(a)(26) separately with respect to the employees of a qualified separate line of business are provided in §1.414(r)–9. An employer may apply the rules of section 414(r) for purposes of section 401(a)(26) even if it does not apply the rules of section 414(r) for purposes of section 410(b).

(ii) *Special rule for employer-wide plans*. Notwithstanding the first sentence of paragraph (c)(3)(i) of this section, an employer that is treated as operating qualified separate lines of business in accordance with paragraph (b) of this section for purposes of both sections 410(b) and 401(a)(26) may apply the requirements of section 401(a)(26) on an employer-wide rather than a qualified-separate-line-of-business basis with respect to any plan (within the meaning of §1.414(r)–9(c)(2), but without regard to the mandatory disaggregation rule of §1.401(a)(26)–2(d)(1)(iv) for portions of a plan that benefit employees of different qualified separate lines of business), but only if the special rule for employer-wide plans in paragraph (c)(2)(ii) of this section is applied to the same plan for the same plan year.

(4) *Separate application of section 129(d)(8)*. [Reserved]

(5) *Separate application of other Code requirements*. Under no circumstance may the requirements of any section of the Code (other than a section described in paragraphs (c)(2) through (c)(4) of this section) be applied separately with respect to the employees of a qualified separate line of business unless the section specifically cross-references, or is specifically cross-referenced by, section 414(r). The Code sections whose requirements may not be applied separately with respect to the employees of a qualified separate line of business include, but are not limited to, sections 79(d)(3), 105(h), 117(d)(3), 120(c)(2), 125(g)(3), 127(b)(2), 129(d)(3), 132, 195, 401(a)(3) (as in effect on September 1, 1974), 414(q)(4),

501(c)(17)(A)(ii), 501(c)(17)(B)(iii), 501(c)(18)(B), and 505(b)(1)(A).

(d) *Application of requirements*—(1) *In general*. The requirements of paragraphs (b) and (c) of this section must be applied in accordance with the rules in this paragraph (d).

(2) *Interpretation*. The provisions of this section and of §§ 1.414(r)–2 through 1.414(r)–11 are to be interpreted in a reasonable manner consistent with the purpose of section 414(r) to recognize an employer's operation of qualified separate lines of business for bona fide business reasons and not for reasons of evading the requirements of any section of the Code, including sections 410(b), 401(a)(26), and 129(d)(8). See section 414(r)(1) and (r)(7). Thus, for example, an employer is not permitted to apply these regulations in a manner that may literally comply with the other provisions of this section and of §§ 1.414(r)–2 through 1.414(r)–11, but that does not reflect the employer's operation of qualified separate lines of business for bona fide business reasons.

(3) *Separate operating units*. No additional requirements beyond those provided in these regulations apply to a separate operating unit. Thus, a separate operating unit that satisfies the requirements of paragraph (b)(2) of this section is deemed to satisfy the geographic separation requirement of section 414(r)(7) and accordingly is treated as a qualified separate line of business for all purposes under this section, including the separate application of section 401(a)(26).

(4) *Certain mergers and acquisitions*. A portion of an employer that is acquired in a transaction described in section 410(b)(6)(C) and § 1.410(b)–2(f) (i.e., an asset or stock acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business) is deemed to satisfy the requirements to be a qualified separate line of business, other than the 50-employee requirement and the notice requirement of pararaphs (b)(2)(iv)(R) and (b)(2)(iv)(C) of this section, respectively. In addition, the acquired employees are not taken into account, and the property and services provided by the acquired portion to customers of the employer are disregarded, for purposes of determining whether the employer's remaining lines of business satisfy the requirements of §§ 1.414(r)–3 through 1.414(r)–6. The rules in this paragraph (d)(4) apply only for those testing years with first testing days that fall within the transition period described in section 410(b)(6)(C). For this purpose, the transition period described in section 410(b)(6)(C) lasts only for so long as the conditions in that section are satisfied. For the definition of ''first testing day,'' see § 1.414(r)–11(b)(7). See § 1.414(r)–5(d)(4), *Example 1*, for an example of the application of the rule in this paragraph (d)(4). See also § 1.414(r)–5(d) for an administrative scrutiny safe harbor applicable to certain separate lines of business acquired in a transaction described in this section.

(5) *Governmental and tax-exempt employers*—(i) *General rule*. Except as provided in paragraph (d)(5)(ii) of this section, the rules of this section are applicable in determining whether section 401(a)(26) is satisfied by a plan maintained by an employer that is exempt from tax under Subtitle A of the Internal Revenue Code (including a governmental plan within the meaning of section 414(d)). Similarly, except as provided in paragraph (d)(5)(ii) of this section, the rules of this section are applicable in determining whether section 410(b) is satisfied by a plan that is subject to section 410(b) (including by virtue of § 1410(b)–2(e)) and is maintained by an employer that is exempt from tax under Subtitle A of the Internal Revenue Code (including a governmental plan within the meaning of section 414(d)).

(ii) *Additional rules*. [Reserved]

(6) *Testing year basis of application*—(i) *Section 414(r)*. Whether an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with paragraph (b) of this section is determined on a year-by-year basis with respect to the testing year. It is therefore possible for an employer to satisfy paragraph (b) of this section for one testing year and to fail to satisfy it for another testing year. It is also possible for an employer to satisfy paragraph (b) of this section for two testing years but to have designated its lines of business differently in each of those two testing years. In determining

whether an employer satisfies paragraph (b) of this section for a testing year, the requirements of that paragraph are applied solely with respect to the testing year. Thus, all property and services provided by the employer to its customers during the testing year must be provided exclusively by portions of the employer that for the testing year constitute qualified separate lines of business. Furthermore, each employee of the employer must respectively be treated as an employee of one and only one of those qualified separate lines of business for all purposes with respect to the testing year.

(ii) *Sections 410(b), 401(a)(26), and 129(d)(8).* For purposes of paragraph (c) of this section, relating to the separate application of sections 410(b), 401(a)(26), and 129(d)(8) to the employees of a qualified separate line of business, the determination whether an employer operates qualified separate lines of business in accordance with paragraph (b) of this section for a testing year generally applies for all plan years beginning in the testing year. Rules for the separate application of sections 410(b), 401(a)(26), and 129(d)(8) are respectively provided in §§1.414(r)–8, 1.414(r)–9, and 1.414(r)–10.

(7) *Averaging rules.* The employer is permitted to apply certain provisions of these regulations on the basis of a consecutive-year average (not to exceed five consecutive years) under the averaging rules of §1.414(r)–11(c).

(8) *Definitions.* In applying the provisions of this section and of §§1.414(r)–2 through 1.414(r)–11, the definitions in §§1.414(r)–11(b) and 1.410(b)–9 govern, unless otherwise provided.

(9) *Effective*—(i) *General rule.* The provisions of this section and of §§1.414(r)–2 through 1.414(r)–11 apply to plan years and testing years beginning on or after January 1, 1994 (or January 1, 1996, in the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans)).

(ii) *Reasonable compliance*—(A) *In general.* With respect to plan years beginning before the date on which the Commissioner begins issuing determinations under section 414(r)(2)(C), and on or after the first day of the first plan year to which section 414(r) applies under section 1112(a) of the Tax Reform Act of 1986, an employer is treated as operating qualified separate lines of business if the employer reasonably determines that it meets the requirements of section 414(r) (other than the requirement of administrative scrutiny under section 414(r)(2)(C)).

(B) *Determination of reasonable compliance.* Whether an employer reasonably determines that it meets the requirements of section 414(r) generally will be determined on the basis of all relevant facts and circumstances, including the extent to which the employer has resolved unclear issues in its favor. For the period described in paragraph (d)(9)(ii)(A) of this section, the Internal Revenue Service will consider the employer's compliance with the terms of these final regulations (other than the requirement of administrative scrutiny under paragraph (b)(2)(iv)(D) of this section) to constitute a reasonable determination that the employer neets tge reqyurements of section 414(r) (other than the requirement of administrative scrutiny under section 414(r)(2)(C)).

(C) *Effect on other plans.* If an employer sponsors a plan that has a plan year beginning within the period decribed in paragraph (d)(9)(ii)(A) of this section, the employer's reasonable determination of its qualified separate lines of business for the testing year in which that plan year begins, and the allocation of employees to those qualified separate lines of business, must also be used for purposes of applying §1.414(r)–8 and §1.414(r)–9 for plan years that begin in that testing year but after the end of the period described in paragraph (d)(9)(ii)(A) of this section.

(e) *Additional rules.* The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the qualified separate line of business requirements of section 414(r). These additional rules may include, for example, new safe harbors in §1.414(r)–5.

[T.D. 8376, 56 FR 63437, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32916, June 27, 1994]

§ 1.414(r)–2 Line of business.

(a) *General rule.* A line of business is a portion of an employer that is identified by the property or services it provides to customers of the employer. For this purpose, an employer is permitted to determine its lines of business by designating the property or services that each of its lines of business provides to customers of the employer. Paragraph (b) of this section explains how an employer determines its lines of business for a testing year. Paragraph (c) of this section provides examples illustrating the application of this section.

(b) *Employer determination of its lines of business*—(1) *In general.* An employer determines its lines of business for a testing year first by identifying all the property and services it provides to its customers during the testing year, and then by designating which portion of the property and services is provided by each of its lines of business.

(2) *Property and services provided to customers*—(i) *In general.* Property, whether real or personal, tangible or intangible, is provided by an employer to a customer if the employer provides the property to or on behalf of the customer for consideration. Similarly, services are provided by an employer to a customer if the employer renders the services to or on behalf of the customer for consideration. An individual item of property or service is taken into account under this paragraph (b)(2) only if the employer provides the item to a person other than the employer in the ordinary course of a trade or business conducted by the employer and the person to whom the employer provides the item is acting in the capacity of a customer of the employer. A type of tangible property is deemed to be provided to customers of the employer for purposes of this section if, with respect to a business that produces or manufactures that type of tangible property, the employer satisfies the special rule in § 1.414(r)–3(d)(2)(iii)(B) for vertically integrated businesses.

(ii) *Timing of provision of property or services.* Generally an employer determines its lines of business on the basis of the property and services it provides to its customers for consideration during the testing year. However, it is not necessary both that property or services actually be provided, and that consideration for the property or services actually be paid, during the current testing year. For an employer to be considered to provide property or services to customers for consideration during a testing year under this paragraph (b)(2), it is sufficient that the property or services actually be provided to customers during the testing year, the consideration actually be paid during the testing year, or the employer actually incur significant costs during the testing year associated with the provision of the property or services to a specified customer or specified customers.

(3) *Employer designation*—(i) *In general.* Once the employer has identified all the property and services it provides to its customers during the testing year under paragraph (b)(2) of this section, the employer determines its lines of business for the testing year by designating which portion of those property and services is provided by each of its lines of business. For this purpose, the employer must apportion all the property and services identified under paragraph (b)(2) of this section among its lines of business. An employer generally is not required to designate its lines of business for the testing year in the same manner as it designates its lines of business for any other testing year.

(ii) *Ability to combine unrelated types of property or services in a single line of business.* For purposes of this paragraph (b)(3), there is no requirement that a line of business provide only one type of property or service, or only related types of property or services. Nor is there any requirement that a line of business provide solely property or solely services. Thus, the employer is permitted to combine in a single line of business dissimilar types of property or services that are otherwise unrelated to one another.

(iii) *Ability to separate related types of property or services into two or more lines of business.* For purposes of this paragraph (b)(3), there is no requirement that all property or services of related types or the same type be provided by a single line of business. Thus, the employer is permitted to designate two or

more lines of business that provide related types of property or services, or the same type of property or service. An employer might designate two or more lines of business that provide property or services of related types or the same type, for example, where the lines of business manufacture, prepare, or provide the property or services in different geographic areas (e.g., in different regions of the country or the world), or at different levels in the chain of commercial distribution (e.g., wholesale versus retail), or in different types of transactions (e.g, sale versus lease), or for different types of customers (e. g., governmental versus private), or subject to different legal constraints (e. g., regulated versus unregulated), or if the lines of business have developed differently (e.g., one line of business was acquired while another line of business developed internally). Notwithstanding the foregoing, an employer is not permitted to designate two or more lines of business that provide property or services of related types or the same type, if the employer's designation is unreasonable. An employer's designation would be unreasonable, for example, if the designation separated two types of property or services in different lines of business, but the employer did not provide those types of property or services separately from one another to its customers. Similarly, an employer's designation would be unreasonable if it separated two types of property or services in different lines of business, but the provision of one type of property or service was merely ancillary or incidental to, or regularly associated with, the provision of the other type of property or service. See generally §1.414(r)–1(d)(2) (requiring an employer's operation of qualified separate lines of business to be for bona fide business reasons).

(iv) *Affiliated service groups*. An employer is not permitted to designate its lines of business in a manner that results in separating employees of an affiliated service group (within the meaning of section 414(m)) from other employees of the employer. See section 414(r)(8).

(c) *Examples*—(1) *In general*. Paragraphs (c)(2) and (c)(3) of this section provide examples that illustrate the application of this section.

(2) *Examples illustrating employer designation*. The following examples illustrate the application of paragraph (b)(3) of this section relating to an employer's designation of the property or services provided to customers by each of its lines of business.

Example 1. Employer A is a domestic conglomerate engaged in the manufacture and sale of consumer food and beverage products and the provision of data processing services to private industry. Employer A provides no other property or services to its customers. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing all its consumer food products, a second providing all its consumer beverage products, and a third providing all its data processing services. Employer A has three lines of business for purposes of this section.

Example 2. The facts are the same as in *Example 1*, except that Employer A determines that neither the consumer food products line of business nor the consumer beverage products line of business would satisfy the separateness criteria of §1.414(r)–3 for recognition as a separate line of business. Accordingly, pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers between only two lines of business, one providing all its consumer food and beverage products, and a second providing all its data processing services. Employer A has two lines of business for purposes of this section.

Example 3. The facts are the same as in *Example 2*, except that Employer A also owns and operates a regional commuter airline, a professional basketball team, a pharmaceutical manufacturer, and a leather tanning company. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing all its consumer food and beverage products, a second providing all its data processing services, and a third providing all the other property and services provided to customers through Employer A's regional commuter airline, professional basketball team, pharmaceutical manufacturer, and leather tanning company. Even though the third line of business includes dissimilar types of property and services that are otherwise unrelated to one another, paragraph (b)(3)(ii) of this section permits Employer A to combine these property and services in a single line of business. Employer A has three lines of business for purposes of this section.

Example 4. The facts are the same as in *Example 2*, except that Employer A has recently

acquired Corporation L, whose only product is a well-known brand of gourmet ice cream. Although Employer A manufactures and sells other ice cream products, it does not manufacture or market the newly acquired brand of gourmet ice cream except through Corporation L. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing only the newly acquired brand of gourmet ice cream, a second providing all its other consumer food and beverage products (including the other ice cream products manufactured and sold by Employer A) and a third providing all its data processing services. Even though the gourmet ice cream line of business provides the same type of property as the consumer food and beverage line of business (i.e., ice cream), paragraph (b)(3)(iii) of this section permits Employer A to separate its ice cream products between two different lines of business. Employer A has three lines of business for purposes of this section.

Example 5. The facts are the same as in *Example 2,* except that Employer A operates the data processing services portion of its business in two separate subsidiaries, one serving customers in the eastern half of the United States and the other serving customers in the western half of the United States. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing all its consumer food and beverage products, a second providing data processing services to customers in the eastern half of the United States, and a third providing data processing services to customers in the western half of the United States. Even though the second and third lines of business provide the same type of service (i.e., data processing services), paragraph (b)(3)(iii) of this section permits Employer A to separate its data processing services into two lines of business. Employer A has three lines of business for purposes of this section.

Example 6. Employer B is a diversified engineering firm offering civil, chemical, and aeronautical engineering services to government and private industry. Employer B provides no other property or services to its customers. Employer B operates the aeronautical engineering services portion of its business as two separate divisions, one serving federal government customers and the other serving customers in private industry. Pursuant to paragraph (b)(3) of this section, Employer B apportions all the property and services it provides to its customers among four lines of business, one providing all its civil engineering services, a second providing all its chemical engineering services, a third providing aeronautical engineering services to federal government customers, and a fourth providing aeronautical engineering services to customers in private industry. Even though the third and fourth lines of business include the same type of service (i.e., aeronautical engineering services), paragraph (b)(3)(iii) of this section permits Employer B to separate its aeronautical engineering services into two lines of business. Employer B has four lines of business for purposes of this section.

Example 7. Among its other business activities, Employer C manufacturers industrial diesel generators. At no additional cost to its buyers, Employer C warrants the proper functioning of its diesel generators for a one-year period following sale. Pursuant to its warranty, Employer C provides labor and parts to repair or replace any components that malfunction within the one-year warranty period. Because Employer C does not provide the industrial diesel generators, on the one hand, and the warranty repair services and replacement parts, on the other hand, separately from one another to its customers, under paragraph (b)(3)(iii) of this section it would be unreasonable for Employer C to separate these property and services in different lines of business.

Example 8. Among its other business activities, Employer D leases office photocopying equipment. Employer D also provides photocopying supplies and repair services to its lessees for a separate charge. Employer D generally does not provide such supplies and repair services to persons other than its lessees. Lessees of Employer D's equipment are permitted to use photo-copying supplies and repair services from suppliers other than Employer D. Because the provision of the photo-copying supplies and repair services are merely ancillary or incidental to the provision of the leased photo-copiers, under paragraph (b)(3)(iii) of this section it would be unreasonable for Employer D to separate these property and services in different lines of business.

Example 9. Employer E operates a medical clinic. The employees of the clinic include physicians, nurses, and laboratory technicians, all of whom participate in providing medical and related services to patients of the clinic. Under paragraph (b)(3)(iii) of this section, it would be unreasonable for Employer E to separate the services of the physicians, nurses, and laboratory technicians in different lines of business.

Example 10. Employer F is a law firm. The employees of the firm include lawyers, paralegals, and secretaries, all of whom participate in renderlng legal and related services to clients of the firm. Under paragraph (b)(3)(iii) of this section, it would be unreasonable for Employer F to separate the services of the lawyers, paralegals, and secretaries in different lines of business.

Example 11. Employer G is a management consulting firm. The employees of the firm

include management consultants, secretaries, and other support staff personnel, all of whom participate in rendering management consulting and related services to clients of the firm. Under paragraph (b)(3)(iii) of this section, it would be unreasonable for Employer G to separate the services of the management consultants, secretaries, and other support staff personnel in different lines of business.

(3) *Examples illustrating property and services provided to customers.* The following examples illustrate the application of paragraph (b)(2) of this section relating to property and services provided to customers of the employer.

Example 1. Employer H operates several dairy farms and dairy product processing plants. The dairy farms provide part of their output of milk and milk by-products to Employer H's dairy product processing plants and also sell part to retail distributors unrelated to Employer H. The dairy farms' provision of milk and milk by-products to Employer H's dairy product processing plants does not constitute the provision of property or services to customers of Employer H because the milk and milk by-products are not provided to a person other than employer H. However, the dairy farms' provision of milk and milk by-products to independent retail distributors does constitute the provision of property or services to customers of Employer H under paragraph (b)(2) of this section.

Example 2. The facts are the same as in *Example 1*, except that the dairy farms provide their entire output of milk and milk by-products to Employer H's dairy product processing plants. The dairy farms' provision of milk and milk by-products to the dairy product processing plants generally does not constitute the provision of property or services to customers of Employer H because the milk and milk by-products are not provided to a person other than Employer H. However, paragraph (b)(2)(i) of this section provides a special rule for vertically integrated businesses that satisfy §1.414(r)–3(d)(2)(iii)(B). If §1.414(r)–3(d)(2)(iii)(B) is satisfied, then, under the special rule of paragraph (b)(2)(i) of this section, the milk and milk by-products are deemed to be provided to customers of Employer H.

Example 3. Among its other business activities, Employer J manufactures automobiles. Employer J operates a cafeteria at one of its automobile manufacturing facilities. The cafeteria is intended primarily for use by employees of Employer J, but nonemployees are not prohibited from using the cafeteria. The cafeteria charges the same prices to employees and non-employees. Under paragraph (b)(2) of this section, the provision of cafeteria services to employees of Employer J does not constitute the provision of property or services to customers of Employer J, because the cafeteria services are provided to the employees in their capacity as employees of Employer J and not as customers of Employer J.

Example 4. Employer K sells books and periodicals to members of the public and provides telecommunications services to private industry. Employer K periodically acquires and disposes of businesses in both asset and stock transactions. In addition, for its own investment purposes, Employer K acquires and disposes of corporate and other securities. Under paragraph (b)(2) of this section, the sale by Employer K of businesses and investment securities does not constitute the provision of property or services to customers of Employer K, because the sales are not made in the ordinary course of a trade or business conducted by Employer K. However, the sale of published materials and the provision of telecommunications services to persons unrelated to Employer K does constitute the provision of property or services to customers of Employer K.

Example 5. Employer L is active in the financial services industry. Subsidiary 1 of Employer L is a brokerage firm that is regulated as a broker-dealer under applicable federal and state law. In its capacity as a dealer, Subsidiary 1 holds in its own inventory securities of unrelated corporations and regularly sells these securities to unrelated persons. Under paragraph (b)(2) of this section, the sale by Subsidiary 1 of the securities to unrelated persons constitutes the provision of property or services to customers of Employer L, because the sales are made in the ordinary course of Subsidiary 1's trade or business as a broker-dealer.

Example 6. The facts are the same as in *Example 5.* Subsidiary 2 of Employer L is an insurance company that is regulated under applicable state insurance laws. In managing its investments, Subsidiary 2 regularly makes use of the brokerage services of Subsidiary 1 (which Subsidiary 1 regularly provides to unrelated persons as well). Under paragraph (b)(2) of this section, Subsidiary 1's provision of brokerage services to Subsidiary 2 does not constitute the provision of property or services to customers of Employer L, because the brokerage services are not provided to a person other than Employer L. However, Subsidiary 1's provision of brokerage services to unrelated persons does constitute the provision of property or services to customers of Employer L.

Example 7. Employer M is a shipbuilder. In a testing year, Employer M enters into a contract with a customer to construct a new cargo ship for delivery two years later. Employer M incurs significant costs designing and planning for the production of the new ship during the testing year, but receives no payments from the customer during that

year. Under paragraph (b)(2) of this section, Employer M is treated as providing the cargo ship to the customer during the testing year.

Example 8. The facts are the same as in *Example 7*, except that, pursuant to a request from the customer, Employer M also incurred significant costs developing a prototype and submitting a bid on the new cargo ship in the prior testing year, and that these costs were not reimbursed by the customer. Under paragraph (b)(2) of this section, Employer M is also treated as providing the cargo ship to the customer in the prior testing year.

[T.D. 8376, 56 FR 63439, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32917, June 27, 1994]

§ 1.414(r)–3 Separate line of business.

(a) *General rule*. A separate line of business is a line of business (as determined under § 1.414(r)–2) that is organized and operated separately from the remainder of the employer. Paragraph (b) of this section sets forth the rules for determining whether a line of business is organized and operated separately from the remainder of the employer. Paragraph (c) of this section provides certain supplementary rules necessary to apply the requirements of paragraph (b) of this section, as well as examples illustrating the application of those requirements. Paragraph (d) of this section provides an optional rule for lines of business that are vertically integrated.

(b) *Separate organization and operation*—(1) *In general*. A line of business is organized and operated separately from the remainder of the employer for a testing year only if it satisfies all the requirements of paragraphs (b)(2) through (b)(5) of this section for the testing year.

(2) *Separate organizational unit*. The line of business must be formally organized as a separate organizational unit or group of separate organizational units within the employer. For this purpose, an organizational unit is a corporation, partnership, division, or other unit having a similar degree of organizational formality. This requirement must be satisfied on every day of the testing year.

(3) *Separate financial accountability*. The line of business must be a separate profit center or group of separate profit centers within the employer. This requirement must be satisfied on every day of the testing year. In addition, the employer must maintain books and records that provide separate revenue and expense information that is used for internal planning and control with respect to each profit center comprising the line of business.

(4) *Separate employee workforce*. The line of business must have its own separate employee workforce. A line of business has its own separate workforce only if at least 90 percent of the employees who provide services to the line of business, and who are not substantial-service employees with respect to any other line of business, are substantial-service employees with respect to the line of business. See paragraph (c)(2) of this section to determine how the percentage in the preceding sentence is calculated for the testing year.

(5) *Separate management*. The line of business must have its own separate management. A line of business has its own separate management only if at least 80 percent of the employees who are top-paid employees with respect to the line of business are substantial-service employees with respect to the line of business. See paragraph (c)(3) of this section to determine how the percentage in the preceding sentence is calculated for the testing year.

(c) *Supplementary rules*—(1) *In general*. This paragraph (c) provides certain supplementary rules necessary to apply the requirements of paragraph (b) of this section, as well as examples illustrating the application of those requirements.

(2) *Determination of separate employee workforce*. The percentage in paragraph (b)(4) of this section is the fraction (expressed as a percentage)—

(i) The numerator of which is the number of substantial-service employees with respect to the line of business within the meaning of § 1.414(r)–11(b)(2); and

(ii) The denominator of which is the total number of employees who provide services to the line of business within the meaning of paragraph (c)(5) of this section and who are not substantial-service employees with respect to any other line of business.

(3) *Determination of separate management*. The percentage in paragraph

(b)(5) of this section is the fraction (expressed as a percentage)—

(i) The numerator of which is the number of employees who are both top-paid employees and substantial-service employees with respect to the line of business within the meaning of §1.414(r)–11(b)(3) and (2), respectively; and

(ii) The denominator of which is the total number of top-paid employees with respect to the line of business within the meaning of §1.414(r)–11(b)(3).

(4) *Employees taken into account.* For purposes of applying this paragraph (c), only employees who are employees on the first testing day are taken into account. For this purpose, there are no excludable employees except nonresident aliens described in section 410(b)(3)(C). Consequently, all other employees who are employees on the first testing day are taken into account, including collectively bargained employees. For the definition of first testing day, see §1.414(r)–11(b)(7).

(5) *Services taken into account*—(i) *Provision of services to a line of business.* An employee provides services to a line of business if more than a negligible portion of the employee's services contributes to providing the property or services provided by the line of business to customers of the employer. All of the services of each employee who provides services to the employer contribute, whether directly or indirectly, to the provision of property or services to customers of the employer, and therefore each employee who provides services to the employer must be treated as providing more than a negligible portion of the employee's services to one or more lines of business operated by the employer.

(ii) *Period for which services are provided.* Only services performed by an employee during the testing year that contribute to providing the property or services provided by a line of business to customers are taken into account. An employee's services during the testing year are considered to contribute to providing the property or services provided by a line of business to customers of the employer if—

(A) The employee's services during the testing year contribute to providing such property or services to customers of the employer during the testing year; or

(B) It is reasonably anticipated that the employee's services during the testing year will contribute to providing such property and services to customers of the employer after the close of the testing year.

(iii) *Optional rule for employees who change status*—(A) *In general.* Solely for purposes of the separateness rules of this section and the assignment rules of §1.414(r)–7, if an employee changes status as described in paragraph (c)(5)(iii)(B) of this section, an employer may, for up to three consecutive testing years after the base year (within the meaning of paragraph (c)(5)(iii)(B) (*1*) or (*2*) of this section), treat the employee as providing the same level of service to its lines of business as the employee provided in the base year.

(B) *Change in employee's status.* An employee changes status as described in this paragraph (c)(5)(iii)(B) if—

(*1*) For a testing year (the base year), the employee was a substantial-service employee with respect to a qualified separate line of business of the employer (prior line of business) and, for the immediately succeeding testing year, the employee is not a substantial-service employee with respect to that prior line of business; or

(*2*) For a testing year (the base year), the employee was a residual shared employee and, for the immediately succeeding testing year, the employee is a substantial-service employee with respect to a qualified separate line of business.

(6) *Examples of the separate employee workforce requirement.* The following examples illustrate the application of the separate employee workforce requirement in paragraph (b)(4) of this section and the supplementary rules of this paragraph (c). Unless otherwise specified, it is assumed that the employees and their services described in these examples are taken into account under paragraphs (c) (4) and (5) of this section for the testing year and that the employer does not use the option under §1.414(r)–11(b)(2) to treat employees who provide less than 75 percent of their services to a line of business as

substantial-service employees with respect to the line of business.

Example 1. Employer A operates three lines of business as determined under §1.414(r)–2. One of Employer A's lines of business manufactures and sells tires and other automotive products. Employee M is a tire press operator in Employer A's tire factory. Employee N is the manager of the tire factory. Under these facts, the services of Employees M and N contribute to providing tires to customers of Employer A. Both employees therefore provide services to Employer A's tire and automotive products line of business within the meaning of paragraph (c)(5) of this section.

Example 2. The facts are the same as in *Example 1.* In addition, none of the services of Employees M and N that contribute to providing property or services to customers contribute to providing any property or service other than tires to customers of Employer A. Under these facts, Employees M and N provide at least 75 percent of their respective services to Employer A's tire and automotive products line of business. Therefore Employees M and N are substantial-service employees with respect to Employer A's tire and automotive products line of business within the meaning of §1.414(r)–11(b)(2), and do not provide any services within the meaning of paragraph (c)(5) of this section to any of Employer A's other lines of business. Moreover, because Employees M and N provide at least 75 percent of their services to Employer A's tire and automotive products line of business and are substantial-service employees with respect to that line, they are disregarded in applying paragraph (b)(4) of this section to any other line of business, even if they provide services to the other line.

Example 3. The facts are the same as in *Example 2.* Employer A's second line of business manufactures and sells construction machinery, and Employer A's third line of business manufactures and sells agricultural equipment. As part of these lines of business, Employer A operates a construction machinery factory and an agricultural equipment factory on the same site as the tire factory described in *Example 2.* Employer A's facilities at the site include a health clinic and a fitness center that serve the employees of the construction machinery factory, the agricultural equipment factory, and the tire factory. Employee O is a nurse in the health clinic, and Employee P is a fitness instructor in the fitness center. Both employees therefore provide services within the meaning of paragraph (c)(5) of this section to Employer A's tire and automotive products line of business, construction machinery line of business, and agricultural equipment line of business. In addition, under these facts, Employer A determines that approximately 33 percent of the services of Employees O and P are provided to each of Employer A's three lines of business. As a result, neither Employee O or P provide at least 75 percent of their respective services to any of Employer A's lines of business. Therefore, Employees O and P are not substantial-service employees with respect to any of Employer A's three lines of business within the meaning of §1.414(r)–11(b)(2).

Example 4. The facts are the same as in *Example 3.* Employee Q is the president and chief executive officer of Employer A and is responsible for reviewing the performance of all Employer A's lines of business. Under these facts, the services of Employee Q contributes to providing property and services to customers of each of Employer A's three lines of business. Employee Q therefore provides services to each of these three lines of business. Employer A determines that Employee Q provides the following percentages of his services to Employer A's three lines of business: tire and automotive products—40 percent; construction machinery—40 percent, and agricultural equipment—20 percent. Employee Q does not provide at least 75 percent of his services to any of Employer A's lines of business. Therefore, Employee Q is not a substantial-service employee with respect to any of Employer A's three lines of business within the meaning of §1.414(r)–11(b)(2).

Example 5. The facts are the same as in *Example 4,* except that Employer A also owns 75 percent of Corporation X. Corporation X is not treated as part of Employer A within the meaning of §1.410(b)–9. Employee R is an accountant in the accounting department of Employer A. Employee R devotes all of his time to maintaining the accounting books and records of the tire and automotive products line of business of Employer A and the accounting books and records of Corporation X. Employer A determines that Employee R provides 40 percent of his services directly to the tire and automotive products line of business. Employer A also determines that Employee R provides the following percentages of the remainder of Employee R's services (i.e., his provision of services of maintaining the accounting books and records of Corporation X) indirectly to Employer A's three lines of business by virtue of the services he provides to Corporation X: tire and automotive products—25 percent; construction machinery—20 percent, and agricultural equipment—15 percent. Therefore, Employee R provides 65 percent of his services to the tire and automotive products line of business of Employer A (i.e., 40 percent directly and 25 percent indirectly). Under the definition of substantial-service employee in §1.414(r)–11(b)(2), Employer A may treat Employee R as a substantial-service employee with respect to the tire and automotive products line of business because Employee R provides at least 50 percent of his services to that

line. In that case, Employee R would be disregarded in applying paragraph (b)(4) of this section to the construction machinery and agricultural equipment lines of business.

Example 6. The facts are the same as in *Example 5*. Employee S is a lawyer in the legal department located at the headquarters who devotes all her time to product liability suits filed against the construction machinery line of business. Under these facts, the services of Employee S contribute to providing property and services to customers of Employer A in the construction machinery line of business, and therefore Employee S provides services to that line of business. Because Employee S's services do not contribute to providing property or services in any other of Employer A's lines of business within the meaning of paragraph (c)(5) of this section, Employee S provides more than 75 percent of her services to the construction machinery line of business and therefore is a substantial-service employee with respect to Employer A's construction machinery line of business within the meaning of §1.414(r)–11(b)(2).

Example 7. The facts are the same as in *Example 6*. Employer A also maintains a separate facility that houses a centralized procurement, marketing, and billing operation for all of its lines of business. None of the procurement, marketing, or billing employees specializes in any particular line of business. Under these facts, the services of the procurement, marketing, and billing employees contribute to providing property and services to customers of Employer A in each of Employer A's three lines of business. Employer A determines that each of the procurement, marketing, and billing employees provides approximately an equal proportion of their services to each of Employer A's three lines of business. These employees therefore provide services to all of Employer A's lines of business within the meaning of paragraph (c)(5) of this section. However, none of them provides at least 75 percent of his services to any line of business. Therefore, these employees are not substantial-service employees with respect to any of Employer A's three lines of business within the meaning of §1.414(r)–11(b)(2).

Example 8. The facts are the same as in *Example 7*. Employee T works for the construction machinery line of business. During the testing year, he is temporarily detailed to the agricultural equipment line of business. His temporary detail lasts for one week, after which he returns to his regular duties with the construction machinery line of business. Under these facts, Employee T does not provide more than a negligible portion of his services during the testing year to the agricultural equipment line of business. Accordingly, Employee T does not provide services to the agricultural equipment line of business within the meaning of paragraph (c)(5) of this section. In addition, because Employee T provides at least 75 percent of his services to the construction machinery line of business, Employee T is a substantial-service employee with respect to Employer A's agricultural equipment line of business within the meaning of §1.414(r)–11(b)(2).

Example 9. The facts are the same as in *Example 8*, except that, during the testing year but before the first testing day, Employee T retires from employment with Employer A. Under paragraph (c)(5)(ii) of this section, Employee T is not taken into account in determining whether Employer A's construction machinery line of business has its own separate employee workforce within the meaning of paragraph (b)(4) of this section.

Example 10. Employer B is a multinational controlled group of corporations that engages in the exploration, production, refining, and marketing of petrochemical products. Employer B operates two lines of business as determined under §1.414(r)–2. The first line of business (the ''exploration, production, and refining line of business'') provides lubricating oil, gasoline, and other petrochemical products to wholesale customers of Employer B as well as to the second line of business. The wholesale customers of Employer B include independent jobbers, independent franchisees that operate retail filling stations under Employer B's trademark and tradename, as well as chemical and plastics manufacturers. The second line of business (the ''retail marketing line of business'') provides lubricating oil and gasoline products to retail customers of Employer B through filling stations owned and operated by Employer B. Employee U is an attendant at a filling station owned and operated by Employer B. Employee U performs no other services for Employer B, Under these facts, Employee U provides at least 75 percent of his services to Employer B's retail marketing line of business and therefore is a substantial-service employee with respect to that line of business within the meaning of §1.414(r)–11(b)(2), and does not provide any services within the meaning of paragraph (c)(5) of this section to any of Employer B's other lines of business.

Example 11. The facts are the same as in *Example 10*. Employer B operates a refinery that produces lubricating oil, gasoline, and other petrochemical products. Employee V is an operating engineer at the refinery who is involved at a stage in the refining process before lubricating oil and gasoline products have been separated from other types of petrochemical products. Employee V performs no other services for Employer B. Under these facts, Employee V's services contribute to providing property and services to customers of Employer B in both the exploration, production, and refining line of business and the retail marketing line of business. Employee V therefore provides services

to both lines of business within the meaning of paragraph (c)(5) of this section. See paragraph (d) of this section, however, for an optional rule for vertically integrated lines of business.

Example 12. The facts are the same as in *Example 11.* Employee W is a petroleum engineer who conducts geological studies of potential future drilling sites. Although Employee W's services during the testing year will not contribute to providing lubricating oil, gasoline, and other petrochemical products to customers of Employer B during the testing year, it is reasonably anticipated (in accordance with paragraph (c)(5)(ii)(B) of this section) that her services during the testing year will contribute to providing such products to customers of Employer B after the close of the testing year. Under these facts, Employee W provides her services to both of Employer B's lines of business within the meaning of paragraph (c)(5) of this section.

(7) *Examples of the separate management requirement.* The following examples illustrate the application of the separate management requirement in paragraph (b)(5) of this section and the supplementary rules of this paragraph (c). Unless otherwise specified, it is assumed that employees who provide services to a line of business are not substantial-service employees with respect to any other line of business and that, in determining the top-paid employees with respect to a line of business, the employer is using the option under §1.414(r)–11(b)(3) to disregard all employees who provide less than 25 percent of their services to that line of business.

Example 1. (a) Employer C operates three lines of business as determined under §1.414(r)–2. One of its lines of business is the operation of a chain of athletic equipment and apparel stores. Of Employer C's total workforce, 12,000 employees provide more than a negligible amount of the services they provide to Employer C to the athletic equipment and apparel stores line of business, within the meaning of paragraph (c)(5) of this section. Of the 1,200 employees who constitute the top ten percent by compensation of those 12,000 employees, 930 are substantial-service employees with respect to that line of business. Because 930 is 77.5 percent of 1,200, less than 80 percent of the top-paid employees with respect to the line of business are substantial-service employees with respect to that line of business. Therefore, Employer C's athletic equipment and apparel stores line of business does not have its own separate management under paragraph (b)(5) of this section.

(b) Assume that, in determining the top-paid employees with respect to the athletic equipment and apparel stores line of business, Employer C chooses to disregard all employees who provide less than 25 percent of their services to the line of business as permitted under the definition in §1.414(r)–11(b)(3). Of the 12,000 employees who provide more than a negligible amount of their services to the athletic equipment and apparel stores line of business, 10,000 provide at least 25 percent of their services to that line. Of the 1,000 employees who constitute the top ten percent by compensation of those 10,000 employees, 930 are substantial-service employees with respect to the athletic equipment and apparel stores line of business. Because 930 is 93 percent of 1,000, at least 80 percent of the top-paid employees with respect to the line of business are substantial-service employees with respect to that line of business. Therefore, Employer C's athletic equipment and apparel stores line of business has its own separate management and satisfies the requirement of paragraph (b)(5) of this section.

Example 2. The facts are the same as in *Example 1.* Employee X is a vice president of the accounting department located at the headquarters, who devotes all of his time supervising the staff of Employer C's accounting department. Employer C determines that 10 percent of Employee X's services contribute to providing property and services to customers of Employer C's athletic equipment and apparel stores line of business and 45 percent of Employee X's services contribute to providing property and services to customers to each of Employer C's other two lines of business. Because Employee X does not provide at least 25 percent of his services to Employer C's athletic equipment and apparel stores line of business, Employee X is not one of the 10,000 employees described in *Example 1* and therefore cannot be a top-paid employee within the meaning of §1.414(r)–11(b)(3) with respect to the athletic equipment and apparel stores line of business. Therefore, Employee X is not taken into account in determining whether the athletic equipment and apparel stores line of business satisfies the separate management requirement of paragraph (b)(5) of this section.

Example 3. The facts are the same as in *Example 2* except that Employee X provides 60 percent of his services to Employer C's second line of business, an athletic equipment factory, and 30 percent of his service to Employer C's third line of business, a fast-food chain. Because Employee X provides at least 50 percent of his services to the athletic equipment factory line of business, Employer C chooses to treat him as a substantial- service employee with respect to that line of business, as permitted under

§1.414(r)–11(b)(2). Thus, Employee X is taken into account as a substantial-service employee with respect to the athletic equipment factory line of business and is disregarded in applying the separate workforce and separate management requirements under paragraphs (b) (4) and (5) to the fast-food chain line of business.

Example 4. Employer D operates four lines of business as determined under §1.414(r)–2. One of its lines of business is a machine tool shop. Sixty of Employer D's employees provide at least 25 percent of their services to the machine tool shop line of business. Of the six employees who constitute the top 10 percent by compensation of those 60 employees, four are substantial-service employees with respect to the line of business. Because four is 67 percent of six, 80 percent of the top-paid employees with respect to the machine tool shop line of business are not substantial-service employees with respect to that line of business. Therefore the machine tool shop line of business does not satisfy the separate management requirement of paragraph (b)(5) of this section.

Example 5. The facts are the same as in *Example 4*, except that, in addition, another of Employer D's lines of business is an automotive repair shop, and 80 of Employer D's employees provide at least 25 percent of their services to that line of business. Employer D combines the machine shop line of business with the automotive repair shop line of business and treats them as a single line of business. As a result, Employer D has three lines of business as determined under §1.414(r)–2. Assume that 150 of Employer D's employees provide more than 25 percent of their services to the machine tool shop/automotive repair shop line of business within the meaning of paragraph (c)(5) of this section. Of the 15 employees who constitute the top 10 percent by compensation of these 150 employees, 12 are substantial-service employees with respect to that line of business. Because 12 is 80 percent of 15, at least 80 percent of the top-paid employees with respect to the machine tool shop/automotive repair shop line of business are substantial-service employees with respect to that line of business. Therefore, the machine tool shop/automotive repair shop line of business satisfies the separate management requirement of paragraph (b)(5) of this section.

(d) *Optional rule for vertically integrated lines of business*—(1) *In general.* If two lines of business satisfy the requirements of this paragraph (d) with respect to a type of property or service for a testing year, the employer is permitted to apply the optional rule in this paragraph (d) for the testing year.

(2) *Requirements.* Two lines of business satisfy the requirements of this paragraph (d) with respect to a type of property or service only if—

(i) One of the lines of business (the upstream line of business) provides a type of property or service to the other line of business (the downstream line of business);

(ii) The downstream line of business either—

(A) Uses, consumes, or substantially modifies the property or service in the course of itself providing property or services to customers of the employer; or

(B) Provides the same property or service to customers of the employer at a different level in the chain of commercial distribution from the upstream line of business (e.g., retail versus wholesale); and

(iii) The upstream line of business either—

(A) Provides the same type of property or service to customers of the employer, and at least 25 percent of the total number of units of the same type of property or service provided by the upstream line of business to all persons (including customers of the employer, the downstream line of business, and all other lines of business of the employer) are provided to customers of the employer by the upstream line of business, when measured on a uniform basis; or

(B) Provides to the downstream line of business property consisting primarily of a type of tangible property (i.e., goods, not services) that it produces or manufactures, and some entities outside the employer's controlled group that are engaged in a similar business as the upstream line of business provide the same type of tangible property to unrelated customers (i.e., customers outside those entities' respective controlled groups).

(3) *Optional rule—(i) Treatment of employees.* For purposes of determining the lines of business to which an employee provides services under paragraph (c)(5) of this section, an employee is not treated as providing services to the downstream line of business if—

(A) The employee is considered to provide services to the downstream line of business under paragraph (c)(5) of this section (applied without regard

to the optional rule in this paragraph (d)); and

(B) The employee is so considered solely because the employee's services contribute to providing the property or service from the upstream line of business to the downstream line of business.

(ii) *Purposes for which optional rule applies*. If an employee applies the optional rule in this paragraph (d), the treatment specified in paragraphs (d)(3)(i) (A) and (B) of this section applies for all the following purposes and only for the following purposes—

(A) The separate employee workforce and separate management requirements of paragraphs (b)(4) and (b)(5) of this section;

(B) The 50-employee requirement of §1.414(r)–4(b); and

(C) The determination of the employees of a qualified separate line of business under §1.414(r)–7.

(4) *Examples*. The following examples illustrate the application of the optional rule in this paragraph (d).

Example 1. Employer E operates two lines of business as determined under §1.414(r)–2, one engaged in upholstery textile manufacturing and the other in furniture manufacturing. During the testing year, the upholstery textile line of business provides its entire output of upholstery textiles to the furniture line of business. The furniture line of business uses the upholstery textiles in the manufacture of upholstered furniture for sale to customers of Employer E. The furniture line of business thus substantially modifies the upholstery textiles provided to it by the upholstery textile line of business in providing upholstered furniture products to customers of Employer E. In addition, although the upholstery textile line of business does not provide upholstery textiles to customers of Employer E, some entities engaged in upholstery textile manufacturing provide upholstery textiles to customers outside their controlled groups. Under these facts, Employer E's two lines of business satisfy the requirements of this paragraph (d) with respect to upholstery textiles for the testing year.

Example 2. Employer B is a multinational controlled group of corporations that engages in the exploration, production, refining, and marketing of petrochemical products. See *Example 10* under paragraph (c)(7) of this section. Employer B operates two lines of business as determined under §1.414(r)–(2). The first line of business (''the exploration, production, and refining line of business'') provides lubricating oil, gasoline, and other petrochemical products to wholesale customers of Employee B as well as the second line of business. The wholesale customers of Employee B include independent jobbers, independent franchisees that operate retail filling stations under Employee B's trademark and tradename, as well as chemical and plastics manufacturers. The second line of business (the ''retail marketing line of business'') provides lubricating oil and gasoline products to retail customers of Employee B through filing stations owned and operated by Employee B. During the testing year, the exploration, production and refining line of business provides 25,000 gallons of lubricating oil, 100,000 gallons of unleaded and 150,000 gallons of leaded gasoline to the retail marketing line of business, and 75,000 gallons of lubricating oil, 500,000 gallons of unleaded gasoline and 15,000 gallons of leaded gasoline to wholesale customers of Employer B. Thus, the exploration, production, and refining line of business provides 75 percent of its output of lubricating oil during the testing year to wholesale customers of Employer B. In addition, because unleaded and leaded gasoline is the same type of property (i.e., gasoline), the exploration, production, and refining line of business provides 67 percent of its output of gasoline products during the testing year to wholesale customers of Employer B. Furthermore, the retail line of business provides lubricating oil and gasoline products to customers of Employer B at different levels in the chain of commercial distribution than the exploration, production, and refining line of business. Under these facts, Employer B's two lines of business satisfy the requirements of this paragraph (d) with respect to both lubricating oil and gasoline products for the testing year.

Example 3. The facts are the same as in *Example 2*. Employer B operates a refinery that produces lubricating oil, gasoline, and other petrochemical products. Employee V is an operating engineer at the refinery who is involved at a stage in the refining process before lubricating oil and gasoline products have been separated from other types of petrochemical products. Employee V performs no other services for Employer B. Absent application of the optional rule in this paragraph (d), Employee V would be considered to provide services to both of Employer B's lines of business. See *Example 11* under paragraph (c)(7) of this section. However, because Employee V's services to the retail marketing line of business contribute solely to providing lubricating oil and gasoline products from the exploration, production, and refining line of business to the retail marketing line of business, under the optional rule in paragraph (d)(3)(i) of this section Employee V is not treated as providing services to the retail marketing line of business.

Example 4. The facts are the same as in *Example 3*. Employee W is a petroleum engineer

who conducts geological studies of potential future drilling sites. Employee W performs no other services for Employer B. Absent application of the optional rule in this paragraph (d), Employee W would be considered to provide services to both of Employer B's lines of business. See *Example 12* under paragraph (c)(7) of this Section. However, because Employee W's services to the retail marketing line of business contribute solely to providing lubricating oil and gasoline products from the exploration, production, and refining line of business to the retail marketing line of business, under the optional rule in paragraph (d)(3)(i) of this section Employee W is not treated as providing services to the retail marketing line of business.

Example 5. The facts are the same as in *Example 4*. Employee Y is a vice president in Employer B's home office. As part of his senior management responsibilities, Employee Y helps to set the rate of production at Employer B's refineries in the United States and also helps to set the price charged at the pump at the retail filling stations owned and operated by Employer B in this country. Absent application of the optional rule in this paragraph (d), Employee X would be considered to provide services to both of Employer B's lines of business within the meaning of paragraph (c)(5) of this section for purposes of satisfying the separate workforce requirement of paragraph (b)(4) of this section. Because Employee X helps to set the price charged at the pump by Employer B's retail marketing line of business, Employee X's services to the retail marketing line of business are not limited to contributing solely to providing lubricating oil and gasoline products from the exploration, production, and refining line of business to the retail marketing line of business, as required under paragraph (d)(3)(i)(B) of this section. Accordingly, even though Employer B's two lines of business satisfy the requirements of this paragraph (d) with respect to both lubricating oil and gasoline products for the testing year, and even though Employer B applies the optional rule in this paragraph (d), Employee X is still considered to provide services to both of Employer B's lines of business.

[T.D. 8376, 56 FR 63442, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32917, June 27, 1994]

§ 1.414(r)–4 Qualified separate line of business—fifty-employee and notice requirements.

(a) *In general*. This section sets forth the rules for determining whether a separate line of business (as determined under §1.414(r)–3) satisfies the 50-employee and notice requirements of §1.414(r–1(b)(2)(iv) (B) and (C), respectively.

(b) *Fifty-employee requirement*. A separate line of business satisfies the 50-employee requirement of §1.414(r)–1(b)(2)(iv)(B) for a testing year only if on each day of the testing year there are at least 50 employees who provide services to the separate line of business for the testing year and do not provide services to any other separate line of business of the employer for the testing year within the meaning of §1.414(r)–3(c)(5). For this purpose, all employees of the employer are taken into account (including collectively bargained employees), except employees described in §1.414(q)–1, Q&A–9(g)(i.e., the same employees, subject to certain modifications, who are excluded in determining the number of employees in the top-paid group under section 414(q)(4)).

(c) *Notice requirement*—(1) *General rule*. A separate line of business satisfies the notice requirement of §1.414(r)–1(b)(2)(iv)(C) for a testing year only if the employer notifies the Secretary that it treats itself as operating qualified separate lines of business for the testing year in accordance with §1.414(r)–1(b). The employer's notice for the testing year must specify each of the qualified separate lines of business operated by the employer and the section or sections of the Code to be applied on a qualified-separate-line-of-business basis. See §1.414(r)–1(c). The employer's notice must take the form, must be filed at the time and the place, and must contain any additional information prescribed by the Commissioner in revenue procedures, notices, or other guidance of general applicability. No other notice, whether actual or constructive, satisfies the requirement of this paragraph (c).

(2) *Effect of notice*. Once an employer has provided the notice prescribed in this paragraph (c) for a testing year, and the time for filing the notice for the testing year has expired without its being modified, withdrawn, or revoked, the employer is deemed to have irrevocably elected to apply the requirements of the section or sections of the Code specified in the notice separately with respect to the employees of each qualified separate line of business

specified in the notice for all plan years that begin in the testing year. The Commissioner may, in revenue procedures, notices, or other guidance of general applicability, provide for exceptions to the rule in this paragraph (c)(2) as well as for the effect that will be given to the employer's notice for purposes of any future testing year.

[T.D. 8376, 56 FR 63446, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32919, June 27, 1994]

§ 1.414(r)–5 Qualified separate line of business—administrative scrutiny requirement—safe harbors.

(a) *In general.* A separate line of business (as determined under § 1.414(r)–3 satisfies the administrative scrutiny requirement of § 1.414(r)–1(b)(2)(iv)(D) for a testing year if the separate line of business satisfies any of the safe harbors in paragraphs (b) through (g) of this section for the testing year. The safe harbor in paragraph (b) of this section implements the statutory safe harbor of section 414(r)(3). The safe harbors in paragraphs (c) through (g) of this section constitute the guidelines provided for under section 414(r)(2)(C). A separate line of business that does not satisfy any of the safe harbors in this section nonetheless satisfies the requirement of administrative scrutiny if the employer requests and receives an individual determination from the Commissioner under § 1.414(r)–6 that the separate line of business satisfies the requirement of administrative scrutiny.

(b) *Statutory safe harbor*—(1) *General rule.* A separate line of business satisfies the safe harbor in this paragraph (b) for the testing year only if the highly compensated employee percentage ratio of the separate line of business is—

(i) At least 50 percent; and

(ii) Non more than 200 percent.

(2) *Highly compensated employee percentage ratio.* For purposes of this paragraph (b), the highly compensated employee percentage ratio of a separate line of business is the fraction (expressed as a percentage), the numerator of which is the percentage of the employees of the separate line of business who are highly compensated employees, and the denominator of which is the percentage of all employees of the employer who are highly compensated employees.

(3) *Employees taken into account.* For purposes of this paragraph (b), the employees taken into account are the same employees who are taken into account for purposes of applying section 410(b) with respect to the first testing day. For this purpose, employees described in section 410 (b)(3) and (b)(4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement applicable under any plan of the employer, and with reference to the lowest service requirement applicable under any plan of the employer, as if all the plans were a single plan under § 1.410(b)–6(b)(2). The employees of the separate line of business are determined by applying § 1.414(r)–7 to the employees taken into account under this paragraph (b)(3). An employee is treated as a highly compensated employee for purposes of this paragraph (b) if the employee is treated as a highly compensated employee for purposes of applying section 410(b) with respect to the first testing day. For the definition of ''first testing day,'' see § 1.414(r)–11(b)(7).

(4) *Ten-percent exception.* A separate line of business is deemed to satisfy paragraph (b)(1)(i) of this section for the testing year if at least 10 percent of all highly compensated employees of the employer provide services to the separate line of business during the testing year and do not provide services to any other separate line of business of the employer during the testing year within the meaning of § 1.414(r)–3(c)(5).

(5) *Determination based on preceding testing year.* A separate line of business that satisfied this safe harbor for the immediately preceding testing year (without taking into account the special rule in this paragraph (b)(5)) is deemed to satisfy the safe harbor for the current testing year. The preceding sentence applies to a separate line of business only if the employer designated the same line of business in the immediately preceding testing year as in the current testing year and either—

(i) The highly compensated employee percentage ratio of the separate line of business for the current testing year

does not deviate by more than 10 percent (not 10 percentage points) from the highly compensated employee percentage ratio of the separate line of business for the immediately preceding testing year; or

(ii) No more than five percent of the employees of the separate line of business for the current testing year were employees of a different separate line of business for the immediately preceding testing year, and no more than five percent of the employees of the separate line of business for the immediately preceding testing year are employees of a different separate line of business for the current testing year.

(6) *Examples*. The following examples illustrate the application of the safe harbor in this paragraph (b).

Example 1. (i) Employer A operates three separate lines of business as determined under §1.414(r)–3, that respectively consist of a railroad, an insurance company, and a newspaper. Employer A employs a total of 400 employees, 100 of whom are highly compensated employees. Thus, the percentage of all employees of Employer A who are highly compensated employees in 25 percent. After applying §1.414(r)–7, the distribution of highly and nonhighly compensated employees among Employer A's separate lines of business is as follows:

	Employer-wide	Railroad	Insurance company	Newspaper
Number of Employees	400	100	150	150
Number of HCEs	100	20	50	30
Number of Non-HCEs	300	80	100	120
HCE Percentage	25% (100/400)	20% (20/100)	33% (50/150)	20% (30/150)
HCE Percentage Ratio	N/A	80% (20%/25%)	133% (33%/25%)	80% (20%/25%)

(ii) Because the highly compensated employee percentage ratio of each separate line of business is at least 50 percent and no more than 200 percent, each of Employer A's separate lines of business satisfies the requirements of the safe harbor in this paragraph (b).

Example 2. (i) Employer B operates three separate lines of business as determined under §1.414(r)–3, that respectively consist of a dairy products manufacturer, a candy manufacturer, and a chain of housewares stores. Employer B employs a total of 1,000 employees, 100 of whom are highly compensated employees. Thus, the percentage of all employees of Employer B who are highly compensated employees is 10 percent. After applying §1.414(r)–7, the distribution of highly and nonhighly compensated employees among Employer B's separate lines of business is as follows:

	Employer-wide	Dairy products	Candy	Housewares stores
Number of Employees	1,000	200	500	300
Number of HCEs	100	5	50	45
Number of Non-HCEs	900	195	450	255
HCE Percentage	10% (100/1,000)	2.5% (5/200)	10% (50/500)	15% (45/300)
HCE Percentage Ratio	N/A	25% (2.5%/10%)	100% (10%/10%)	150% (15%/10%)

(ii) Because the highly compensated employee percentage ratio for the dairy products line of business is less than 50 percent, it does not satisfy the requirements of the statutory safe harbor in this paragraph (b). However, because Employer B's other two separate lines of business (candy manufacturing and housewares stores) each has a highly compensated employee percentage ratio that is no less than 50 percent and no greater than 200 percent, they each satisfy the statutory safe harbor in this paragraph (b).

Example 3. (i) The facts are the same as in *Example 2*, except that Employer B operates only two separate lines of business as determined under §1.414(r)–3, one consisting of the dairy products manufacturer and the candy manufacturer, and the other consisting of the chain of housewares stores. After applying §1.414(r)–7, the distribution of highly and nonhighly compensated employees among

Employer B's separate lines of business is as follows:

	Employer-Wide	Candy/Dairy Products	Housewares Stores
Number of Employees	1,000	700	300
Number of HCEs	100	55	45
Number of Non-HCEs	900	645	255
HCE Percentage	10% (100/1,000)	7.9% (55/700)	15% (45/300)
HCE Percentage Ratio	N/A	79% (7.9%/10%)	150% (15%/10%)

(ii) Because the highly compensated employee percentage ratio for both of Employer B's separate lines of business is at least 50 percent and no more than 200 percent, they each satisfy the requirements of the statutory safe harbor in this paragraph (b).

(c) *Safe harbor for separate lines of business in different industries*—(1) *In general*. A separate line of business satisfies the safe harbor in this paragraph (c) for the testing year if it is in a different industry or industries from every other separate line of business of the employer. For this purpose, a separate line of business is in a different industry or industries from every other separate line of business of the employer only if—

(i) The property or services provided to customers of the employer by the separate line of business (as designated by the employer for the testing year under §1.414(r)–2) fall exclusively within one or more industry categories established by the Commissioner for purposes of this paragraph (c); and

(ii) None of the property or services provided to customers of the employer by any of the employer's other separate lines of business (as designated by the employer for the testing year under §1.414(r)–2) falls within the same industry category or categories.

(2) *Optional rule for foreign operations*. For purposes of satisfying this paragraph (c), an employer is permitted to disregard any property or services provided to customers of the employer during the testing year by a foreign corporation or foreign partnership (as defined in section 7701(a)(5)), to the extent that income from the provision of the property or services is not effectively connected with the conduct of the trade or business within the United States within the meaning of section 864(c). Thus, for example, an employer is permitted to take into account only property and services provided to customers of the employer by its domestic subsidiaries and property and services provided by its foreign subsidiaries that generate income effectively connected with the conduct of a trade or business within the United States in determining whether the property or services provided to customers of the employer by a separate line of business fall exclusively within one or more industry categories and also whether the property or services provided by any other separate line of business fall within the same industry category or categories.

(3) *Establishment of industry categories*. The Commissioner shall, by revenue procedure or other guidance of general applicability, establish industry categories for purposes of this paragraph (c).

(4) *Examples*. The following examples illustrate the application of the safe harbor in this paragraph (c). For purposes of these examples, it is assumed that, pursuant to paragraph (c)(3) of this section, the Commissioner has established the following industry categories (among others): transportation equipment and services; banking, insurance, and finance; machinery and electronics; and entertainment, sports, and hotels.

Example 1. Among its other business activities, Employer C operates a commercial airline that constitutes a separate line of business under §1.414(r)–3. In addition, no other separate line of business of Employer C provides to customers of Employer C any property or services in the transportation equipment and services industry category. Under these facts, the separate line of business described in this example satisfies the safe harbor in this paragraph (c).

Example 2. The facts are the same as in *Example 1,* except that Employer C also operates a trucking company that constitutes another separate line of business of Employer C under §1.414(r)–3. Because the commercial airline and the trucking company both provide to customers of Employer C services in the transportation equipment and services industry category, neither separate line of business satisfies the safe harbor in this paragraph (c).

Example 3. Among its other business activities, Employer D operates a commercial bank and luxury hotel that together constitute a single separate line of business under §1.414(r)–3. No other separate line of business of employer D provides to customers of Employer D property or services in either the banking, insurance, or financial industry category, or the entertainment, sports, or hotel industry category. Under these facts, the separate line of business described in this example satisfies the safe harbor in this paragraph (c).

Example 4. The facts are the same as in *Example 3,* except that Employer D also manufactures computers in the United States and abroad. Employer D apportions its computer operations by designating these operations between two separate lines of business, one consisting of its domestic operations located in the United States and the second consisting of its foreign operations by a foreign subsidiary. Because both lines of business provide property and services in the machinery and electronics industry category to customers of Employer D, neither separate line of business would satisfy the safe harbor in this paragraph (c). However, pursuant to the optional rule in paragraph (c)(2) of his section, Employer D disregards the property and services provided by its foreign computer subsidiary. As a result, no other separate line of business of Employer D provides to customers of Employer D any property or services in the machinery and electronics industry category. Under these facts, Employer D's domestic computer operations separate line of business satisfies the safe harbor in this paragraph (c).

(d) *Safe harbor for separate lines of business that are acquired through certain mergers and acquisitions*—(1) *General rule.* A portion of the employer that is acquired through a transaction described in section 410(b)(6)(C) and §1.410(b)–2(f) (i.e., an asset or stock acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business) (the ''acquired line of business'') satisfies the safe harbor in this paragraph (d) for each testing year in the transition period provided in paragraph (d)(3) of this section if each of the following requirements is satisfied—

(i) For each testing year within the transition period the employer designates the acquired line of business as a line of business within the meaning of §1.414(r)–2;

(ii) On the first testing day in each testing year in the transition period:

(A) The acquired line of business constitutes a separate line of business within the meaning of §1.414(r)–3 (taking into account §1.414(r)–1(d)(4));

(B) No more than 10 percent of the employees who are substantial-service employees with respect to the acquired line of business were substantial-service employees with respect to a different separate line of business for the immediately preceding testing year; and

(C) No more than 10 percent of the employees who were substantial-service employees with respect to the acquired line of business for the immediately preceding testing year are substantial-service employees with respect to a different separate line of business in the respective testing year.

(iii) If the transaction described in paragraph (d)(1) of this section occurs after the first testing day in a testing year, the determinations required by paragraphs (d)(1)(ii) (B) and (C) of this section with respect to that testing year are made as of the date of the transaction.

(2) *Employees taken into account.* For purposes of this paragraph (d), the employees taken into account are the same employees who are taken into account for purposes of applying section 410(b) with respect to the first testing day. For this purpose, employees described in section 410(b)(3) and (b)(4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement, and with reference to the lowest service requirement applicable under any plan of the employer that benefits employees of the separate line of business, as if all the plans were a single plan under §1.410(b)–6(b)(2). The employees of the separate line of business are determined by applying §1.414(r)–7 to the employees taken into account under this paragraph (d)(2).

(3) *Transition period*. The transition period for purposes of this safe harbor is the period that begins with the first testing year beginning after the date that the transaction described in paragraph (d)(1) of this section occurs. The employer is permitted, but not required, to extend the transition period to include one, two, or three of the testing years immediately succeeding that first testing year.

(4) *Examples*. The following examples illustrate the application of the safe harbor in this paragraph (d).

Example 1. Employer E is treated as operating three qualified separate lines of business pursuant to §1.414(r)–1(b). In 1996, Employer E acquires a company that employs 4,000 employees who manufacture and sell pharmaceutical supplies, and designates that portion as a line of business under §1.414(r)–2. Under §1.414(r)–1(d)(4), the pharmaceutical supplies line of business is deemed to satisfy the requirements to be a qualified separate line of business (other than the 50-employee and notice requirements) for testing year 1996. In addition, the determination of whether Employer E's remaining three lines of business constitute qualified separate lines of business for testing year 1996 is made without taking into account the acquired employees and by disregarding the property and services provided to customers of Employer E by the pharmaceutical supplies line of business.

Example 2. The facts are the same as in *Example 1* except that, by the first testing day in 1997 (Transition Year 1), there are 300 additional substantial-service employees with respect to the pharmaceutical supplies line of business, increasing the total number to 4,300. Of those 300 employees, 250 were substantial-service employees with respect to a different separate line of business for testing year 1996 and 50 are new hires. Assume that, on the first testing day in Transition Year 1, the pharmaceutical supplies line of business satisfies the requirements of §1.414(r)–3 (taking into account §1.414(r)–1(d)(4)) and therefore constitutes a separate line of business. Because 250 is 6 percent of 4,300, no more than ten percent of the employees who are substantial-service employees with respect to the pharmaceutical supplies line of business were substantial- service employees with respect to a different separate line of business for the immediately preceding testing year. The 50 newly hired employees are disregarded in making this determination. Under these facts, the pharmaceutical supplies separate line of business satisfies the safe harbor in this paragraph (d) for Transition Year 1.

Example 3. The facts are the same as in *Example 2*, except that, before the first day of the next testing year (''Transition Year 2''), Employer E permanently transfers 200 of the 4,300 employees who were substantial-service employees with respect to the pharmaceutical line of business on the first testing day in Transition Year 1 to a different line of business and does not hire any additional employees for the pharmaceutical supplies line of business. Therefore, by the first testing day in Transition Year 2, the number of employees who are substantial-service employees with respect to the pharmaceutical line of business of Employer E has decreased from 4,300 to 4,100. Assume that, on that first testing day in Transition Year 2, the pharmaceutical supplies line of business constitutes a separate line of business within the meaning of §1.414(r)–3. Because 200 is approximately 5 percent of 4,300, no more than 10 percent of the employees who were substantial-service employees of the pharmaceutical line of business for Transition Year 1 are not substantial-service employees of the pharmaceutical line of business in Transition Year 2. Under these facts, the pharmaceutical supplies separate line of business continues to satisfy the safe harbor in this paragraph (d) for Transition Year 2.

(e) *Safe harbor for separate lines of business reported as industry segments*—(1) *In general*. A separate line of business satisfies the safe harbor in this paragraph (e) for the testing year if, for the employer's fiscal year ending latest in the testing year, the separate line of business is reported as one or more industry segments on its annual report required to be filed in conformity with either—

(i) Form 10–K, annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (''Form 10–K''); or

(ii) Form 20–F, Annual Report Pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 with Item 18 financials (''Form 20–F''), and the employer timely files either the Form 10–K or Form 20–F with the Securities and Exchange Commission (''SEC'').

(2) *Reported as an industry segment in conformity with Form 10–K or Form 20–F*. For purposes of this paragraph (e), a separate line of business is reported as one or more industry segments in conformity with either Form 10–K or Form 20–F only if—

(i) The separate line of business consists of one or more industry segments within the meaning of paragraphs 10(a),

11(b), and 12 through 14 of the Statement of Financial Accounting Standards No. 14, Financial Reporting for Segments of a Business Enterprise (''FAS 14''); and

(ii) The property or services provided to customers of the employer by the separate line of business (as designated by the employer for the testing year under §1.414(r)–2) is identical to the property or services provided to customers of the employer by the industry segment or segments (as determined under paragraphs 10(a), 11(b), and 12 through 14 of FAS 14).

(3) *Timely filing of Form 10–K or Form 20–F.* For purposes of this paragraph (e), a Form 10–K of Form 20–F is timely filed with the SEC if it is filed within the required period as provided under 17 CFR 240.12b–25(b)(2)(ii). Therefore, the required period for timely filing of the Form 10–K is the 90-day period after the end of the fiscal year covered by the annual report (including the 15-day extension), and the required period for timely filing of the Form 20–F is the 6-month period after the end of the fiscal year covered by the annual report (including the 15-day extension).

(4) *Examples.* The following examples illustrate the application of the safe harbor in this paragraph (e).

Example 1. Among its other business activities, Employer F operates a bearing manufacturing firm that constitutes a separate line of business under §1.414(r)–3. Employer F is required to file an annual Form 10–K with the SEC. On its timely filed Form 10–K, Employer F reports its bearing manufacturing operations as an industry segment in accordance of FAS 14 (as determined under paragraphs 10(a), 11(b), and 12 through 14 of FAS 14). The group of bearing products provided by the separate line of business (as designated by Employer F under §1.414(r)–2) is identical to the group of bearing products provided by the industry segment (as determined under paragraphs 10(a), 11(b), and 12 through 14 of FAS 14). Under these facts, the separate line of business described in this example satisfies the safe harbor in this paragraph (e).

Example 2. The facts are the same as in *Example 1,* except that Employer F has apportioned its bearing manufacturing operations between two separate lines of business as determined under §1.414(r)–3, one engaged in the manufacture of bearings for use in the automotive industry, and a second engaged in the manufacture of bearings for use in the aerospace industry. Because neither separate line of business provides a group of property or services to customers of Employer F that is identical to the group of bearing products provided by the industry segment reported on Employer F's annual Form 10–K, neither separate line of business described in this example satisfies the safe harbor in this paragraph (e).

(f) *Safe harbor for separate lines of business that provide the same average benefits as other separate lines of business*—(1) *General rule.* A separate line of business satisfies the safe harbor in this paragraph (f) for the testing year only if the level of benefits provided to employees of the separate line of business satisfies paragraph (f)(2) or (f)(3) of this section, whichever is applicable.

(2) *Separate lines of business with a disproportionate number of nonhighly compensated employees*—(i) *Applicability of safe harbor.* This paragraph (f)(2) applies to a separate line of business that for the testing year has a highly compensated employee percentage ratio of less than 50 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement.* A separate line of business satisfies this paragraph (f)(2) only if the actual benefit percentage of the group of nonhighly compensated employees of the separate line of business for the testing period that ends with or within the testing year is at least as great as the actual benefit percentage of the group of all other nonhighly compensated employees of the employer for the same testing period. See §1.410 (b)–5(c) and (d)(3)(ii) for the definitions of actual benefit percentage and testing period, respectively. In determining actual benefit percentages for purposes of this paragraph (f)(2)(ii), the special rule in §1.410(b)–5(e)(3) (permitting an employer to determine employee benefit percentages separately for defined contribution and defined benefit plans) may not be used.

(3) *Separate lines of business with a disproportionate number of highly compensated employees*—(i) *Applicability of safe harbor.* This paragraph (f)(3) applies to a separate line of business that for the testing year has a highly compensated employee percentage ratio of more than 200 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement.* A separate line of business satisfies this paragraph (f)(3) only if the actual benefit percentage of

the group of highly compensated employees of the separate line of business for the testing period that ends with or within the testing year is no greater than the actual benefit percentage of the group of all other highly compensated employees of the employer for the same testing period. See §1.410 (b)–5(c) and (d)(3)(ii) for the definitions of actual benefit percentage and testing period, respectively. In determining actual benefit percentages for purposes of this paragraph (f)(3)(ii), the special rule in §1.410(b)–5(e)(3) (permitting an employer to determine employee benefit percentages separately for defined contribution and defined benefit plans) may not be used.

(4) *Employees taken into account*. An employee of a separate line of business (as determined under §1.414(r)–7 is taken into account for a testing period for purposes of this paragraph (f) only if the employee is an employee of the separate line of business on the first testing day, and would not be an excludable employee for purposes of applying the average benefit percentage test of §1.410(b)–5 to a plan for a plan year included in that testing period. In determining whether an employee is an excludable employee for purposes of the average benefit percentage test, the employer is assumed not to be operating qualified separate lines of business under §1.414(r)–1(b). An employee is treated as a highly compensated employee for purposes of this paragraph (f) if the employee is treated as a highly compensated employee for purposes of applying section 410(b) on the first testing day. See §1.414(r)–11(b)(7) for the definition of ''first testing day''.

(5) *Example*. The rules of this paragraph (f) are illustrated by the following example.

Example. (i) Employer G is treated as operating two separate lines of business, Line 1 and Line 2, in accordance with §1.414(r)–1(b). Employer G maintains three qualified plans. Plan A is a calendar-year profit-sharing plan that benefits all employees of Employer G. Plan B is a defined benefit plan with a plan year ending March 31 that benefits all employees of Line 1. Plan C is a defined benefit plan with a plan year ending November 30 that benefits all employees of Line 2.

(ii) In 1995, Line 1 has a highly compensated employee percentage ratio of 25 percent. Employer G's first testing day is March 31. After applying the rules of §1.414(r)–7, the nonhighly compensated employees of Line 1 and Line 2 on March 31, 1995, are N1–N80 and N81–N100, respectively. N1 is an excludable employee under §1.410(b)–6 for purposes of the average benefit percentage test during the testing period that includes the plan years of Plans A, B, and C that end in 1995 (the ''1995 testing period''), and would therefore not be taken into account in determining whether any of those plans satisfied the average benefit percentage test of §1.410(b)–5 for plan years included in that testing period, because N1 does not satisfy the minimum age and service conditions under any plan of the employer. All other employees of Line 1 and Line 2 on March 31, 1995 are nonexcludable employees for purposes of the average benefit percentage test during the 1995 testing period.

(iii) In order for Line 1 to satisfy the requirements of this paragraph (f) for 1995, the actual benefit percentage of N2–N80 for the 1995 testing period under Plans A, B and C must be at least as great as the actual benefit percentage of N81–N100 for the same testing period under the same plans. N1 is not taken into account because N1 is an excludable employees for purposes of the average benefit percentage test for the 1995 testing period. Any other employees who were taken into account for purposes of the average benefit percentage test for the 1995 testing period are excluded because they are not employees of Line 1 or Line 2 on March 31, 1995.

(g) *Safe harbor for separate lines of business that provide minimum or maximum benefits*. —(1) *In general*. A separate line of business satisfied the safe harbor in this paragraph (g) for the testing only if the level of benefits provided to employees of the separate line of business satisfies paragraph (g)(2) or (g)(3) of this section, whichever is applicable. For this purpose, the level of benefits is determined with respect to all qualified plans of the employer that benefit employees of the separate line of business for plan years that begin in the testing year.

(2) *Minimum benefit required*—(i) *Applicability*. This paragraph (g)(2) applies to a separate line of business that for the test year has a highly compensated employee percentage ratio of less than 50 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement*. A separate line of business satisfies this paragraph (g)(2) only if one of the following requirements is satisfied—

(A) At least 80 percent of all nonhighly compensated employees of the

separate line of business either accrue a benefit for the plan year that equals or exceeds the defined benefit minimum in paragraph (g)(2)(iii) of this section, receive all allocation for the plan year that equal or exceeds the defined contribution minimum in paragraph (g)(2)(iv) of this section, or accrue a benefit and receive an allocation that together equal or exceed the combined plan minimum in paragraph (g)(4) of this section. The defined benefit minimum must be provided in a defined plan, and the defined contribution minimum must be provided in a defined contribution plan.

(B) The separate line of business would satisfy the requirements of paragraph (g)(2)(ii)(A) of this section if the 80 percent threshold were reduced to 60 percent, and the average of the accrual rates or allocation rates of all nonhighly compensated employees in the separate line of business equals or exceeds the minimum amount described for each individual employee in paragraph (g)(2)(ii)(A) of this section.

(iii) *Defined benefit minimum*—(A) *In general*. The defined benefit minimum for a plan year is the employer-derived accrual that would result in a normal accrual rate for the plan year equal to 0.75 percent of compensation. For purposes of this paragraph (g)(2)(iii), the normal accrual rate is the percentage (not less than 0) determined by subtracting the employee's normalized accrued benefit as of the end of the prior plan year (expressed as a percentage of average annual compensation as of the end of the prior plan year) from the employee's normalized accrued benefit as of the end of the plan year (expressed as a percentage of average annual compensation as of the end of the plan year).

(B) *Normal form and equivalent benefits*. The benefit that is tested for purposes of this paragraph (g)(2)(iii) is the accrued retirement benefit commencing at normal retirement age. If the normal form of benefit for a plan being tested is other than a straight life annuity beginning at a normal retirement age of 65, the benefit must be normalized (within the meaning of §1.401(a)(4)–12) to a straight life annuity commencing at age 65. No adjustment is permitted for early retirement benefits or for any ancillary benefit, including disability benefits.

(C) *Compensation definition*. The underlying definition of compensation used for purposes of determining accrual rates under this paragraph (g)(2)(iii) must be a definition of compensation that automatically satisfies section 414(s) without a test for nondiscrimination (see §1.414(s)–1(c)).

(D) *Average compensation requirement*. For purposes of determining accrual rates, compensation must be average annual compensation within the meaning of §1.401(a)(4)–3(e)(2) determined using a five-year averaging period. The compensation history to be taken into account are all years beginning with the first year in which the employee benefits under the plan, and ending with the last plan year in which the employee participates in the plan. However, a plan may disregard in a reasonable and consistent manner: years before the effective date of these regulations as set forth in §1.414(r)–1(d)(9)(i), years more than 10 years preceding the current plan year, and years for which the employer does not use this paragraph (g)(2) to satisfy this safe harbor with respect to the separate line of business. If a plan provides a defined benefit minimum that uses three consecutive years (in lieu of five) for calculating average annual compensation, the 0.75 percent annual accrual in paragraph (g)(2)(iii)(A) of this section is multiplied by 93.3 percent, resulting in a normal accrual rate equal to 0.70 percent. If a plan provides a defined benefit minimum that uses more than five consecutive years for calculating average annual compensation or the plan is an accumulation plan as defined in §1.401(a)(4)–12, the 0.75 percent annual accrual rate in paragraph (g)(2)(iii)(A) of this section is multiplied by 133.3 percent, resulting in a normal accrual rate equal to 1.0 percent.

(E) *Special rules*. The special rules of §1.401(a)(4)–3(f) apply for purposes of determining whether a benefit accrual satisfies the minimum benefit requirement. For example, benefits may be determined on other than a plan year basis as permitted by §1.401(a)(4)–3(f)(6). A plan described in section 412(i)

may be used to provide the defined benefit minimum described in this paragraph (g)(2). In such case, the rules in §1.416–1, M–17, apply to such a plan. For purposes of this paragraph (g)(2)(iii) an employee is treated as accruing a benefit equal to the minimum benefit in paragraph (g)(2)(iii)(A) of this section if the reason that the employee does not accrue such a benefit is either—

(*1*) The application of a plan provision that applies uniformly to all employees in the plan and limits the service used for purposes of benefit accrual to a specified maximum no less than 25 years, or

(*2*) The employee has attained normal retirement age and fails to accrue a benefit solely because of the provisions of section 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

(iv) *Defined contribution minimum*—(A) *In general*. The defined contribution minimum for a plan year is an allocation that results in an allocation rate for the plan year (within the meaning of §1.401(a)(4)–2(c)) equal to three percent of an employee's plan year compensation. Plan year compensation must be based on a definition of compensation that automatically satisfies section 414(s) without a test for nondiscrimination (see §1.414(s)–1(c)). For this purpose, allocations that are taken into account to do not include matching contributions described in §1.401(m)–1(f)(12), elective contributions described in §1.401(k)–1(g)(3), any adjustment in allocation rates permitted under section 401(*l*) or imputed disparity under §1.401(a)(4)–7.

(B) *Modified allocation definition for averaging*. For purposes of determining whether the average allocation rates for all nonhighly compensated employees of the separate line of business satisfy the minimum benefit requirement in paragraph (g)(2)(ii)(B) of this section, matching contributions described in §1.401(m)–1(f)(12) are treated as employer allocations.

(3) *Maximum benefit permitted—(*i*) Applicability*. This paragraph (g)(3) applies to a separate line of business that for the testing year has a highly compensated employee percentage ratio that exceeds 200 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement*. A separate line of business satisfies this paragraph (g)(3) only if one of the following requirements is satisfied—

(A) No highly compensated employee of the separate line of business accrues a benefit for the plan year that results in an accrual rate that exceeds the defined benefit maximum in paragraph (g)(3)(iii) of this section, receives an allocation that exceeds the defined contribution maximum in paragraph (g)(3)(iv) of this section, or accrues a benefit and receives an allocation that together exceed the combined plan maximum in paragraph (g)(4) of this section. All benefits provided by qualified defined benefit plans are subject to the defined benefit maximum, and all benefits provided by qualified defined contribution plans are subject to the defined contribution maximum.

(B) The average of the accrual rates or allocation rates of all highly compensated employees of the separate line of business is no more than 80 percent of the maximum amount described for any individual employee in paragraph (g)(3)(ii)(A) of this section.

(iii) *Defined benefit maximum*—(A) *In general*. The defined benefit maximum is the employer-derived accrued benefit that would result from calculating a normal accrual rate equal to 2.5 percent of compensation.

(B) *Determination of defined benefit maximum*. The accrual rate used for the defined benefit maximum is determined in the same manner as the normal accrual rate used for the defined benefit minimum is determined under paragraph (g)(2)(iii) of this section, except as provided below. Thus, a defined benefit plan may provide, in addition to the defined benefit maximum, any benefit the value of which is not taken into account under paragraph (g)(2)(iii) of this section. For example, a plan may provide qualified disability benefits described in section 411(a)(9) or ancillary benefits described in §1.401(a)(4)–4(e)(2).

(C) *Adjustment for different compensation definitions*. If a plan subject to the defined benefit maximum determines accrual rates by using three consecutive years (in lieu of five) for purposes

of determining average annual compensation, the 2.5 percent annual accrual rate in paragraph (g)(3)(iii)(B) of this section is multiplied by 93.3 percent, resulting in a maximum accrual rate equal to 2.33 percent. Compensation may be less inclusive than the compensation described in paragraph (g)(2)(iii)(C) of this section. However, no adjustment is made to the maximum normal accrual rate because of the use of a definition of compensation that is less inclusive than the compensation described in paragraph (g)(2)(iii)(C) of this section. In addition, no adjustment is made to the maximum normal accrual rate because the plan uses more than five consecutive years for calculating average annual compensation or the plan is an accumulation plan as defined in §1.401(a)(4)–12.

(D) *Adjustment for certain subsidies.* If the plan provides subsidized optional forms of benefit, the accrual rate for purposes of this paragraph (g)(3) must be determined by taking those subsidies into account. An optional form of benefit is considered subsidized if the normalized optional form of benefit is larger than the normalized normal retirement benefit under the plan. In the case of a plan with subsidized optional forms, the determination of accrual rate for the plan year under paragraph (g)(2)(iii)(A) of this section is the percentage (not less than 0) determined by subtracting the largest of the sums of the employee's normalized QJSAs and QSUPPs determined for each age under §1.401(a)(4)–3(d)(1)(ii) as of the end of the prior plan year (expressed as a percentage of average annual compensation as of the end of the prior plan year) from the largest of the sums of the employee's normalized QJSAs and QSUPPs determined for each age under §1.401(a)(4)–3(d)(1)(ii) as of the end of the plan year (expressed as a percentage of average annual compensation as of the end of the plan year).

(iv) *Defined contribution maximum.* The defined contribution maximum is an allocation that results in an allocation rate for the plan year (within the meaning of §1.401(a)(4)–2(c)) equal to 10 percent of an employee's plan year compensation. Compensation may be less inclusive than the compensation described in paragraph (g)(2)(iv)(A) of this section. However, no adjustment is made to the defined contribution maximum because of the use of a definition of compensation that is less inclusive than the compensation described in paragraph (g)(2)(iv)(A) of this section. For this purpose, allocations that are taken into account do not include elective contributions described in §1.401(K)–1(g)(3), any adjustment in allocation rates permitted under section 401(*l*) or imputed disparity under §1.401(a)(4)–7 but do include employer matching contributions under §1.401(m)–1(f)(12).

(4) *Duplication of benefits or contributions*—(i) *Plans of the same type.* In the case of an employee who benefits under more than one defined benefit plan, the defined benefit minimum required or the defined benefit maximum permitted under this paragraph (g) is determined by reference to the employee's aggregate employer-provided benefit under all qualified defined benefit plans of the employer. In the case of an employee who benefits under more than one defined contribution plan, the defined contribution minimum required or the defined contribution maximum permitted under this paragraph (g) is determined by reference to the employee's aggregate employer-provided allocations under all qualified defined contribution plans of the employer.

(ii) *Plans of different types.* In the case of an employee who benefits under both a defined benefit plan and a defined contribution plan, a percentage of the minimum benefit required or the maximum benefit permitted under this paragraph (g) may be provided in each type of plan as long as the combined percentage equals at least 100 percent in the case of the minimum benefit required and does not exceed 100 percent in the case of the maximum benefit permitted. Thus, for example, if a highly compensated employee benefits under both types of plans and accrues an aggregate adjusted normal accrual rate equal to 1.25 percent of average annual compensation under all defined benefit plans of the employer (i.e, 50 percent of the defined benefit maximum described in paragraph (g)(3)(iii)

of this section), in order to comply with the maximum benefit safe harbor, the employee may not receive an aggregate allocation under all defined contribution plans of the employer in excess of five percent of plan year compensation (i.e., 50 percent of the defined contribution maximum described in paragraph (g)(3)(iv) of this section).

(iii) *Special rule for floor-offset arrangements.* In the case of a floor-offset arrangement (as described in §1.401(a)(4)–8(d)), the minimum or maximum benefit rules are applied to each plan as if the other plan did not exist. Thus, the defined benefit plan must provide at least 100 percent of the defined benefit minimum (or no more than 100 percent of the defined benefit maximum) based on the gross benefit prior to offset, and the defined contribution plan must provide at least 100 percent of the defined contribution minimum (or no more than 100 percent of the defined contribution maximum).

(5) *Certain contingency provisions ignored.* For purposes of this paragraph (g), an employee's accrual or allocation rate is determined without regard to any minimum benefit or any maximum benefit limitation that is applicable to the employee only if the separate line of business fails otherwise to satisfy the requirement of administrative scrutiny.

(6) *Employees taken into account.* For purposes of this paragraph (g), an employee is taken into account if the employee is taken into account for purposes of applying section 410(b) with respect to any testing day for the testing year. For this purpose, employees described in section 410 (b)(3) and (b)(4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement applicable, and with reference to the lowest service requirement applicable under any plan of the employer that benefits employees of the separate line of business, as if all the plans were a single plan under §1.410(b)–6(b)(2). For purposes of the minimum benefit requirement of paragraph (g)(2) of this section, section 410(b)(4) may be applied with reference to the lowest minimum age requirement, and with reference to the lowest minimum service requirement, applicable under any plan of the employer that benefits highly compensated employees of the separate line of business, as if all the plans were a single plan under §1.410(b)–6(b)(2), or, if no plan of the employer benefits highly compensated employees of the separate line of business, with reference to the greatest age and service requirements permitted under section 410(a)(1)(A). The employees of the separate line of business are determined by applying §1.414(r)–7 to the employees taken into account under this paragraph (g)(6). An employee is treated as a highly compensated employee for purposes of this paragraph (g) if the employee is treated as a highly compensated employee for purposes of applying section 410(b) on any testing day for the testing year. For the definition of ''testing day,'' see §1.414(r)–11(b)(6).

[T.D. 8376, 56 FR 63446, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32919, June 27, 1994]

§1.414(r)–6 Qualified separate line of business—administrative scrutiny requirement—individual determinations.

(a) *In general.* A separate line of business (as determined under §1.414(r)–3) that does not satisfy any of the safe harbors in §1.414(r)–5 for a testing year nonetheless satisfies the administrative scrutiny requirement of §1.414(r)–1(b)(2)(iv)(D) if the employer requests and receives from the Commissioner an individual determination under this section that the separate line of business satisfies the requirement of administrative scrutiny for the testing year. This section implements the individual determinations provided for under section 414(r)(2)(C). The Commissioner shall issue such an individual determination only when it is consistent with the purpose of section 414(r), taking into account the nondiscrimination requirements of sections 401(a)(4) and 410(b). Paragraph (b) of this section authorizes the Commissioner to establish procedures for requesting and granting individual determinations.

(b) *Authority to establish procedures.* The Commissioner may, in revenue rulings and procedures, notices, and other guidance, published in the Internal Revenue Bulletin (see

§ 601.601(d)(2)(ii)(b) of this chapter), provide any additional guidance that may be necessary or appropriate for requesting and granting individual determinations under this section. For example, such guidance may specify the circumstances in which an employer may request an individual determination and factors to be taken into account in deciding whether to grant a favorable individual determination. In addition, such guidance may describe situations that automatically fail the administrative scrutiny requirement.

[T.D. 8376, 56 FR 63452, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32920, June 27, 1994]

§ 1.414(r)–7 Determination of the employees of an employer's qualified separate lines of business.

(a) *Introduction*—(1) *In general.* This section provides the rules for determining the employees of each qualified separate line of business operated by an employer. Paragraph (a)(2) of this section lists the specific provisions of the regulations for which these rules apply. Paragraph (b) of this section provides the procedure for assigning the employees of the employer among the qualified separate lines of business of the employer and for determining the day or days on which such assignments must be made. Under this procedure, each employee (i.e., a substantial-service employee or a residual shared employee as defined in § 1.414(r)–11(b)(2) and (4)) is assigned to a single qualified separate line of business in a consistent manner for all purposes listed in paragraph (a)(2) of this section with respect to the testing year and plan years beginning within the testing year. Paragraph (c) of this section provides methods for allocating residual shared employees among qualified separate lines of business.

(2) *Purposes for which this section applies.* This section applies solely for purposes of determining whether—

(i) A separate line of business satisfies the statutory safe harbor of § 1.414(r)–5(b) for a testing year (see § 1.414(r)–5(b)(3) for the employees taken into account for this purpose);

(ii) A separate line of business satisfies the merger and acquisition safe harbor of § 1.414(r)–5(d) for a testing year (see § 1.414(r)–5(d)(2) for the employees taken into account for this purpose);

(iii) A separate line of business satisfies the average benefits safe harbor of § 414(r)–5(f) for a testing year (see § 414(r)–5(f)(4) for the employees taken into account for this purpose);

(iv) A separate line of business satisfies the minimum or maximum benefits safe harbor of § 414(r)–5(g) for a testing year (see § 1.414(r)–5(g)(6) for the employees taken into account for this purpose);

(v) A plan of the employer satisfies sections 410(b) and 401(a)(4) for a plan year (see § 414(r)–8(d)(3) for the employees taken into account for this purpose); or

(vi) A plan of the employer satisfies section 401(a)(26) for a plan year (see § 414(r)–9(c)(3) for the employees taken into account for this purpose).

(b) *Assignment procedure*—(1) *In general.* To apply the provisions listed in paragraph (a)(2) of this section with respect to a testing year or plan year, as the case may be, each of the employees taken into account under that provision must be assigned to a qualified separate line of business of the employer on one or more testing days (or section 401(a)(26) testing days) during the year. The first day for which this assignment procedure is required for a testing year is the first testing day. See § 414(r)–11(b)(6), (7) and (8) (definitions of ''testing day'', ''first testing day'' and ''section 401(a)(26) testing day''). Section § 414(r)–8 may require that the assignment procedure be repeated for testing days that fall after the first testing day (including testing days that fall after the close of the testing year in a plan year that begins in the testing year). Accordingly, new employees may be taken into account for the first time on these later testing days who were not taken into account on the first testing day. Section § 414(r)–9 may have the same effect with respect to section 401(a)(26) testing days that fall after the first testing day.

(2) *Assignment for the first testing day.* The employees taken into account under a provision described in paragraph (a)(2) of this section with respect to the first testing day for a testing

year are assigned among the employer's qualified separate lines of business by applying the following procedure to each of those employees—

(i) An employee who is a substantial-service employee with respect to a qualified separate line of business within the meaning of § 414(r)–11(b)(2) must be assigned to that qualified separate line of business;

(ii) An employee who is a residual shared employee within the meaning of § 414(r)–11(b)(4) must be assigned to a qualified separate line of business under paragraph (c) of this section.

Each employee assigned to a qualified separate line of business under paragraph (b)(2)(i) of this section or this paragraph (b)(2)(ii) remains assigned to the same qualified separate line of business for all purposes with respect to the testing year listed in paragraph (a)(2) of this section and for all plan years beginning in that testing year. Once an employee is assigned to a qualified separate line of business with respect to a particular testing day or section 401(a)(26) testing day, that employee remains assigned to that qualified separate line of business after the employee terminates employment. However, after the employee terminates employment, that employee will in most cases not be taken into account with respect to a subsequent testing day or section 401(a)(26) testing day for purposes of applying one or more of the provisions in paragraph (a)(2) of this section.

(3) *Assignment of new employees for subsequent testing days.* After the first testing day for the testing year, the employees taken into account under a provision described in paragraph (a)(2) of this section with respect to a subsequent testing day (or a section 401(a)(26) testing day) for the testing year may include one or more employees who previously have not been assigned to a qualified separate line of business for any purpose listed in paragraph (a)(2) of this section with respect to the testing year. An employee may not previously have been assigned to a qualified separate line of business for any purpose with respect to the testing year if, for example, the employee has just been hired or has just become a nonexcludable employee. Previously unassigned employees are assigned among the employer's qualified separate lines of business by applying the procedure in paragraph (b)(2) of this section to those employees. In determining whether an employee who is not employed by the employer during the testing year is a substantial-service or a residual shared employee with respect to a qualified separate line of business, § 414(r)–3(c)(5) is applied with reference to services performed by the employee during a period in the immediately succeeding testing year that are reasonably representative of the employee's services for the employer.

(4) *Special rule for employers using annual option under section 410(b).* Notwithstanding the fact that paragraphs (b)(1) through (b)(3) of this section generally only require employees to be assigned on testing days beginning with the first testing day, if a plan is tested under section 410(b) using the annual option of § 410(b)–8(a)(4) (including for purposes of the average benefit percentage test), employees must be assigned on every day of the plan year of that plan for purposes of this paragraph (b). Thus, all employees who provide services at any time during the plan year of a plan that is tested using the annual option of § 1.410(b)–8(a)(4) must be assigned to a line of business even if they terminate employment before the first testing day within the meaning of § 414(r)–11(b)(7) of the testing year in which the plan year begins.

(c) *Assignment and allocation of residual shared employees*—(1)*In general.* All residual shared employees must be allocated among an employer's qualified separate lines of business under one of the allocation methods provided in paragraphs (c)(2) through (5) of this section. An employer is permitted to select which method of allocation to apply for the testing year to residual shared employees. However, the same allocation method must be used for all of the employer's residual shared employees and for all purposes listed in paragraph (a)(2) of this section with respect to the testing year.

(2) *Dominant line of business method of allocation*—(i) *In general.* Under the method of allocation in this paragraph (c)(2), all residual shared employees are allocated to the employer's dominant

line of business. This method does not apply unless the employer has a dominant line of business within the meaning of paragraph (c)(2)(ii) or (c)(2)(iv) of this section. If an employer has more than one dominant line of business under this paragraph (c), the employer must select which qualified separate lines of business is its dominant line of business.

(ii) *Dominant line of business.* An employer's dominant line of business is that qualified separate line of business that has an employee assignment percentage of at least 50 percent.

(iii) *Employee assignment percentage*—(A) *Determination of percentage.* The employee assignment percentage of a qualified separate line of business is the fraction (expressed as a percentage)—

(*1*) The numerator of which is the number of substantial-service employees with respect to the qualified separate line of business who are assigned to that line of business under paragraph (b) of this section; and

(*2*) The denominator of which is the total number of substantial-service employees who are assigned to all qualified separate lines of business of the employer under paragraph (b) of this section.

(B) *Employees taken into account.* The employee assignment percentage is calculated solely with respect to employees who are taken into account for purposes of satisfying section 410(b) with respect to the first testing day. Therefore, this percentage is calculated only once for all purposes with respect to a testing year. The employees described in section 410(b)(3) and (4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement applicable under any plan of the employer, and with reference to the lowest service requirement applicable under any plan of the employer, as if all the plans were a single plan under §1.410(b)–6(b)(2).

(iv) *Option to apply reduced percentage.* An employer is permitted to determine whether it has a dominant line of business by substituting 25 percent for 50 percent in paragraph (c)(2)(ii) of this section. This option is available for a testing year only if the qualified separate line of business satisfies one of the following requirements:

(A) The qualified separate line of business accounts for at least 60 percent of the employer's gross revenues for the employer's latest fiscal year ending in the testing year.

(B) The employee assignment percentage of the qualified separate line of business would be at least 60 percent if collectively bargained employees were taken into account.

(C) Each qualified separate line of business of the employer satisfies the statutory safe harbor of §1.414(r)–5(b), the average benefits safe harbor of §1.414(r)–5(f), or the minimum or maximum benefits safe harbor of §1.414(r)–5(g). Whether a qualified separate line of business satisfies one of these safe harbors is determined after the application of this section, including the assignment of all residual shared employees under this paragraph (c)(2).

(D) The employee assignment percentage of the qualified separate line of business is at least twice the employee assignment percentages of each of the employer's other qualified separate lines of business.

(v) *Examples.* The following examples illustrate the application of the method of allocation in this paragraph (c)(2).

Example 1. (i) Employer A operates four qualified separate lines of business as determined under §1.414(r)–1(b) for the testing year, consisting of a software developer, a health food products supplier, a real estate developer, and a ski equipment manufacturer. In applying this section for the first testing day with respect to the testing year, Employer A determines that it has a total of 21,000 employees, of whom 10,000 are substantial-service employees not excludable under section 410(b)(3) or (b)(4). Pursuant to paragraph (b) of this section, these 10,000 employees are assigned among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate	Ski equipment
Substantial-Service Employees	2,500	1,000	2,500	4,000
Percentage Assigned to QSLOB	25%	10%	25%	40%

(ii) Under these facts, Employer A is not permitted to apply the method of allocation in paragraph (c)(2)(ii) of this section, because none of its qualified separate lines of business satisfies the 50 percent requirement in paragraph (c)(3)(ii) of this section.

Example 2. The facts are the same as in *Example 1*, except that, after allocating all residual shared employees to the ski equipment line of business, the software, ski equipment and health food supplier lines of business each would satisfy the statutory safe harbor of §1.414(r)–5(b), and that the real estate development line of business would satisfy the minimum or maximum benefits safe harbor of §1.414(r)–5(g). Under these facts, Employer A is permitted to apply the method of allocation in this paragraph (c)(2) to allocate all its residual shared employees to the ski equipment line of business, because the employee assignment percentage of the ski equipment line of business exceeds 25 percent and each qualified separate line of business satisfies either the statutory safe harbor of §1.414(r)–5(b) or the minimum or maximum benefits safe harbor of §1.414(r)–5(g).

Example 3. (i) The facts are the same as in *Example 1*, except that, Employer A chooses not to satisfy the minimum or maximum benefits safe harbor of §1.414(r)–5(g). Instead, Employer A combines the real estate developer and ski equipment manufacturer into a single line of business. As a result, Employer A has three qualified separate lines of business as determined under §1.414(r)–1(b). Assume that no residual shared employee becomes a substantial-service employee as a result of the new combination. Employer A's substantial-service employees are assigned among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate/ ski equipment
Substantial-Service Employees	2,500	1,000	6,500
Percentage Assigned to QSLOB	25%	10%	65%

(ii) Under these facts, Employer A is permitted to apply the method of allocation in this paragraph (c)(2) to allocate all its residual shared employees to the combined real estate development and ski equipment manufacturing line of business, because more than 50 percent of Employer A's substantial-service employees that are taken into account for the first testing day are assigned to that qualified separate line of business.

Example 4. (i) The facts are the same as in *Example 1*, except that, of the remaining 11,000 employees of Employer A, 10,000 employees are substantial-service employees who are collectively bargained employees. Pursuant to paragraph (b) of this section, the 10,000 substantial-service employees and the 10,000 substantial-service employees who are collectively bargained employees are assigned among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate	Ski equipment
Substantial-Service Employees	2,500	1,000	2,500	4,000
Percentage of total substantial-service employees assigned to QSLOB	25%	10%	25%	40%
Substantial-Service Employees (including collectively bargained employees)	2,500	1,000	2,500	14,000
Percentage of total employees (including collectively bargained employees) assigned to QSLOB	12.5%	5%	12.5%	70%

(ii) Thus, the ski equipment line of business satisfies the 25-percent threshold in paragraph (c)(2)(iv) of this section. In addition, the ski equipment's percentage of substantial-service employees is at least 60 percent when taking into account substantial-service employees who are collectively bargained employees and therefore satisfies the requirement under paragraph (c)(2)(iv)(B) of this section. Under these facts, Employer A is permitted to apply the method of allocation in this paragraph (c)(2) to allocate all its residual shared employees to the ski equipment line of business.

(3) *Pro-rata method of allocation*—(i) *In general*. Under the method of allocation in this paragraph (c)(3), all residual shared employees are allocated among an employer's qualified separate lines of business in proportion to the employee assignment percentage of each qualified separate line of business, as determined under paragraph (c)(2)(iii) of this section.

(ii) *Allocation procedure.* The procedure for allocating residual shared employees under the method in this paragraph (c)(3) is as follows—

(A) The number of highly compensated residual shared employees who are allocated to each qualified separate line of business is equal to the product determined by multiplying the total number of highly compensated residual shared employees of the employer by the employee assignment percentage determined with respect to the qualified separate line of business under paragraph (c)(3)(i) of this section;

(B) The number of nonhighly compensated residual shared employees who are allocated to each qualified separate line of business is equal to the product determined by multiplying the total number of nonhighly compensated residual shared employees of the employer by the employee assignment percentage determined with respect to the qualified separate line of business under paragraph (c)(3)(i) of this section;

(C) For purposes of this procedure, the employer is permitted to determine which highly compensated residual shares employees and which nonhighly compensated residual shared employees are allocated to each qualified separate line of business, provided that the required number of highly and nonhighly compensated residual shared employees are allocated to each qualified separate line of business.

(iii) *Examples.* The following example illustrates the application of the method of allocation in this paragraph (c)(4).

Example 1. The facts that are the same as in *Example 1* under paragraph (c)(2)(v) of this section except that there are no additional residual shared employees after the first testing day. Of Employer A's 1,000 residual shared employees, 800 are highly compensated employees and 200 are nonhighly compensated employees. Employer A applies the pro-rata method of allocation in this paragraph (c)(3). Under these facts, the 1,000 residual shared employees are allocated among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate	Ski equipment
Substantial-Service Employees	2,500	1,000	2,500	4,000
Percentage Assigned to QSLOB ("employee assignment percentage")	25%	10%	25%	40%
Residual Shared HCEs	200	80	200	320
Allocated to QSLOB	(25%X800)	(10%X800)	(25%X800)	(40%X200)
Residual Shared NHCEs	50	20	50	80
Allocated to QSLOB	(25%X200)	(10%X200)	(25%X200)	(40%X200)

(4) *HCE percentage ratio method of allocation*—(i) *In general.* Under the method of allocation in this paragraph (c)(4), all residual shared employees are allocated among an employer's qualified separate lines of business according to the highly compensated employee percentage assignment ratio of each qualified separate line of business.

(ii) *Highly compensated employee percentage assignment ratio.* For purposes of this paragraph (c)(4), the highly compensated employee percentage assignment ratio of a qualified separate line of business is the fraction expressed as a percentage)—

(A) The numerator of which is the percentage of all employees who have previously been assigned to the qualified separate line of business under this section with respect to the testing year who are highly compensated employees; and

(B) The denominator of which is the percentage of all employees who have previously been assigned to any qualified separate line of business under this section with respect to the testing year who are highly compensated employees.

Thus, the highly compensated employee percentage assignment ratio of each of the employer's qualified separate lines of business is recalculated each time a residual shared employee is allocated to a qualified separate line of business under this paragraph (c)(5).

(iii) *Allocation procedure.* The procedure for allocating all residual shared

employees under the method in this paragraph (c)(4) is as follows—

(A) If there are any qualified separate lines of business with a highly compensated employee percentage assignment ratio of less than 50 percent (as determined immediately before the employee is allocated to a qualified separate line of business), the highly compensated residual shared employee must be allocated to one of these qualified separate lines of business;

(B) If there are any qualified separate lines of business with a highly compensated employee percentage assignment ratio of greater than 200 percent (as determined immediately before the employee is allocated to a qualified separate line of business), the nonhighly compensated residual shared employee must be allocated to one of these qualified separate lines of business;

(C) If there are no qualified separate lines of business with a highly compensated employee percentage assignment ratio less than 50 percent, a highly compensated residual shared employee may be allocated to any qualified separate line of business with a highly compensated employee percentage assignment ratio of no more than 200 percent, provided that the employee's allocation to the qualified separate line of business does not cause its highly compensated employee percentage assignment ratio to exceed 200 percent (as determined immediately after the employee is allocated to the qualified separate line of business);

(D) If there are no qualified separate lines of business with a highly compensated employee percentage assignment ratio greater than 200 percent, a nonhighly compensated residual shared employee may be allocated to any qualified separate line of business with a highly compensated employee percentage assignment ratio of no less than 50 percent, provided that the employee's allocation to the qualified separate line of business does not cause its highly compensated employee percentage assignment ratio to fall below 50 percent (as determined immediately after the employee is allocated to the qualified separate line of business);

(E) For purposes of this procedure, the employer is permitted to determine which highly compensated residual shared employees and which nonhighly compensated residual shared employees are allocated to each qualified separate line of business, provided that the requirements of this paragraph (c)(4)(iii) are satisfied.

(5) *Small group method*—(i) *In general*. Under the method of allocation provided for in this paragraph (c)(5), each residual shared employee is allocated to a qualified separate line of business chosen by the employer. This method does not apply unless all of the requirements of paragraphs (c)(5)(ii), (iii), and (iv) of this section are satisfied.

(ii) *Size of group*. The total number of the employer's residual shared employees allocated under this paragraph (c) must not exceed three percent of all of the employer's employees. For this purpose, the employer's employees include only those employees taken into account under paragraph (c)(2)(iii)(B) of this section.

(iii) *Composition of qualified separate line of business*. The qualified separate line of business to which the residual shared employee is allocated must have an employee assignment percentage under paragraph (c)(2)(iii) of this section of at least ten percent. In addition, the qualified separate line of business to which the residual shared employee is allocated must satisfy the statutory safe harbor under §1.414(r)–5(b) after the employee is so allocated.

(iv) *Reasonable allocation*. The allocation of residual shared employees under the small group method provided for in this paragraph (c)(5) must be reasonable. Reasonable allocations generally include allocations that are based on the level of services that the residual shared employees provide to the employer's qualified separate lines of business, the similar treatment of similarly situated residual shared employees, and other bona fide business criteria; in contrast, an allocation that is designed to maximize benefits for select employees is not considered a reasonable allocation. For example, allocation of all residual shared employees who work in the same department, or at the same location, to the same qualified separate line of business would be an indication of reasonableness. However, allocation of a group of

similarly situated residual shared employees to a qualified separate line of business for which they provide minimal services might not be considered reasonable. In addition, the allocation of the professional employees of a department to one qualified separate line of business and the allocation of the support staff of the same department to a different qualified separate line of business would not be reasonable.

[T.D. 8376, 56 FR 63453, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32920, June 27, 1994]

§ 1.414(r)–8 Separate application of section 410(b).

(a) *General rule*. If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b) for a testing year, the requirements of section 410(b) must be applied in accordance with this section separately with respect to the employees of each qualified separate line of business for purposes of testing all plans of the employer for plan years that begin in the testing year (other than a plan tested under the special rule for employer-wide plans in § 1.414(r)–(c)(2)(ii) for such a plan year). Conversely, if an employer is not treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b) for a testing year, the requirements of section 410(b) must be applied on an employer-wide basis for purposes of testing all plans of the employer for plan years that begin in the testing year. See § 1.414(r)–1(c)(2) and (d)(6). Paragraph (b) of this section explains how the requirements of section 410(b) are applied separately with respect to the employees of a qualified separate line of business for purposes of testing a plan. Paragraph (c) of this section explains the coordination between sections 410(b) and 401(a)(4). Paragraph (d) of this section provides certain supplementary rules necessary for the application of this section.

(b) *Rules of separate application*—(1) *In general*. If the requirements of section 410(b) are applied separately with respect to the employees of each qualified separate line of business operated by the employer for a testing year, a plan (other than a plan that is tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) for a plan year) satisfies the requirements of section 410(b) only if—

(i) The plan satisfies section 410(b)(5)(B) of an employer-wide basis; and

(ii) The plan satisfies section 410(b) on a qualified-separate-line-of-business basis.

(2) *Satisfaction of section 410(b)(5)(B) on an employer-wide basis*—(i) *General rule*. Section 410(b)(5)(B) provides that a plan is not permitted to be tested separately with respect to the employees of a qualified separate line of business unless the plan benefits a classification of employees found by the Secretary to be nondiscriminatory. A plan satisfies this requirement only if the plan satisfies either the ratio percentage test of § 1.410(b)–2(b)(2) or the nondiscriminatory classification test of § 1.410(b)–4 (without regard to the average benefit percentage test of § 1.410(b)–5), taking into account the other applicable provisions of §§ 1.410(b)–1 through 1.410(b)–10. For this purpose, the nonexcludable employees of the employer taken into account in testing the plan under section 410(b) are determined under § 1.410(b)–6, without regard to the exclusion in § 1.410(b)–6(e) for employees of other qualified separate lines of business of the employer. Thus, in testing a plan separately with respect to the employees of one qualified separate line of business under this paragraph (b)(2), the otherwise nonexcludable employees of the employer's other qualified separate lines of business are not treated as excludable employees. However, under the definition of ''plan'' in paragraph (d)(2) of this section, these employees are not treated as benefiting under the plan for purposes of applying this paragraph (b)(2).

(ii) *Application of facts and circumstances requirements under nondiscriminatory classification test*. The fact that an employer has satisfied the qualified-separate-line-of-business requirements in §§ 1.414(r)–1 through 1.414(r)–7 is taken into account in determining whether a classification of employees benefiting under a plan that falls between the safe and unsafe harbors satisfies § 1.410(b)–4(c)(3) (facts and circumstances requirements). Except

in unusual circumstances, this fact will be determinative.

(iii) *Modification of unsafe harbor percentage for plans satisfying ratio percentage test at 90 percent level*—(A) *General rule*. If a plan benefits a group of employees for a plan year that would satisfy the ratio percentage test of §1.410(b)–2(b)(2) on a qualified-separate-line-of-business basis under paragraph (b)(3) of this section if the percentage in §1.410(b)–2(b)(2) were increased to 90 percent, the unsafe harbor percentage in §1.410(b)–4(c)(4)(ii) for the plan is reduced by five percentage points (not five percent) for the plan year and is applied without regard to the requirement that the unsafe harbor percentage not be less than 20 percent. Thus, if the requirements of this paragraph (b)(2)(iii)(A) are satisfied, the unsafe harbor percentage in §1.410(b)–4(c)(4)(ii) is treated as 35 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent.

(B) *Facts and circumstances alternative*. If a plan satisfies the requirements of paragraph (b)(2)(iii)(A) of this section, but has a ratio percentage on an employer-wide basis that falls below the unsafe harbor percentage determined under paragraph (b)(2)(iii)(A) of this section, the plan nonetheless is deemed to satisfy section 410(b)(5)(B) on an employer-wide basis if the Commissioner determines that, on the basis of all of the relevant facts and circumstances, the plan benefits such employees as qualify under a classification of employees that does not discriminate in favor of highly compensated employees.

(3) *Satisfaction of section 410(b) on a qualified-separate-line-of-business basis*. A plan satisfies section 410(b) on a qualified-separate-line-of-business basis only if the plan satisfies either the ratio percentage test of §1.410(b)–2(b)(2) or the average benefit test of §1.410(b)–2(b)(3) (including the nondiscriminatory classification test of §1.410(b)–4 and the average benefit percentage test of §1.410(b)–5), taking into account the other applicable provisions of §§1.410(b)–1 through 1.410(b)–10. For this purpose, the non-excludable employees of the employer taken into account in testing the plan under section 40(b) are determined under §1.410(b)–6, taking into account the exclusion in §1.410(b)–6(e) for employees of other qualified separate lines of business of the employer. Thus, in testing a plan separately with respect to the employees of one qualified separate line of business under this paragraph (b)(3), all employees of the employer's other qualified separate lines of business are treated as excludable employees.

(4) *Examples*. The following examples illustrate the application of this paragraph (b).

Example 1. (i) Employer A is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b) for the 1994 testing year with respect to all of its plans. Employer A operates two qualified separate lines of business as determined under §1.414(r)–1(b)(2), Line 1 and Line 2. Employer A maintains only two plans, Plan X which benefits solely employees of Line 1, and Plan Y which benefits solely employees of Line 2. In testing Plan X under section 410(b) with respect to the first testing day for the plan year of Plan X beginning in the 1994 testing year, it is determined that Employer A has 2,100 nonexcludable employees, of whom 100 are highly compensated employees and 2,000 are nonhighly compensated employees. After applying §1.414(r)–7 to these employees, 50 of the highly compensated employees and 100 of the nonhighly compensated employees are treated as employees of Line 2, and the remaining 50 highly compensated employees and the remaining 1,900 nonhighly compensated employees are treated as employees of Line 1.

(ii) All of the highly compensated employees and 1,300 of the nonhighly compensated employees who are treated as employees of Line 1 benefit under Plan X. Thus, on an employer-wide basis, Plan X benefits 50 percent of all Employer A's highly compensated employees (50 out of 100) and 65 percent of all Employer A's nonhighly compensated employees (1,300 out of 2,000). Plan X consequently has a ratio percentage determined on an employer-wide basis of 130 percent (65%÷50%), see §1.410(b)–9, and could satisfy section 410(b) under the ratio percentage test of §1.410(b)–2(b)(2) if that section were applied on an employer-wide basis without regard to the provisions of this paragraph (b). Under paragraph (a) of this section, however, the requirements of section 410(b) must be applied separately with respect to the employees of each qualified separate line of business operated by Employer A for all plans of Employer A for plan years that begin in the 1994 testing year. This rule does

not apply to plans tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii). Plan X benefits only 65 percent of the nonhighly compensated employees of Employer A, however, and therefore cannot satisfy the 70 percent requirement necessary to be tested under that rule. As a result, for the plan year of Plan X beginning in the 1994 testing year, Plan X is not permitted to satisfy section 410(b) on an employer-wide basis and, instead, is only permitted to satisfy section 410(b) separately with respect to the employees of each qualified separate line of business operated by Employer A, in accordance with paragraphs (b)(2) and (b)(3) of this section.

Example 2. The facts are the same as in *Example 1.* All of the 50 highly compensated employees treated as employees of Line 2 benefit under Plan Y, and 80 of the 100 nonhighly compensated employees treated as employees of Line 2 benefit under Plan Y. Thus, Plan Y benefits 50 percent of all Employer A's highly compensated employees (50 out of 100) and only 4 percent of all Employer A's nonhighly compensated employees (80 out of 2,000). Thus, while Plan Y has a ratio percentage of 80 percent (80%÷100%) on a qualified-separate-line-of-business basis, it has a ratio percentage of only 8 percent (4%÷50%) on an employer-wide basis. See §1.410(b)–9. Under §1.410(b)–4(c)(4)(iii), the nonhighly compensated employee concentration percentage is 2,000/2,100 or 95 percent. Because 8 percent is less than 20 percent (the unsafe harbor percentage applicable to Employer A under §1.410(b)–4(c)(4)(ii)), Plan Y does not satisfy the nondiscriminatory classification test of §1.410(b)–4 on an employer-wide basis. Nor does Plan Y satisfy the ratio percentage test of §1.410(b)–2(b)(2) on an employer-wide basis, since 8 percent is less than 70 percent. Under these facts, Plan Y does not satisfy section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section for the plan year of Plan Y beginning in the 1994 testing year, and therefore fails to satisfy section 410(b) for that year. This is true even though Plan Y satisfies section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section.

Example 3. The facts are the same as in *Example 2,* except that all of the employees treated as employees of Line 2 benefit under Plan Y. Thus, Plan Y benefits 50 percent of all of Employer A's highly compensated employees (50 out of 100) and 5 percent of all of Employer A's nonhighly compensated employees (100 out of 2,000). Plan Y therefore has a ratio percentage of 100 percent (100%÷100%) on a qualified-separate-line-of-business basis and a ratio percentage of 10 percent (5%÷50%) on an employer-wide basis. Because Plan Y has a ratio percentage of at least 90 percent on a qualified-separate-line-of-business basis, a reduced unsafe harbor percentage applies to Plan Y under paragraph (b)(2)(iii)(A) of this section. The reduced unsafe harbor percentage applicable to Plan Y is 8.75 percent because Employer A's nonhighly compensated employee concentration percentage is 95 percent. Plan Y's employer-wide ratio percentage of 10 percent therefore exceeds the unsafe harbor percentage. Plan Y thus satisfies section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section for the plan year of Plan Y beginning in the 1994 testing year. Plan Y also satisfies section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section.

Example 4. The facts are the same as in *Example 3,* except that Employer A's total nonexcludable nonhighly compensated employees are 2,500 (rather than 2,000), of whom 100 are treated as employees of Line 2 and of whom 90 benefit under Plan Y. Plan Y has a ratio percentage of 90 percent (90%÷100%) on a qualified-separate-line-of-business basis, and Employer A's nonhighly compensated employee concentration percentage is 2,500/2,600 or 96 percent. Thus, the reduced unsafe harbor percentage applicable to Plan Y under paragraph (b)(2)(iii)(A) of this section is 8 percent. Plan Y benefits 50 percent of all of Employer A's highly compensated employees (50 out of 100) and 3.6 percent of all of Employer A's nonhighly compensated employees (90 out of 2,500). Plan Y therefore has a ratio percentage of only 7.2 percent (3.6%÷50%) on an employer-wide basis, which falls below the reduced unsafe harbor percentage of 8 percent. Nonetheless, under paragraph (b)(2)(iii)(B) of this section, Plan Y will be deemed to satisfy section 410(b)(5)(B) on an employer-wide basis if the Commissioner determines that, on the basis of all of the relevant facts and circumstances, the plan benefits such employees as qualify under a classification of employees that does not discriminate in favor of highly compensated employees.

Example 5. (i) The facts are the same as in *Example 1,* except that Plan X benefits only 950 of the employees of Line 1. Assume Plan X satisfies the reasonable classification requirement of §1.410(b)–4(b) on an employer-wide basis. Plan X benefits 50 percent of all Employer A's highly compensated employees (50 out 100) and 47.5 percent of all Employer A's nonhighly compensated employees (950 out of 2,000). Plan X consequently has a ratio percentage determined on an employer-wide basis of 95 percent (47.5%÷50%), see §1.410(b)–9, and thus satisfies section 410(b)(5)(B) on an employer-wide basis.

(ii) Plan X has a ratio percentage determined on a qualified-separate-line-of-business basis of 50 percent (50% ÷ 100%). Because 50 percent is less than 70 percent, Plan X must satisfy the nondiscriminatory classification test of §1.410(b)–4 and the average

benefit percentage test of §1.410(b)–5 on a qualified-separate-line-of-business basis in order to satisfy the other requirements of section 410(b). Plan X satisfies the nondiscriminatory classification requirement of §1.410(b)–4(c) on a qualified-separate-line-of-business because its ratio percentage determined on a qualified-separate-line-of-business basis is more than 22.25 percent, the safe harbor percentage applicable to Line 1 under §1.410(b)–4(c)(4)(i). Because Plan X satisfies the reasonable classification requirement of §1.410(b)–4(b) on an employer-wide basis, it is also deemed to satisfy this requirement on a qualified-separate-line-of-business basis. See §1.410(b)–7(c)(5). In determining whether Plan X satisfies the average benefit percentage test of §1.410(b)–5, only Plan X and only employees of Line 1 are taken into account. See §§1.410(b)–6(e) and 1.410(b)–7(e).

Example 6. The facts are the same as in *Example 2*, except that, prior to the 1994 testing year, Employer A merges Plan X and Plan Y so that they form a single plan within the meaning of section 414(*l*). Under the definition of ''plan'' in paragraph (d)(2) of this section, however, the portion of the newly merged plan that benefits employees of Line 2 (former Plan Y) is still treated as a separate plan from the portion of the newly merged plan that benefits employees of Line 1 (former Plan X). The portion of the newly merged plan that benefits employees of Line 2 (former Plan Y) fails to satisfy section 410(b) for the reasons stated in *Example 2*. Under these facts, because the portion of the newly merged plan that benefits employees of Line 2 fails to satisfy section 410(b), the entire newly merged plan fails to satisfy section 410(b) for the plan year of the newly merged plan that begins in the 1994 testing year. See paragraph (d)(5) of this section.

(c) *Coordination of section 401(a)(4) with section 410(b)*—(1) *General rule*. For purposes of these regulations, the requirements of section 410(b) encompass the requirements of section 401(a)(4) (including, but not limited to, the permitted disparity rules of section 401(*l*), the actual deferral percentage test of section 401(k)(3), and the actual contribution percentage test of section 401(m)(2)). Therefore, if the requirements of section 410(b) are applied separately with respect to the employees of each qualified separate line of business of an employer for purposes of testing one or more plans of the employer for plan years that begin in a testing year, the requirements of section 401(a)(4) must also be applied separately with respect to the employees of the same qualified separate lines of business for purposes of testing the same plans for the same plan years. Furthermore, if section 401(a)(4) requires that a group of employees under the plan satisfy section 410(b) for purposes of satisfying section 401(a)(4), section 410(b) must be applied for this purpose in the same manner provided in paragraph (b) of this section. See, for example, §§1.401(a)(4)–2(c)(1) and 1.401(a)(4)–3(c)(1) (requiring each rate group of employees under a plan to satisfy section 410(b)), §1.401(a)(4)–4(b) (requiring the group of employees to whom each benefit, right, or feature is currently available under a plan to satisfy section 410(b)), and §1.401(a)(4)–9(c)(1) (requiring the group of employees included in each component plan into which a plan is restructured to satisfy section 410(b)). Thus, the group of employees must satisfy section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section and also must satisfy section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section, in both cases as if the group of employees were the only employees benefiting under the plan.

(2) *Examples*. The following examples illustrate the application of the rule in this paragraph (c).

Example 1. Employer B is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b) for the 1993 testing year. Employer B operates two qualified separate lines of business as determined under §1.414(r)–1(b)(2), Line 1 and Line 2. Employer B maintains Plan Z, which benefits employees in both Line 1 and Line 2. Under the definition of ''plan'' in paragraph (d)(2) of this section, the portion of Plan Z that benefits employees of Line 1 is treated as a separate plan from the portion of Plan Z that benefits employees of Line 2. Under this paragraph (c), this result applies for purposes of both section 410(b) and section 401(a)(4).

Example 2. The facts are the same as in *Example 1*, except that Plan Z benefits solely employees of Line 1. In testing Plan Z under section 401(a)(4) for the plan year of Plan Z beginning in the 1993 testing year, Employer B restructures Plan Z into several component plans (within the meaning of §1.401(a)(4)–9(c)). Under §1.401(a)(4)–9(c)(1), each of these component plans is required to satisfy section 410(b). This paragraph (c) requires that each of the component plans be

tested separately with respect to the employees of each qualified separate line of business operated by Employer B. This testing must be done in accordance with paragraph (b) of this section. Consequently, each component plan must satisfy section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section and must also satisfy section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section.

Example 3. The facts are the same as in *Example 1*, except that Plan Z is a profit-sharing plan, and contributions to Plan Z are made pursuant to cash or deferred arrangement in which all employees of Employer B are eligible to participate. Assume that, as a result, Plan Z satisfies the requirements to be tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii). Under these facts, the requirements of sections 410(b), 401(a)(4) and 401(k), including the actual deferral percentage test of section 401(k)(3) and §1.401(k)–1(b), would generally be required to be applied separately to the portions of Plan Z that benefit the employees of Line 1 and Line 2, respectively. However, if Plan Z is tested under the special rule in §1.414(r)–1(c)(2)(ii), these requirements must be applied on an employer-wide basis.

(d) *Supplementary rules*—(1) *In general*. This paragraph (d) provides certain supplementary rules necessary for the application of this section.

(2) *Definition of plan*. For purposes of this section, the term *plan* means a plan within the meaning of §1.410(b)–7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)–7(c) (including the mandatory disaggregation rule for portions of a plan that benefit employees of different qualified separate lines of business) and the permissive aggregation rules of §1.410(b)–7(d). Thus, for purposes of this section, the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the other portions of the same plan that benefit employees of other qualified separate lines of business of the employer, unless the plan is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) for the plan year.

(3) *Employees of a qualified separate line of business*. For purposes of applying paragraph (b) of this section with respect to a testing day, the employees of each qualified separate line of business of the employer are determined by applying §1.414(r)–7 to the employees of the employer otherwise taken into account under section 410(b) for the testing day. For purposes of applying paragraph (c) of this section with respect to a testing day, the employees of each qualified separate line of business of the employer are determined by applying §1.414(r)–7 to the employees of the employer otherwise taken into account under section 410(a)(4) for the testing day. For the definition of *testing day*, see §1.414(r)–11(b)(6).

(4) *Consequences of failure*. If a plan fails to satisfy either paragraph (b)(2), (b)(3), or (c)(1) of this section, the plan (and any plan of which it constitutes a portion) fails to satisfy section 401(a). However, this failure alone does not cause the employer to fail to be treated as operating qualified separate lines of business in accordance with §1.414(r)–1(b), unless the employer is relying on benefits provided under the plan to satisfy the minimum benefit portion of the safe harbor in §1.414(r)–5(g)(2) with respect to at least one of its qualified separate lines of business.

[T.D. 8376, 56 FR 63457, Dec. 4, 1991, as amended by T.D. 8376, 57 FR 52591, Nov. 4, 1992; T.D. 8548, 59 FR 32921, June 27, 1994]

§1.414(r)–9 Separate application of section 401(a)(26).

(a) *General rule*. If an employer is treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with §1.414(r)–1(b) for a testing year, the requirements of section 401(a)(26) must be applied separately with respect to the employees of each qualified separate line of business for purposes of testing all plans of the employer for plan years that begin in the testing year (other than a plan tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for such a plan year). Conversely, if an employer is not treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with §1.414(r)–1(b) for a testing year, the requirements of section 401(a)(26) must be applied on an employer-wide basis for purposes of testing all plans of the employer for plan years that begin in the

testing years. See §1414(r)–1(c)(3) and (d)(6). Paragraph (b) of this section explains how the requirements of section 401(a)(26) are applied separately with respect to the employees of a qualified separate line of business for purposes of testing a plan. Paragraph (c) of this section provides certain supplementary rules necessary for the application of this section.

(b) *Requirements applicable to a plan.* If the requirements of section 401(a)(26) are applied separately with respect to the employees of a qualified separate line of business for a testing year, a plan (other than a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for a plan year) satisfies section 401(a)(26) only if it satisfies the requirements of §§1.401(a)(26)–1 through 1.401(a)(26)–9 on a qualified-separate-line-of-business basis. For this purpose, the nonexcludable employees of the employer taken into account in testing the plan under section 401(a)(26) are determined under §1.401(a)(26)–6(b), taking into account the exclusion in §1.401(a)(26)–6(b)(8) for employees of other qualified separate lines of business of the employer. Thus, in testing a plan separately with respect to the employees of one qualified separate line of business under this paragraph (b), all employees of the employer's other qualified separate lines of business are treated as excludable employees.

(c) *Supplementary rules*—(1) *In general.* This paragraph (c) provides certain supplementary rules necessary for the application of this section.

(2) *Definition of plan.* For purposes of this section, the term *plan* mean a plan within the meaning of §1.401(a)(26)–2(c) and (d), including the mandatory disaggregation rule of §1.401(a)(26)–2(d)(6) for portions of a plan that benefit employees of different qualified separate lines of business. Thus, for purposes of this section, the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the other portions of the same plan that benefit employees of other qualified separate lines of business of the employer, unless the plan is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for the plan year.

(3) *Employees of a qualified separate line of business.* For purposes of applying paragraph (b)(2) of this section with respect to a section 401(a)(26) testing day, the employees of each qualified separate line of business of the employer are determined by applying §1.414(r)–7 to the employees of the employer otherwise taken into account under section 401(a)(26) for the section 401(a)(26) testing day. For the definition of *section 401(a)(26) testing day*, see §1.414(r)–11(b)(8).

(4) *Consequences of failure.* If a plan fails to satisfy paragraph (b)(2) of this section, the plan (and any plan of which it constitutes a portion) fails to satisfy section 401(a). However, this failure alone would not cause the employer to fail to be treated as operating qualified separate lines of business in accordance with §1.414(r)–1(b), unless the employer is relying on benefits provided under the plan to satisfy the minimum benefit portion of the safe harbor in §1.414(r)–5(g)(2) with respect to at least one of its qualified separate lines of business.

[T.D. 8376, 56 FR 63459, Dec. 4, 1991]

§1.414(r)–10 Separate application of section 129(d)(8). [Reserved]

§1.414(r)–11 Definitions and special rules.

(a) *In general.* This section contains certain definitions and special rules applicable under these regulations. Paragraph (b) of this section provides certain definitions that apply for purposes of these regulations. Paragraph (c) of this section provides averaging rules under which certain provisions of these regulations may be applied on the basis of a two-year or a three-year average.

(b) *Definitions*—(1) *In general.* In applying the provisions of this section and of §§1.414(r)–1 through 1.414(r)–10, unless otherwise provided, the definitions in this paragraph (b) govern in addition to the definitions in §1.410(b)–9.

(2) *Substantial-service employee.* An employee is a substantial-service employee with respect to a line of business for a testing year if at least 75 percent of the employee's services are provided to that line of business for that testing year within the meaning of §1.414(r)–3(c)(5). In addition, if an employee provides at least 50% and less than 75% of the employee's services to a line of business for the testing year within the meaning of §1.414(r)–3(c)(5), the employer may treat that employee as a substantial-service employee with respect to that line of business provided the employee is so treated for all purposes of these regulations. The employer may choose such treatment separately with respect to each employee.

(3) *Top-paid employee.* Generally, an employee is a top-paid employee with respect to a line of business for a testing year if the employee is among the top 10 percent by compensation of those employees who provide services to that line of business for that testing year within the meaning of §1.414(r)–3(c)(5) and who are not substantial-service employees within the meaning of paragraph (b)(2) of this section with respect to any other line of business. In addition, in determining the group of top-paid employees, the employer may choose to disregard all employees who provide less than 25 percent of their services to the line of business. For purposes of this paragraph (b)(3), an employee's compensation is the compensation used to determine the employee's status as a highly or nonhighly compensated employee under section 414(q) for purposes of applying section 410(b) with respect to the first testing day. For this purpose, only compensation received during the determination year (within the meaning of §1.414(q)–1T, Q&A–13) is taken into account. See §1.414(r)–3(c)(7) for examples of the determination of top-paid employee.

(4) *Residual shared employee.* An employee is a residual shared employee for a testing year if the employee is not a substantial-service employee with respect to any line of business for the testing year.

(5) *Testing year.* The term *testing year* means the calendar year.

(6) *Testing day.* The term *testing day* means any day on which §1.410(b)–8(a)(1) requires any plan (within the meaning of §1.414(r)–8(d)(2)) of the employer actually to satisfy section 410(b) with respect to plan year that begins in the testing year. Thus, if a plan is required to satisfy section 410(b) on one day within each quarter of the plan year under the quarterly testing option of §1.410(b)–8(a)(3), each of those four days is a testing day. Similarly, if a plan is required to satisfy section 410(b) on every day of the plan year under the daily testing option of §1.410(b)–8(a)(2), every day of the plan year is a testing day.

(7) *First testing day.* The term *first testing day* means the testing day that occurs earliest in time of all the testing days under all plans of the employer with respect to the testing year. If a plan is tested under the annual testing option of §1.410(b)–8(a)(4) (other than for purposes of the average benefit percentage test of §1.410(b)–5) for a plan year that begins in a testing year, then, solely for purposes of determining the first testing day in a testing year, the employer may treat any day in the plan year as a testing day, provided that the coverage of each plan of the employer on the day selected is reasonably representative of the coverage of the plan over the entire plan year. The first testing day with respect to a testing year must fall within that testing year.

(8) *Section 401(a)(26) testing day.* The term *section 401(a)(26) testing day* means any day on which §1.401(a)(26)–7(a) or (b) requires any plan of the employer actually to satisfy section 401(a)(26) with respect to a plan year that begins in the testing year. In no event may a section 401(a)(26) testing day with respect to a testing year fall before the first testing day for that testing year. For purposes of this paragraph (b)(8), the term *plan* has the same meaning as in §1.414(r–9(c)(2).

(c) *Averaging rules*—(1) *In general.* The provisions specified in this paragraph (c) are permitted to be applied based on the average of the percentages for the current testing year and the consecutive testing years (not to exceed four consecutive testing years) immediately preceding the current testing year.

(2) *Specified provisions*. The provisions specified in this paragraph (c) are—

(i) The 90-percent separate employee workforce requirement of §1.414(r)–3(b)(4);

(ii) The 80-percent separate management requirement of §1.414(r)–3(b)(5);

(iii) The 25-percent provision-to-customers requirement of §1.414(r)–3(d)(2)(iii);

(iv) The minimum and maximum highly compensated employee percentage ratios under the statutory safe harbor of §1.414(r)–5(b)(1)(i) and (ii) (50 percent and 200 percent, respectively), but not the 10-percent exception in §1.414(r)–5(b)(4);

(v) The employee assignment percentage applied for purposes of the dominant line of business method of allocating residual shared employees under §1.414(r)–7(c)(2) and the pro-rata method for allocating residual shared employees under §1.414(r)–7(c)(3).

(3) *Averaging of large fluctuations not permitted*. A provision is not permitted to be applied based on an average determined under this paragraph (c) if the percentage for any testing year taken into account in calculating the average falls below a mimimum percentage, or exceeds a maximum percentage, by more than 10 percent (not 10 percentage points) of the respective minimum or maximum percentage. Thus, for example, the statutory safe harbor of §1.414(r)–5(b) is not permitted to be applied based on an average determined under this paragraph (c) if the percentage for any testing year taken into account in calculating the average falls below 45 percent (which is 10 percent below the 50-percent minimum) or exceeds 220 percent (which is 10 percent above the 200-percent maximum).

(4) *Consistency requirements*. A provision is permitted to be applied on an averaging basis under this paragraph (c) regardless of how any other provision is applied, except in the case of the separate employee workforce and separate management requirements of §1.414(r)–3(b)(4) and (5), which each must be applied on the same basis as the other. A provision is also permitted to be applied on an averaging basis under this paragraph (c) for a testing year, regardless of how the provision is applied for any other testing year. However, once a provision is applied on an averaging basis under this paragraph (c) for a testing year, it must be applied on the same basis to all the employer's lines of business to which the provision is applied for the testing year. The percentage for a preceding testing year may be taken into account under this paragraph (c) only if—

(i) The employer calculates the percentage for the preceding testing year in the same manner as the employer calculates the percentage for the current testing year;

(ii) The employer is treated as operating qualified separate lines of business in accordance with §1.414(r)–1(b) for the preceding testing year; and

(iii) The employer designated the same lines of business in the preceding testing year as in the current testing year.

[T.D. 8376, 56 FR 63460, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32922, June 27, 1994]

§1.414(s)–1 Definition of compensation.

(a) *Introduction*—(1) *In general*. Section 414(s) and this section provide rules for defining compensation for purposes of applying any provision that specifically refers to section 414(s) or this section. For example, section 414(s) is referred to in many of the nondiscrimination provisions applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). In accordance with section 414(s)(1), this section defines compensation as compensation within the meaning of section 415(c)(3). It also implements the election provided in section 414(s)(2) to treat certain deferrals as compensation and exercises the authority granted to the Secretary in section 414(s)(3) to prescribe alternative nondiscriminatory definitions of compensation.

(2) *Limitations on scope of section 414(s)*. Section 414(s) and this section do not apply unless a provision specifically refers to section 414(s) or this section. For example, even though a definition of compensation permitted under section 414(s) must be used in determining whether the contributions or

benefits under a pension, profit–sharing, or stock bonus plan satisfy a certain applicable provision (such as section 401(a)(4)), except as otherwise specified, the plan is not required to use a definition of compensation that satisfies section 414(s) in calculating the amount of contributions or benefits actually provided under the plan.

(3) *Overview.* Paragraph (b) of this section provides rules of general application that govern a definition of compensation that satisfies section 414(s). Paragraph (c) of this section contains specific definitions of compensation that satisfy section 414(s) without satisfying any additional nondiscrimination requirement under section 414(s). Paragraph (d) of this section provides rules permitting the use of alternative definitions of compensation that satisfy section 414(s) as long as the nondiscrimination requirement and other requirements described in paragraph (d) of this section are satisfied. Paragraph (e) and (f) of this section provide special rules permitting the use of rate of compensation, or prior-employer compensation or imputed compensation, rather than actual compensation, under a definition of compensation that satisfies section 414(s). Paragraph (g) of this section provides other special rules, including a special rule for determining the compensation of a self-employed individual under an alternate definition of compensation. Paragraph (h) of this section provides definitions for certain terms used in this section.

(b) *Rules of general application*—(1) *Use of a definition.* Any definition of compensation that satisfies section 414(s) may be used when a provision explicitly refers to section 414(s) unless the reference or this section specifically indicates otherwise.

(2) *Consistency rule.*—(i) *General rule.* A definition of compensation selected by an employer for use in satisfying an applicable provision must be used consistently to define the compensation of all employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, although any definition of compensation that satisfies section 414(s) may be used for section 401(a)(4) purposes, the same definition of compensation generally must be used consistently to define the compensation of all employees taken into account in determining whether a plan satisfies section 401(a)(4). Furthermore, a different definition of compensation that satisfies section 414(s) is permitted to be used to determine whether another plan maintained by the same employer separately satisfies the requirements of section 401(a)(4). Although a definition of compensation must be used consistently, an employer may change its definition of compensation for a subsequent determination period with respect to the applicable provision. Rules provided under any applicable provision may modify the consistency requirements of this paragraph (b)(2).

(ii) *Scope of consistency rule.* Compensation will not fail to be defined consistently for a group of employees merely because some employees do not receive one or more of the types of compensation included in the definition. For example, a definition of compensation that includes salary, regular or scheduled pay, overtime, and specified types of bonuses will not fail to define compensation consistently merely because only salaried employees receive salary and these specified types of bonuses and only hourly employees receive regular or scheduled pay and overtime.

(3) *Self-employed individuals.* Notwithstanding paragraph (b)(1) of this section, self-employed individuals' compensation can only be determined under paragraph (c)(2) of this section (with or without the modification permitted by paragraph (c)(4) of this section or a modification permitted by paragraph (c)(5) of this section) or by using an equivalent alternative compensation amount determined in accordance with paragraph (g)(1) of this section. These limitations on self-employed individuals do not affect their common-law employees. Thus, the compensation of common-law employees of a partnership or sole proprietorship may be defined using an alternative definition, provided the definition otherwise satisfies paragraph (c)(3), (d), (e), or (f) of this section. If an alternative definition of compensation under paragraph (c)(3), (d), (e), or

(f) of this section is used for other employees to satisfy an applicable provision, the consistency requirement is only met if paragraph (g) of this section is used for the self-employed individuals.

(c) *Specific definitions of compensation that satisfy section 414(s)*—(1) *General rules*. The definitions of compensation provided in paragraphs (c)(2) and (c)(3) of this section satisfy section 414(s) and need not satisfy any additional requirements under section 414(s). Paragraph (c)(2) of this section describes definitions of compensation within the meaning of section 415(c)(3). Paragraph (c)(3) of this section provides a safe harbor alternative definition that excludes certain additional items of compensation. Paragraph (c)(4) of this section permits any definition provided in paragraph (c)(2) or (c)(3) of this section to include certain types of elective contributions and deferred compensation. Paragraph (c)(5) of this section permits certain modifications to a definition otherwise provided under this paragraph (c).

(2) *Compensation within the meaning of section 415(c)(3)*. A definition of compensation that includes all compensation within the meaning of section 415(c)(3) and excludes all other compensation satisfies section 414(s). Sections 1.415–2(d)(2) and (d)(3) provide rules for determining items of compensation included in and excluded from compensation within the meaning of section 415(c)(3). In addition, section 414(s) is satisfied by the safe harbor definitions provided in §1.415–2(d)(10) and (d)(11) and any additional definitions of compensation prescribed by the Commissioner under the authority provided in §1.415–2(d)(13) that are treated as satisfying section 415(c)(3).

(3) *Safe harbor alternative definition*. Under the safe harbor alternative definition in this paragraph (c)(3), compensation is compensation as defined in paragraph (c)(2) of this section, reduced by all of the following items (even if includible in gross income): reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits.

(4) *Inclusion of certain deferrals in compensation*. Any definition of compensation provided in paragraph (c)(2) or (c)(3) of this section satisfies section 414(s) even though it is modified to include all of the following types of elective contributions and all of the following types of deferred compensation—

(i) Elective contributions that are made by the employer on behalf of its employees that are not includible in gross income under section 125, section 402(e)(3), section 402(h), and section 403(b);

(ii) Compensation deferred under an eligible deferred compensation plan within the meaning of section 457(b) (deferred compensation plans of state and local governments and tax-exempt organizations); and

(iii) Employee contributions (under governmental plans) described in section 414(h)(2) that are picked up by the employing unit and thus are treated as employer contributions.

(5) *Exclusions applicable solely to highly compensated employees*. Any definition of compensation that satisfies paragraph (c)(2) or (c)(3) of this section, with or without the modification permitted by paragraph (c)(4) of this section, may be modified to exclude any portion of the compensation of some or all of the employer's highly compensated employees (including, for example, any one or more of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section).

(d) *Alternative definitions of compensation that satisfy section 414(s)*—(1) *General rule*. In addition to the definitions provided in paragraph (c) of this section, any definition of compensation satisfies section 414(s) with respect to employees (other than self-employed individuals treated as employees under section 401(c)(1)) if the definition of compensation does not by design favor highly compensated employees, is reasonable within the meaning of paragraph (d)(2) of this section, and satisfies the nondiscrimination requirement in paragraph (d)(3) of this section.

(2) *Reasonable definition of compensation*—(i) *General rule*. An alternative definition of compensation under this paragraph (d) is reasonable under section 414(s) if it is a definition of compensation provided in paragraph (c) of

this section, modified to exclude all or any portion of one or more of the types of compensation described in paragraph (d)(2)(ii) of this section. See paragraph (e) of this section, however, for special rules that permit definitions of compensation based on employees' rates of compensation and paragraph (f) of this section for special rules that permit definitions of compensation that include prior-employer compensation or imputed compensation.

(ii) *Items that may be excluded.* A reasonable definition of compensation is permitted to exclude, on a consistent basis, all or any portion of irregular or additional compensation, including (but not limited to) one or more of the following: Any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums), bonuses, or any one or more of the types of compensation excluded under the safe harbor alternative definition in paragraph (c)(3) of this section. Whether a type of compensation is irregular or additional is determined based on all the relevant facts and circumstances. A reasonable definition is also permitted to include, on a consistent basis, all or any portion of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section and, thus, need not include all those types of elective contributions or deferred compensation as otherwise required under paragraph (c)(4) of this section.

(iii) *Limits on the amount excluded from compensation.* A definition of compensation is not reasonable if it provides that each employee's compensation is a specified portion of the employee's compensation measured for the otherwise applicable determination period under another definition. For example, a definition of compensation that specifically limits each employee's compensation for a determination period to 95 percent of the employee's compensation using a definition provided in paragraph (c) of this section is not reasonable. Similarly, a definition of compensation that limits each employee's compensation used to satisfy an applicable provision with a 12-month determination period to compensation under a definition provided in paragraph (c) of this section for one month is not a reasonable definition of compensation. However, a definition of compensation is not unreasonable merely because it excludes all compensation in excess of a specified dollar amount.

(3) *Nondiscrimination requirement*—(i) *In general.* An alternative definition of compensation under this paragraph (d) is nondiscriminatory under section 414(s) for a determination period if the average percentage of total compensation included under the alternative definition of compensation for an employer's highly compensated employees, as a group for the determination period does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group.

(ii) *Total compensation*—(A) *General rule.* For purposes of this paragraph (d)(3), total compensation must be determined using a definition of compensation provided in paragraph (c)(2) of this section, either with or without the modification permitted by paragraph (c)(4) of this section. Thus, total compensation does not include prior-employer compensation or imputed compensation described in paragraph (f)(1) of this section (including imputed compensation for a period during which an employee performs services for another employer). Total compensation taken into account for each employee (including, if added, the elective contributions and deferred compensation described in paragraph (c)(4) of this section) may not exceed the annual compensation limit of section 401(a)(17).

(B) *Alternative definitions with exclusions applicable solely to highly compensated employees.* If an alternative definition of compensation contains a provision that excludes amounts from compensation and, as described in paragraph (c)(5) of this section, the provision only applies in defining the compensation of some highly compensated employees, then, for purposes of this paragraph (d)(3), the total compensation of any highly compensated

employee subject to the provision must be reduced by any amount excluded from the employee's compensation as a result of the provision. However, if the provision applies consistently in defining the compensation of all highly compensated employees, this adjustment to total compensation is not required.

(iii) *Employees taken into account*—(A) *General rule*. In applying the requirement of this paragraph (d)(3), the employees taken into account are the same employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, in determining whether a plan satisfies section 401(a)(4), an alternative definition must satisfy this paragraph (d)(3) taking into account all employees who benefit under the plan for the plan year (within the meaning of §1.410(b)–3(a)). If an employer is using the same alternative definition of compensation to determine whether more than one separate plan satisfies section 401(a)(4), the employer is permitted to take into account all the employees who benefit under all of those plans for the plan year in determining whether the alternative definition of compensation being used satisfies this paragraph (d)(3).

(B) *Exclusion of self-employed individuals*. In applying the requirement of this paragraph (d)(3), self-employed individuals are disregarded.

(C) *Certain employees disregarded*. If an employee's total compensation for the determination period, determined under paragraph (d)(3)(ii) and (d)(3)(vi)(B) of this section, is zero, the employee is disregarded in determining whether the nondiscrimination requirement of paragraph (d)(3) of this section is satisfied for that determination period. For example, an employee who does not receive any actual compensation during a determination period because the employee is on unpaid leave of absence for the entire period, but who is credited with imputed compensation described in paragraph (f)(1) of this section, is disregarded in determining whether the nondiscrimination requirement of this paragraph (d)(3) is satisfied for that determination period.

(iv) *Calculation of average percentages*—(A) *General rule*. To determine the average percentages described in paragraph (d)(3)(i) of this section, an individual compensation percentage must be calculated for each employee in a group, and then the average of the separately calculated compensation percentages for each employee in the group must be determined. The individual compensation percentage for an employee is calculated by dividing the amount of the employee's compensation that is included under the alternative definition by the amount of the employee's total compensation.

(B) *Other reasonable methods*. Notwithstanding paragraph (d)(3)(iv)(A) of this section, any other reasonable method is permitted to be used to determine the average percentages described in paragraph (d)(3)(i) of this section for either or both of the groups (i.e., highly compensated employees and nonhighly compensated employees), provided that the method cannot reasonably be expected to create a significant variance from the average percentage for that group determined using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section. The same method is not required to be used for calculating the two average percentages. For example, to determine the average percentage for nonhighly compensated employees as a group, an employer may calculate an aggregate compensation percentage by dividing the aggregate amount of compensation of nonhighly compensated employees that are included under the alternative definition by the aggregate amount of total compensation of nonhighly compensated employees, provided the resulting percentage is not reasonably expected to vary significantly from the average percentage produced using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section because of the extra weight given employees with higher compensation.

(v) *Facts and circumstances determination*. The determination of whether the average percentage of total compensation included for the employer's highly compensated employees as a group for a determination period exceeds by more than a de minimis amount the

average percentage of total compensation included for the employer's nonhighly compensated employees as a group is based on all the relevant facts and circumstances. The differences between the percentages for prior determination periods may be considered in determining whether the amount of the difference between the percentages is more than de minimis. In addition, an isolated instance of a more than de minimis difference between the compensation percentages that is due to an extraordinary unforeseeable event (such as overtime payments to employees of a public utility due to a major hurricane) will be disregarded if the amount of the difference in prior determination periods was de minimis.

(vi) *Special rules for definitions of compensation based on rate of compensation or that include prior-employer or imputed compensation*—(A) *Special rule for determining compensation included under an alternative definition.* If an alternative definition uses rate of compensation or includes prior-employer compensation or imputed compensation, the amount of each employee's compensation for a determination period that is treated as included under the alternative definition for purposes of determining the average percentages for the nondiscrimination requirement (i.e. the amount used in the numerator) must not be more than 100 percent of the employee's total compensation for that period, determined under paragraph (d)(3)(ii) and (d)(3)(vi)(B) of this section. This limit on the amount of compensation treated as included under the alternative definition applies even if the amount of compensation actually credited to the employee for the determination period under the definition and, thus, used as compensation within the meaning of section 414(s), exceeds the employee's total compensation for the period.

(B) *Special rule for determining total compensation.* If an alternative definition uses rate of compensation or includes prior-employer compensation or imputed compensation, each employee's total compensation for purposes of determining the average percentages for the nondiscrimination requirement (i.e. the amount used in the denominator) must include all the types of elective contributions and deferred compensation described in paragraph (c)(4) of this section.

(e) *Rate of compensation*—(1) *General rule.* A definition of compensation satisfies section 414(s) as a reasonable definition of compensation even though it defines the amount of each employee's basic or regular compensation using the employee's basic or regular rate of compensation rather than using the employee's actual basic or regular compensation from the employer if the definition satisfies the requirements specified in paragraph (e)(3) of this section and otherwise satisfies the requirements of paragraph (d) of this section, including the nondiscrimination test in paragraph (d)(3) of this section. For this purpose, the employee's rate of compensation must be determined using an hourly pay scale, weekly salary, or similar unit of basic or regular compensation applicable to the employee. A definition will not fail to satisfy the requirements of this paragraph (e) merely because it defines compensation as including each employee's basic or regular compensation, the amount of which is determined using each employee's basic or regular rate of compensation, plus actual amounts of irregular or additional compensation, such as overtime or bonuses. In addition, a definition of compensation will not fail to satisfy section 414(s) merely because it defines compensation for each employee as the greater of the employee's actual compensation, the amount of which is determined using a definition that would otherwise satisfy paragraph (c) or (d)(2) of this section, or the employee's basic or regular compensation, the amount of which is determined using the employee's basic or regular rate of compensation.

(2) *Not applicable to certain contributions.* This paragraph (e) does not apply to a definition of compensation used in determining whether elective deferrals (as defined in section 402(g)(3)), matching contributions (as defined in section 401(m)(4)), or employee contributions subject to section 401(m) satisfy any applicable provision. Thus, for example, a definition of compensation that defines compensation based on each employee's basic or regular rate of compensation may not be used to

measure compensation for purposes of determining if a qualified cash or deferred arrangement satisfies the actual deferral percentage test in section 401(k)(3).

(3) *Requirements for definitions of compensation based on rate of compensation*—(i) *Benefit determination*. The definition of compensation must actually be used to calculate the benefits, contributions, or other amounts, that are subject to the applicable provision. For example, a definition of compensation that defines compensation based on each employee's basic or regular rate of compensation may not be used to determine whether a plan satisfies section 401(a)(4) unless the benefits, contributions, or other amounts for each employee in the plan are determined using that definition of compensation.

(ii) *Period for determining compensation*. The amount of each employee's basic or regular compensation for the determination period must be determined using the employee's basic or regular rate of compensation as of a designated date in the determination period. For example, if the determination period is a calendar year, this requirement would be satisfied if the amount of each employee's basic or regular compensation for the calendar year is determined using the employee's basic or regular rate of compensation as of January 1 of the calendar year. Alternatively, the amount of each employee's basic or regular compensation for a determination period can be the sum of the amounts separately determined for shorter specified periods (e.g., weeks or months) within the determination period provided the amount of each employee's basic or regular compensation for each specified period is determined using the employee's basic or regular rate of compensation as of a designated date within the specified period.

(iii) *Dates for determining rate of compensation*. One or more dates may be used to determine employees' rates of compensation for a determination period or specified period provided that, if the same date is not used for all employees, the dates selected are designed to determine the rates of compensation for that period on a consistent basis for all employees taken into account for the determination period. For example, if annual compensation increases are provided to different groups of employees on different dates during the year, it would be consistent to choose a different date for each group in order to include the annual increase in the employees' rates of compensation for the determination period. In addition, the date or dates selected, by themselves, must not cause the portion of total compensation included to vary significantly among employees.

(iv) *Periods without compensation or with reduced compensation*. An employee's compensation may generally only be determined using the employee's rate of compensation for employment periods during which the employer actually compensates the employee. However, if an employee terminates employment or otherwise stops performing services (such as for a leave of absence, layoff or similar event) either without compensation or with reduced compensation during a determination period, the employer may continue to credit the employee with compensation based on the employee's rate of compensation for a period of up to 31 days after the event, but not beyond the end of the determination period. Paragraph (f) of this section contains special rules for crediting imputed compensation for periods extending beyond 31 days during which an employee is not compensated or an employee's compensation is reduced. See also the definition of *Section 414(s) compensation* in §1.401(a)(4)–12 that, for purposes of satisfying section 401(a)(4), permits adjustments to compensation to reflect the equivalent of full-time compensation to the extent necessary to satisfy the requirements of 29 CFR 2530.204–2(d) (regarding double proration of service and compensation).

(f) *Prior-employer compensation and imputed compensation*—(1) *General rule*. Solely for purposes of determining whether a defined benefit plan, as defined in §1.410(b)–9, satisfies section 401(a)(4) or 410(b), an alternative definition that includes prior-employer compensation or imputed compensation satisfies section 414(s) as a reasonable alternative definition if the definition satisfies the requirements specified in

paragraphs (f) (2) and (3) of this section. For this purpose, prior-employer compensation is compensation from an employer other than the employer (determined at the time that the compensation is paid) maintaining the plan that is credited for periods prior to the employee's employment with the employer maintaining the plan and during which the employee performed services for the other employer. For this purpose, imputed compensation is compensation credited for periods after an employee has commenced or recommenced participation in a plan while the employee is not compensated by the employer maintaining the plan or is compensated at a reduced rate by that employer because the employee is not performing services as an employee for the employer (including a period in which the employee performs services for another employer, e.g., a joint venture) or because the employee has a reduced work schedule.

(2) *Requirements for definitions of compensation crediting prior-employer compensation or imputed compensation*—(i) *General requirement.* The definition must otherwise be described in paragraph (c) of this section or must otherwise satisfy the requirements of paragraph (d) or (e) of this section for alternative definitions of compensation, including the nondiscrimination requirement in paragraph (d)(3) of this section.

(ii) *Benefit determination.* A definition of compensation that credits prior-employer compensation or imputed compensation must actually be used to calculate the benefits under the plan. For example, the definition may not be used to determine whether a defined benefit plan satisfies section 401(a)(4) unless the benefits for each employee in the plan are determined using that definition of compensation.

(iii) *Provision applied to all similarly-situated employees.* A provision in a plan's definition of compensation crediting prior-employer compensation or imputed compensation must apply on the same terms to all similarly-situated employees in the plan. The criteria for determining whether employees are similarly situated for this purpose are the same as the criteria for determining whether a plan provision crediting pre-participation or imputed service satisfies the requirements of §1.401(a)(4)–11(d)(3)(iii)(A).

(iv) *Legitimate business purpose.* There must be a legitimate business purpose, based on all of the relevant facts and circumstances, for crediting prior-employer compensation or imputed compensation to an employee for the period being credited. The standard for determining whether crediting prior-employer compensation or imputed compensation satisfies this requirement is the same as the standard for determining whether crediting pre-participation or imputed service under a plan satisfies the requirements of §1.401(a)(4)–11(d)(3)(iii)(B) and whether crediting imputed service satisfies the additional requirements of §1.401(a)(4)–11(d)(3)(iv)(A). However, if the legitimate business reason for crediting imputed compensation relates to the services the employee is performing for another employer and the reason satisfies the standard in §1.401(a)(4)–11(d)(3)(iii)(B), the additional requirements of §1.401(a)(4)–11(d)(3)(iv)(A) are deemed to be satisfied. For example, if an employee becomes employed by another employer as a result of a merger, acquisition or similar transaction with the other employer and imputed compensation is credited to the employee while the employee is performing services for the other employer, the crediting of imputed compensation to the employee satisfies the standard in §1.401(a)(4)–11(d)(3)(iii)(B). Thus, under that example, crediting the imputed compensation to the employee is deemed to satisfy the additional requirements of §1.401(a)(4)–11(d)(3)(iv)(A), even if the employee is not performing those services under an arrangement that provides an ongoing business benefit to the employer maintaining the plan.

(v) *No significant discrimination.* Based on all of the relevant facts and circumstances, crediting prior-employer compensation or imputed compensation must not by design or in operation discriminate significantly in favor of highly compensated employees. The standard for determining whether crediting prior-employer compensation or imputed compensation satisfies this requirement is the same as the standard

for determining whether crediting preparticipation or imputed service satisfies the requirement in §1.401(a)(4)–11(d)(3)(iii)(C) and whether crediting imputed service satisfies the additional requirement of §1.401(a)(4)–11(d)(3)(iv)(B).

(3) *Reasonable method*—(i) *General rule*. Any reasonable method may be used to determine the amount of prior-employer compensation or imputed compensation provided that the requirements of paragraph (f)(3) (ii) or (iii) of this section are satisfied, whichever is applicable.

(ii) *Requirements for prior-employer compensation*. Prior-employer compensation credited to an employee for a period that an employee is performing services for another employer must be compensation for the employee from the other employer (or be based on the employee's basic or regular rate of compensation from the other employer) for that period. In addition, prior employer compensation credited to an employee must not exceed the amount of compensation from the other employer that would have been included under the definition of compensation in effect for that period for compensation from the employer maintaining the plan. Reasonable assumptions may be made in determining the amount of compensation received from another employer for a period that would have been included under the definition of compensation in effect for that period for compensation from the employer maintaining the plan.

(iii) *Requirements for imputed compensation*—(A) *General rule*. The amount of imputed compensation credited to an employee during any period, when combined with the amount of any actual compensation being included, must not exceed an amount that, based on all of the relevant facts and circumstances, is reasonably representative of the amount of compensation that the employee would have received and that would have been included under the definition of compensation in effect for the period if the employee had continued to perform services for the employer during that period at the same level as the employee was performing before the employee stopped performing services or changed to a reduced work schedule. The relevant facts and circumstances include the compensation that the employee was receiving immediately before the employee stopped performing services or changed to a reduced work schedule, and, if applicable, the rate of compensation in effect while the employee is not performing services or has a reduced work schedule that is applicable to the employee's specific job grade immediately before the change occurred.

(B) *Imputed compensation from another employer*. Imputed compensation credited for a period that an employee is performing services for another employer is deemed to satisfy paragraph (f)(3)(iii)(A) of this section if the amount of compensation credited satisfies the requirements of paragraph (f)(3)(ii) of this section for prior-employer compensation. Thus, for example, the amount of imputed compensation credited to an employee for a period that the employee is performing services for another employer is deemed to satisfy paragraph (f)(3)(iii)(A) of this section if the amount credited is compensation for the employee from the other employer (or is based on the employee's basic or regular rate of compensation from the other employer) for that period, and the amount credited does not exceed the compensation from the other employer that would be included for the employee under the definition of compensation in effect for that period for compensation from the employer maintaining the plan.

(4) *Special nondiscrimination rule for safe harbor definitions*. If a definition of compensation crediting prior-employer or imputed compensation is otherwise described in paragraph (c) of this section, and the prior-employer compensation or imputed compensation credited satisfies the requirements of paragraphs (f) (1), (2), and (3) of this section, then the definition is deemed to satisfy paragraph (d) of this section (i.e., it is deemed to be nondiscriminatory).

(g) *Special rules*—(1) *Self-employed individuals*—(i) *General rule*. If an alternative definition of compensation under paragraph (c)(3), (d), (e), or (f) of this section is used to satisfy an applicable provision, an equivalent alternative compensation amount must be

determined for any self-employed individual who is in the group of employees for whom paragraph (b) of this section requires a single definition of compensation to be used. This equivalent alternative compensation amount is determined by multiplying the self-employed individual's total earned income (as defined in section 401 (c)(2)) for the determination period by the percentage of total compensation (as defined in paragraph (d)(3)(ii) of this section) included under the alternative definition for the employer's nonhighly compensated common-law employees as a group (determined in a manner consistent with the rules in paragraph (d)(3)(iii) of this section and, if applicable, paragraph (d)(3)(vi) of this section). Thus, for purposes of this determination, highly compensated common-law employees must be disregarded. This equivalent alternative compensation amount will be treated as the self-employed individual's compensation under the alternative definition of compensation for the determination period.

(ii) *Inclusion of elective contributions.* If the alternative definition of compensation includes any types of elective contributions described in paragraph (c)(4) of this section, the self-employed individual's earned income for this determination must be increased by the amount of elective contributions made by the employer on behalf of the self-employed individual, and the definition of total compensation for this determination must include all the types of elective contributions described in paragraph (c)(4) of this section made by the employees (other than highly compensated employees.

(iii) *Reductions in equivalent alternative compensation amount applicable only to highly compensated employees.* An alternative definition of compensation may provide that compensation under the alternative definition for some or all self-employed individuals who are highly compensated employees is a specified portion of, rather than equal to, the equivalent compensation amount determined under paragraph (g)(1)(i).

(2) *Leased employees.* [Reserved]

(h) *Definitions.* The following definitions apply for purposes of this section:

(1) *Applicable provision.* Applicable provision means a provision that specifically refers to section 414(s) or this section.

(2) *Determination period.* Determination period means a period during which the amount of compensation is measured for use in determining whether the requirements of an applicable provision are satisfied. If no period is provided under the applicable provision for measuring compensation, the determination period is the period for which the applicable provision must be satisfied. The applicable provision may provide additional rules concerning the determination period to be used for satisfying the nondiscrimination requirement in paragraph (d) of this section.

(3) *Employee.* Employee means employee within the meaning of §1.410(b)–9.

(4) *Highly compensated employee.* Highly compensated employee means highly compensated employee within the meaning of §1.410(b)–9.

(5) *Nonhighly compensated employee.* Nonhighly compensated employee means nonhighly compensated employee within the meaning of §1.410(b)–9.

(6) *Self-employed individual.* Self-employed individual means self-employed individual within the meaning of section 401(c)(1).

(i) *Additional rules.* The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional rules for defining compensation within the meaning of section 414(s), including additional definitions of compensation that satisfy section 414(s).

(j) *Effective date and transition rules*—(1) *Statutory effective date.* Section 414(s) applies to years beginning on or after January 1, 1987.

(2) *Regulatory effective date*—(i) *In general.* Except as otherwise provided in paragraph (j)(2)(ii) of this section, §1.414(s)–1 (a) through (i) apply to years beginning on or after January 1, 1994.

(ii) *Plans of tax-exempt organizations.* In the case of a plan maintained by an organization that is exempt from income taxation pursuant to section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans),

§ 1.414(s)–1 (a) through (i) apply to plan years beginning on or after January 1, 1996.

(3) *Compliance during transition period.* For plan years beginning before the effective date of these regulations, as set forth in paragraph (j)(2) of this section, and on or after the statutory effective date as set forth in paragraph (j)(1) of this section, a plan must be operated in accordance with a reasonable, good faith interpretation of section 414(s). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 414(s) will generally be determined based on all relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 414(s)(1) and (2) if it is operated in accordance with the terms of § 1.414(s)–1 (a) through (i). For years beginning on or after the statutory effective date and before the effective date of these regulations, a definition of compensation is also deemed to satisfy section 414(s) as an alternative method of determining compensation under section 414(s)(3) if the definition satisfies the requirements of § 1.414(s)–1 (a) through (i) or if the definition satisfies the prior regulation provisions of § 1.414(s)–1T. (See § 1.414(s)–1T as contained in the CFR edition revised as of April 1, 1991.) In addition, for those transition years, a definition of compensation is deemed to satisfy section 414(s) as an alternative method of determining compensation under section 414(s)(3) if, based on all the relevant facts and circumstances in effect for the year, use of the definition does not cause discrimination in favor of highly compensated employees.

[T.D. 8361, 56 FR 47662, Sept. 19, 1991; 57 FR 10815, 10953, Mar. 31, 1992, as amended by T.D. 8488, 58 FR 47063, Sept. 7, 1993]

§ 1.415–1 General rules with respect to limitations on benefits and contributions under qualified plans.

(a) *Trusts.* Under sections 415 and 401(a)(16), a trust which forms part of a pension, profit-sharing or stock bonus plan will not be qualified under section 401(a) if any one of the following conditions exists:

(1) The annual benefits under a defined benefit plan with respect to any participant for any limitation year exceed the limitations of section 415(b) and § 1.415–3.

(2) The contributions and other additions credited under a defined contribution plan with respect to any participant for any limitation year exceed the limitations of section 415(c) and § 1.415–6.

(3) Where an individual has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan maintained by the same employer, the trust has been disqualifed under section 415(g) and § 1.415–9.

(b) *Certain annuities and accounts*—(1) *In general.* Except as provided in paragraph (c) of this section, an annuity, account, etc., listed in section 415(a)(2) will not be considered to be described in the otherwise applicable section unless—

(i) It satisfies the requirements of § 1.415–3 (relating to limitations on benefits), § 1.415–6 (relating to limitations on contributions and other additions) or § 1.415–7 (relating to limitations where an individual has at any time participated in a defined contribution plan and also has at any time participated in a defined benefit plan maintained by the same employer), whichever is applicable, and

(ii) It has not been disqualifed under § 1.415–9 (relating to disqualification of plans and trusts).

(2) *Special rule for section 403(b) annuity contracts.* (i) With respect to an annuity contract described in section 403(b), the provisions of subparagraph (1) of this paragraph apply only to that portion of the contract which exceeds the limitations of § 1.415–3, § 1.415–6 and § 1.415–7, whichever is applicable.

(ii) In addition, where the amount of the contribution under the section 403(b) annuity contract exceeds the applicable limitation, the exclusion allowance described in section 403(b)(2)(A) is reduced in the manner described in § 1.415–6(e)(1)(ii).

(3) *Cross references to additional rules for section 403(b) annuity contracts.* For

additional rules relating to section 403(b) annuity contracts, see—

(i) Section 1.415–1(f)(2) (relating to the plan year for such annuity contracts),

(ii) Section 1.415–2(b)(7) (relating to the limitation year for such annuity contracts),

(iii) Section 1.415–6(e) (relating to the applicability of the alternative limitations described in section 415(c)(4) to such annuity contracts),

(iv) Sections 1.415–7(c)(2) and 1.415–7(h) (relating to rules for such annuity contracts for purposes of computing the defined contribution plan fraction),

(v) Section 1.415–8(d) (relating to rules for such annuity contracts for purposes of combining plans), and

(vi) Section 1.415–9(c) (relating to rules for such annuity contracts for purposes of determining the amount of a disqualified contribution to the annuity contract).

(c) *Certain accounts, annuities and bonds established for non-employed spouse.* Paragraph (b) of this section is not applicable to an account, annuity or bond as described in section 408(a), 408(b) or 409, respectively established for the benefit of the spouse of the individual who contributes to it for any year for which a deduction is allowable for the individual under section 220. For a special effective date with respect to this paragraph, see paragraph (f)(3) of this section.

(d) *Plan provisions*—(1) *In general.* Although no specific plan provision is required under section 415 in order for a plan to establish or maintain its qualification, the plan provisions must preclude the possibility that the limitations imposed by section 415 will be exceeded. For example, a plan may include provisions which automatically freeze or reduce the rate of benefit accrual (in the case of a defined benefit plan) or the annual addition (in the case of a defined contribution plan) to a level necessary to prevent the limitations from being exceeded with respect to any participant. For rules relating to this type of plan provision and the definitely determinable benefit requirement for pension plans, see §1.401(a)–1(b)(1).

(2) *Special rule for profit-sharing and stock bonus plans.* The use of a plan provision by a profit-sharing or stock bonus plan which automatically freezes or reduces the amount of annual additions to insure that the limitations of section 415 will not be exceeded must comply with the requirement set forth in §1.401–1(b)(1) (ii) and (iii) that such plans provide a definite predetermined formula for allocating the contributions made to the plan among the participants. Thus, if the operation of this provision involves discretionary action on the part of the employer, the definite predetermined allocation formula requirement will be violated. For example, if two defined contribution plans of one employer otherwise provide for aggregate contributions which may exceed the limits of section 415(c), the plan provisions must specify (without involving employer discretion) which plan will reduce contributions and allocations to prevent an excess annual addition and how the reduction will occur.

(e) *Rules for plans maintained by more than one employer*—(1) *Plans described in section 413(b) or section 413(c).* This subparagraph provides for participants of a plan described in section 413(c) or section 413(b) (other than a plan described in section 414(f)). For purposes of applying the limitations of section 415 with respect to a participant of an employer maintaining the plan, benefits or contributions attributable to such participant from all of the employers maintaining the plan must be taken into account. Furthermore, in applying the limitations of section 415 with respect to such a participant, the total compensation received by the participant from all of the employers maintaining the plan may be taken into account.

(2) *Plans described in section 414(f).* (i) This subparagraph provides rules for participants of a multiemployer plan described in section 414(f). For purposes of applying the limitations of section 415 with respect to a participant of an employer maintaining the plan, only the benefits or contributions provided by the employer of such participant shall be taken into account. The benefits provided by an employer under such a plan shall equal the excess of the plan benefit over the plan benefit

computed as if the participant had no covered service with that employer.

(ii) As an alternative to applying the limitations of section 415 with respect to a participant of an employer maintaining the multiemployer plan in the manner described in subdivision (i) of this subparagaph, the rules described in subparagraph (1) of this paragraph may be used for purposes of applying the section 415 limitations in connection with that participant.

(iii) For rules relating to the limitation year for a multiemployer plan, see §1.415–2(b)(6). See also §1.415–8(e) for a special rule relating to the aggregation of multiemployer plans.

(f) *Rules relating to the effective date of section 415*—(1) *In general*. Except as otherwise provided in this paragraph, §§1.415–1 through 1.415–10 are applicable for plan years beginning after 1975 and for limitation years ending with or within plan years beginning after 1975. However, for all such plan years and limitation years through the plan year beginning before January 7, 1981, a reasonable interpretation of the rules set forth in section 415 of the Code and in Rev. Rul. 75–481, 1975–2 C.B. 188, may be relied upon.

(2) *Plan year for certain annuity contracts and individual retirement plans*. For purposes of section 415 and §§1.415–1 through 1.415–10—

(i) An annuity contract described in section 403(b) shall be considered to have a plan year coinciding with the taxable year of the individual on whose behalf the contract has been purchased, and

(ii) An individual retirement plan (as described in section 7701(a)(37)) shall be considered to have a plan year coinciding with the taxable year of the individual on whose behalf the plan is maintained,

unless the individual demonstrates to the satisfaction of the Commissioner that a different 12 month period should be considered to be the plan year.

(3) *Special effective date for certain accounts, annuities and bonds established for non-employed spouse*. Nothwithstanding subparagraph (1) of this paragraph, the provisions of section 415(a)(3) and paragraph (c) of this section are not applicable until taxable years beginning after December 31, 1976.

(4) *Special rules for certain defined contribution plans with respect to the first limitation year to which section 415 applies*. In the case of a defined contribution plan whose plan year does not coincide with the limitation year, the rules of this subparagraph shall be effective with respect to applying the limitations described in section 415(c) and §1.415–6 for the first limitation year to which section 415 and §§1.415–1 through 1.415–10 apply.

(i) Annual additions (as defined in section 415(c)(2) and §1.415–6(b)) which are allocated under the plan prior to the first day of the first plan year to which section 415 and §§1.415–1 through 1.415–10 are effective do not have to be taken into account.

(ii) The amount of compensation (as defined in §1.415–2(d)) taken into account in applying the limitations may include compensation for the entire limitation year.

(5) *Special effective date for special benefit limitation with respect to certain collectively bargained plans*. Notwithstanding subparagraph (1) of this paragraph, section 415(b)(7) is not applicable until limitation years beginning after December 31, 1978.

(6) *Special effective date for excess contributions to section 403(b) annuity contracts*. (i) Notwithstanding subparagraph (1) of this paragraph, the provisions of §1.415–6(e)(1)(ii) (relating to the manner in which contributions to a section 403(b) annuity contract which exceed the limitations of section 415(c)(1) are treated) are only applicable to taxable years beginning after January 24, 1980.

(ii) For all prior taxable years for which the limitations of section 415 are applicable to section 403(b) annuity contracts, any contribution to the account of an individual under a section 403(b) annuity contract for a taxable year which exceeds the limitations of section 415(c)(1), instead of being treated in the manner described in §1.415–6(e)(1)(ii), shall reduce the exclusion allowance under section 403(b)(2) for such taxable year to the extent of the excess.

(7) *Special effective date for rules relating to change of limitation year.* Notwithstanding subparagraph (1) of this paragraph, the provisions of §1.415–2(b)(4) (relating to the effect of a change of the limitation year) are required to be applied only for changes in limitation years which occur after January 7, 1981. These provisions may also be used for all prior changes in limitation years. However, if the provisions of §1.415–2(b)(4) are not used for changes in limitation years which occur prior to January 7, 1981, the requirements of §2.01(4) of Rev. Rul. 75–481, 1975–2 C.B. 188, shall be applicable with respect to such changes.

(8) *Special effective date for TRASOP's.* The limitations of section 415 apply to an Employee Stock Ownership Plan under section 301(d) of the Tax Reduction Act of 1975 (''TRASOP''). The earliest date on which the first plan year of a TRASOP may begin is January 22, 1974. Therefore, notwithstanding subparagraph (1) of this paragraph, the limitations of section 415 are applicable for TRASOP plan years beginning before 1975 and for limitation years ending with or within plan years beginning before 1975. However, the aggregation rules of §1.415–8 do not apply to a limitation year of a TRASOP ending with or within a plan year beginning before 1975.

(9) *Transitional rules.* For special transitional rules, see—

(i) Section 1.415–4 (relating to a transitional rule for defined benefit plans),

(ii) Section 1.415–7(b)(2) (relating to the defined benefit plan fraction applicable to certain participants),

(iii) Section 1.415–7(d) (relating to transitional rules for the defined contribution plan fraction), and

(iv) Section 1.415–7(g) (relating to a special rule for certain plans in effect on September 2, 1974).

(g) *Supersession.* Section 11.415(c)(4)–1 (relating to special elections for section 403(b) annuity contracts purchased by educational organizations, hospitals and home health service agencies) of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this section and §§1.415–2 through 1.415–10.

[T.D. 7748, 46 FR 1697, Jan. 7, 1981]

§ 1.415–2 Definitions and special rules.

(a) *General application.* Unless otherwise provided in the appropriate section, for purposes of §§1.415–1 through 1.415–10, the following definitions and special rules shall apply.

(b) *Limitation year*—(1) *In general.* (i) Unless the election described in subdivision (ii) of this subparagraph is made, the limitation year, with respect to any qualified plan maintained by the employer, is the calendar year.

(ii) Instead of using the calendar year, an employer may elect to use any other consecutive twelve month period as the limitation year. This includes a fiscal year with an annual period varying from 52 to 53 weeks, so long as the fiscal year satisfies the requirements of section 441(f). If the case of a group of employers which constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) which are under common control (within the meaning of section 414(c) as modified by section 45(h)), the election to use a consecutive twelve month period other than the calendar year as the limitation year must be made by all members of the group that maintain a qualified plan.

(2) *Method of election to use a limitation year other than the calendar year or to change limitation year.* (i) The election described in subparagraph (1)(ii) of this paragraph shall be made by the adoption of a written resolution by the employer. This requirement is satisfied if the election is made in connection with the adoption, by the employer, of the plan or any amendments to such plan.

(ii) This resolution will not be considered a change of the limitation year, if it is adopted or modified on or before the later of the adoption date of the first amendment conforming an existing plan to the Employee Retirement Income Security Act of 1974, or December 31, 1976.

(3) *Election of multiple limitation years.* Any employer that maintains more than one qualified plan may elect to use different limitation years for each such plan in accordance with rules determined by the Commissioner. The rule described in this subparagraph

also applies to a controlled group of employers (within the meaning of section 414 (b) or (c), as modified by section 415(h)).

(4) *Effect of change of limitation year.* (i) Once established, the limitation year may be changed only by making the election in the manner described in subparagraph (2) of this paragraph.

(ii) Any change in the limitation year must be a change to a twelve-month period commencing with any day within the current limitation year.

(iii) For purposes of this paragraph, the limitations of section 415 are to be applied in the normal manner to the new limitation year. Moreover, the limitations of section 415 are to be separately applied to a ''limitation period'' which begins with the first day of the current limitation year and which ends on the day before the first day of the first limitation year for which the change is effective. The dollar limitation with respect to this limitation period is determined by multiplying (A) the applicable dollar limitation for the calendar year in which the limitation period ends by (B) a fraction, the numerator of which is the number of months (including any fractional parts of a month) in the limitation period, and the denominator of which is 12. This adjustment of the dollar limitation only applies to a defined contribution plan.

(iv) For a special effective date with respect to this paragraph, see §1.415–1(f)(7).

(v) The provisions of this subparagraph may be illustrated by the following example:

Example. In 1981, an employer with a qualified defined contribution plan using the calendar year as the limitation year elects to change the limitation year to a period beginning July 1 and ending June 30. Because of this change, the plan must satisfy the limitations of section 415(c) for the limitation period beginning January 1, 1981 and ending June 30 of that year. In applying the limitations of section 415(c) to this limitation period, the amount of compensation taken into account may only include compensation for this period. Furthermore, the dollar limitation for this period is the otherwise applicable dollar limitation for calendar year 1981, multiplied by 6/12.

(5) *Limitation year for years prior to effective date.* The limitation year for all years prior to the effective date of section 415 is the consecutive twelve-month period which corresponds to the first limitation year of a plan after the effective date of section 415. (See paragraph (b)(1) of this section for rules relating to the determination of a plan's limitation year.)

(6) *Limitation year for multiemployer plans.* In the case of a multiemployer plan (as defined in section 414(f)), the limitation year is the calendar year unless the plan administrator elects otherwise under paragraph (b)(2) of this section.

(7) *Limitation year for individuals on whose behalf section 403(b) annuity contracts have been purchased.* (i) The limitation year of an individual on whose behalf a section 403(b) annuity contract has been purchased by an employer is determined in the following manner.

(ii) If the individual is not in control (within the meaning of section 414 (b) or (c) as modified by section 415(h)) of any employer, the limitation year is the calendar year. However, the individual may elect to change the limitation year to another twelve-month period. To do this, the individual must attach a statement to his income tax return filed for the taxable year in which the change is made. Any change in the limitation year must comply with the rules set forth in paragraph (b)(4) of this section.

(iii) If the individual is in control (within the meaning of section 414 (b) or (c) as modified by section 415(h)) of an employer, the limitation year is to be the limitation year of that employer.

(8) *Limitation year for individuals on whose behalf individual retirement plans are maintained.* The limitation year of an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) is maintained shall be determined in the manner described in paragraph (b)(7) of this section.

(c) *Defined benefit and defined contribution plan*—(1) *Defined benefit plan.* A ''defined benefit plan'' means a plan described in section 414(j).

(2) *Defined contribution plan.* A ''defined contribution plan'' means a plan described in section 414(i). It includes a money purchase pension plan (as described in §1.401–1(b)(1)(i)), such as a

target benefit plan (as described in §1.410(a)–4(a)(1)). A hybrid plan (as defined in section 414(k)) is to be treated as a defined contribution plan to the extent that benefits payable under the plan are based upon the individual account of the participant.

(d) *Compensation*—(1) *General definition*. Except as otherwise provided, compensation within the meaning of section 415(c)(3) includes all remuneration described in paragraph (d)(2) of this section and excludes all other forms of remuneration. Paragraph (d)(3) of this section provides examples of types of remuneration not includible in compensation within the meaning of section 415(c)(3). Paragraphs (d)(4) and (d)(5) of this section provide rules regarding the payment of compensation in the limitation year. Paragraph (d)(6) of this section provides a special rule for determining the compensation of employees of controlled groups or affiliated service groups. Paragraph (d)(7) of this section provides a special rule for applying the limitations of section 415(c) when a section 403(b) annuity is aggregated with a qualified plan of a controlled employer. Paragraphs (d)(8) and (d)(9) of this section are reserved for special rules for leased employees and for permanent and total disability, respectively. Paragraphs (d)(10) and (d)(11) of this section provide additional definitions of compensation that are treated as satisfying section 415(c)(3). Paragraph (d)(12) of this section permits optional use of prior regulations. Paragraph (d)(13) of this section provides authority to the Commissioner to provide further additional definitions of compensation that satisfy section 415(c)(3).

(2) *Items includible as compensation*. For purposes of applying the limitations of section 415, the term ''compensation'' includes all of the following—

(i) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in §1.62–2(c)).

(ii) In the case of an employee who is an employee within the meaning of section 401(c)(1) and the regulations thereunder, the employee's earned income (as described in section 401(c)(2) and the regulations thereunder).

(iii) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

(iv) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under section 217.

(v) The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted.

(vi) The amount includible in the gross income of an employee upon making the election described in section 83(b).

Paragraphs (d)(2)(i) and (d)(2)(ii) of this section include foreign earned income (as defined in section 911(b)), whether or not excludable from gross income under section 911. Compensation described in paragraph (d)(2)(i) of this section is to be determined without regard to the exclusions from gross income in sections 931 and 933. Similar principles are to be applied with respect to income subject to sections 931 and 933 in determining compensation described in paragraph (d)(2)(ii) of this section.

(3) *Items not includible as compensation*. The term ''compensation'' does not include items such as—

(i) Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the section 415 limitations to that plan, the contributions are not includible in the gross income of the employee for the taxable year in which

contributed. In addition, employer contributions made on behalf of an employee to a simplified employee pension described in section 408(k) are not considered as compensation for the taxable year in which contributed. Additionally, any distributions from a plan of deferred compensation are not considered as compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed. However, any amounts received by an employee pursuant to an unfunded nonqualified plan is permitted to be considered as compensation for section 415 purposes in the year the amounts are includible in the gross income of the employee.

(ii) Amounts realized from the exercise of a non-qualified stock option, or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see section 83 and the regulations thereunder).

(iii) Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option.

(iv) Other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in section 403(b) (whether or not the contributions are excludable from the gross income of the employee).

(4) *Compensation in limitation year.* The compensation (as defined in paragraph (d)(2) of this section) actually paid or made available to an employee within the limitation year is the compensation used for purposes of applying the limitations of section 415.

(5) *Election to use compensation accrued during limitation year*—(i) *Years beginning after December 31, 1991.* For limitation years beginning after December 31, 1991, an employer may not use accrued compensation. Any election previously made to use accrued compensation is not valid for limitation years beginning after December 31, 1991.

(ii) *De minimis accrued compensation.* Notwithstanding paragraph (d)(5)(i) of this section, an employer may include in compensation amounts earned but not paid in a year because of the timing of pay periods and pay days if these amounts are paid during the first few weeks of the next year, the amounts are included on a uniform and consistent basis with respect to all similarly situated employees, and no compensation is included in more than one limitation period. No formal election is required to include the accrued compensation permitted under this de minimis rule. The rule described in this paragraph (d)(5)(ii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)).

(iii) *Years beginning before January 1, 1992.* For limitation years beginning before January 1, 1992, instead of using the compensation actually paid or made available to an employee during the limitation year, an employer may elect to use the compensation accrued for an entire limitation year for purposes of applying the limitations of section 415. In the case of a group of employers that constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) that are under common control (within the meaning of section 414(c) as modified by section 415(h)), the election to use accrued compensation must be made by all members of the group that maintain a qualified plan. Once an election is made, it remains in effect until it is revoked by the employer or group of employers. The rule described in this paragraph (d)(5)(iii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)). If, in a particular limitation year beginning before January 1, 1992, a previously effective election to use accrued compensation is revoked or an election to use accrued compensation is made, any amounts taken into account for compensation purposes for any preceding limitation year may not

be counted again in determining compensation for the particular limitation year.

(6) *Special rule for employees of controlled groups of corporations, etc.* In the case of an employee of two or more corporations which are members of a controlled group of corporations (as defined in section 414(b) as modified by section 415(h)), the term ''compensation'' for such employee includes compensation from all employers that are members of the group, regardless of whether the employee's particular employer has a qualified plan. This special rule is also applicable to an employee of two or more trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c) as modified by section 415(h)), to an employee of two or more members of an affiliated service group as defined in section 414(m), and to an employee of two or more members of any group of employers who must be aggregated and treated as one employer pursuant to section 414(o).

(7) *Special rule when section 403(b) annuity is aggregated with qualified plan of controlled employer.* If a section 403(b) annuity contract is combined or aggregated with a qualified plan of a controlled employer in accordance with either §1.415–7(h)(2)(i) or §1.415–8(d)(2), the following rules apply:

(i) In applying separately the limitations of section 415 (b) or (c) to the qualified plan and the limitations of section 415(c) and the exclusion allowance of section 403(b)(2)(A) to the section 403(b) annuity, compensation from the controlled employer may not be aggregated with compensation from the employer purchasing the section 403(b) annuity.

(ii) However, in applying the limitations of section 415(c) in connection with the combining of the section 403(b) annuity with a qualified defined contribution plan or section 415(e) in connection with the aggregating of the section 403(b) annuity with a qualified defined benefit plan, the total compensation from both employers may be taken into account.

(8) *Special rules for leased employees.* [Reserved]

(9) *Special rules for permanent and total disability.* [Reserved]

(10) *Safe harbor rule with respect to plan's definition of compensation.* If a plan defines compensation for purposes of applying the limitations of section 415 to include only those items specified in paragraph (d)(2)(i) of this section and to exclude all those items listed in paragraph (d)(3) of this section, if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies section 415(c)(3).

(11) *Alternative definition of compensation.* In lieu of defining compensation in accordance with paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the limitations of section 415 in the case of employees other than self-employed individuals treated as employees within the meaning of section 401(c)(1), a plan may define compensation using either of the following definitions used for wage reporting purposes, as modified herein, and the definition will be considered automatically to satisfy section 415(c)(3):

(i) *Information required to be reported under sections 6041, 6051 and 6052.* Compensation is defined as wages within the meaning of section 3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under sections 6041(d), 6051(a)(3), and 6052. See §§1.6041–1(a), 1.6041–2(a)(1), 1,6052–1, and 1.6052–2, and also see §31.6051–1(a)(1)(i)(C) of this chapter. This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under section 217. Compensation under this paragraph (d)(11)(i) must be determined without regard to any rules under section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(ii) *Section 3401(a) wages.* Compensation is defined as wages within the meaning of section 3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(12) *Optional use of prior regulations.* For years beginning before September 19, 1991, employers are permitted, in defining compensation for purposes of section 415(c)(3), to comply with either the provisions of this §1.415–2(d) or the prior regulation provisions of §1.415–2(d). See §1.415–2(d) as contained in the CFR edition revised as of April 1, 1991.

(13) *Additional rules.* The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional definitions of compensation that are treated as satisfying section 415(c)(3).

[T.D. 7748, 46 FR 1698, Jan. 7, 1981, as amended by T.D. 8361, 56 FR 47667, Sept. 19, 1991; 57 FR 10815, 10953, Mar. 31, 1992]

§1.415–3 Limitations for defined benefit plans.

(a) *General rules*—(1) *Maximum limitations.* Under section 415(b) and this section, to satisfy the provisions of section 415(a) for any limitation year, the annual benefit (as defined in paragraph (b)(1)(i) of this section) to which a participant is entitled at any time under a defined benefit plan may not, during the limitation year, exceed the lesser of—

(i) $75,000, or

(ii) 100 percent of the participant's average compensation for his high 3 years of service.

As required in §1.415–1(d), in order to satisfy the limitations on benefits of this section, the plan provisions must preclude the possibility that any annual benefit exceeding these limitations will be payable at any time. Thus, a plan may fail to satisfy the limitations of this section even though no participant has actually accrued a benefit in excess of these limitations.

(2) *Adjustment to dollar limitation.* The dollar limitation described in section 415(b)(1)(A) and paragraph (a)(1)(i) of this section is adjusted for cost of living increases under section 415(d) and §1.415–5(a). The adjusted figure is effective as of January 1 of each calendar year and is applicable to limitation years that end during that calendar year.

(3) *Average compensation for high 3 years of service.* For purposes of applying the limitation on benefits described in this section, a participant's high 3 years of service is the period of 3 consecutive calendar years (or, the actual number of consecutive years of employment for those employees who are employed for less than 3 consecutive years with the employer) during which the employee had the greatest aggregate compensation (as defined in §1.415–2(d)) from the employer. For purposes of this subparagraph, in determining a participant's high 3 years, the plan may use any 12 month period instead of the calendar year provided that it is uniformly and consistently applied.

(b) *Definitions of terms*—(1) *Annual benefit.* (i) The term ''annual benefit'' means a benefit which is payable annually in the form of a straight life annuity under a plan. Such benefit does not include any benefits attributable to either employee contributions or rollover contributions (as defined in sections 402(a)(5), 403(a)(4), 408(d)(3) and 409(b)(3)(C)). Additionally, in applying the limitations on benefits described in paragraph (a)(1) of this section to the annual benefit of a participant, it is immaterial if the participant works beyond the normal retirement age as determined under the terms of the plan. Thus, for example, if an individual, who is subject to the dollar limitation of section 415(b)(1)(A) ($110,625 for 1980), retires in 1980 after working past the plan's normal retirement age of 65, the plan may only provide such individual with an annual benefit of $110,625 in 1980 and not the actuarial equivalent of the amount the individual would have been entitled to receive at age 65 in order to comply with the section 415(b) limitations.

(ii) If the plan provides for a benefit which is not payable in the form of a straight life annuity, the benefit is adjusted in accordance with paragraph (c) of this section for purposes of applying

the limitations on benefits described in paragraph (a)(1) of this section.

(iii) If rollover contributions are made to the plan, the annual benefit attributable to these contributions is determined on the basis of reasonable actuarial assumptions. See paragraph (d) of this section for rules relating to employee contributions.

(iv) For purposes of this paragraph, when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. The annual benefit payable on account of the transfer for any individual that is attributable to the assets transferred will be equal to the annual benefit transferred on behalf of such individual multiple by a fraction, the numerator of which is the total assets transferred and the denominator of which is the total liabilities transferred.

(2) *Retirement benefit*. For purposes of this section, the term ''retirement benefit'' means a benefit provided under the terms of a defined benefit plan which is subject to the limitations of section 415(b) and this section.

(c) *Adjustment where form of benefit is other than straight life annuity*—(1) *In general*. (i) Where a defined benefit plan provides a retirement benefit in any form other than a straight life annuity, the plan benefit is adjusted to a straight life annuity beginning at the same age which is the actuarial equivalent of such benefit in accordance with rules determined by the Commissioner. This adjustment is for purposes of applying the limitations on benefits described in paragraph (a)(1) of this section to the annual benefit of the participant.

(ii) Examples of benefits that are not in the form of a straight life annuity are an annuity which includes a post-retirement death benefit and an annuity providing for a guaranteed number of payments.

(2) *Certain beneifts to which no adjustment is required*. For purposes of the adjustment described in subparagraph (1) of this paragraph, the following values are not taken into account:

(i) The value of a qualified joint and survivor annuity (as defined in section 401(a)(11)(G)(iii) and the regulations thereunder) provided by the plan to the extent that such value exceeds the sum of (A) the value of a straight life annuity beginning on the same date and (B) the value of any post-retirement death benefits which would be payable even if the annuity was not in the form of a joint and survivor annuity.

(ii) The value of benefits that are not directly related to retirement benefits (such as pre-retirement disability and death benefits and post-retirement medical benefits).

(iii) The value of benefits provided by the plan which reflect post-retirement cost of living increases to the extent that such increases are in accordance with section 415(d) and § 1.415–5.

(3) *Examples*. The provisions of subparagraph (2)(i) of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation ABC maintains a defined benefit plan that provides a benefit in the form of a joint and 100% suvivor annuity with a 10 year certain feature. The value of this benefit is equal to 126% of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable in the form of a joint and 100% survivor annuity, without a 10 year certain feature, its value would be equal to only 123% of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable with a 10 year certain feature, but without the joint and 100% survivor aspect, its value would equal 110% of the value of the same amount payable as a straight life annuity beginning on the same date. Thus, the value of the postretirement death benefits which would be payable even if the annuity were not in the form of a joint and survivor annuity is 10%.

(ii) Under subparagraph (2)(i) of this paragraph, the values which may be excluded for purposes of the adjustment required by subparagraph (1) of this paragraph are as follows: The value of the joint and survivor annuity provided by the plan (126%) to the extent that such value exceeds the sum of, the value of the straight life annuity beginning on the same date (100%) and the value of the post-retirement death benefits (10%). Therefore, the value of the joint and survivor annuity provided by the plan exceeds the value of the straight life annuity with the 10 year certain feature by 16% (126%–110%).

(iii) Although 16% of the excess benefit attributable to the annity provided by this

plan may, consequently, be ignored (because this represents the value added to the 10 year certain and life annuity benefit by the joint survivor feature), 10% of such excess benefit (the value added to the straight life annuity benefit by the 10 year certain feature) must be taken into account for purposes of adjusting the benefit under the plan to an actuarially equivalent straight life annuity. Thus, for example, if ABC Corporation were to provide a benefit equal to 95% of a participant's compensation for the high three years of service, the limitation of section 415(b)(1)(B) would be exceeded because the benefit under the plan would be the actuarial equivalent of a straight life annuity equal to 105% of a participant's compensation for the high three years.

Example (2). Corporation XYZ maintains a nondiscriminatory defined benefit plan that provides a benefit which is equal to 100% of a participant's compensation for his high 3 years of service. For married participants, the benefit is payable in the form of a joint and 100% survivor annuity. While for participants who are not married, the benefit is payable in the form of a straight life annuity. The plan also provides that married participants can elect to receive their benefits in the form of a lump sum distribution which is the actuarial equivalent of a joint and 100% survivor annuity. The special rule set forth in subparagraph (2)(i) of this paragraph only applies, however, if the benefit is payable in the form of a qualified joint and survivor annuity. Any other forms of optional benefits must be adjusted to a straight life annuity in accordance with subparagraph (1) of this paragraph. Accordingly, because the benefit payable under the plan in the form of a lump sum distribution is the actuarial equivalent of a straight life annuity which is greater than 100% of a participant's compensation for his high 3 years, the limitation of section 415(b)(1)(B) has been exceeded.

(d) *Employee contributions*—(1) *Mandatory contributions.* Where a defined benefit plan provides for mandatory employee contributions (as defined in section 411(c)(2)(C)), the annual benefit attributable to such contributions is not taken into account for purposes of applying the limitations on benefits described in paragraph (a) of this section. The annual benefit attributable to mandatory contributions is determined by using the factors described in section 411(c)(2)(B) and the regulations thereunder, regardless of whether section 411 applies to that plan.

However, the mandatory employee contributions are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on contributions and other additions described in §1.415–6. (See §1.415–7 for provisions relating to the limitations applicable where an employer maintains a defined benefit and defined contribution plan for the same employee.)

(2) *Voluntary contributions.* Where a defined benefit plan provides for voluntary employee contributions, these contributions are considered a separate defined contribution plan maintained by the employer which is subject to the limitations on contributions and other additions described in §1.415–6. (See §1.415–7 for provisions relating to the limitations applicable where an employer maintains a defined benefit and defined contribution plan for the same employee.)

(3) *Example:* The provisions of this paragraph may be illustrated by the following example:

Example. A is a participant in a defined benefit plan maintained by his employer. Under the terms of the plan A must make contributions to the plan in a stated amount to accrue benefits derived from employer contributions. These contributions are mandatory employee contributions within the meaning of section 411(c)(2)(C) and, thus, the annual benefit attributable to these contributions does not have to be taken into account for purposes of testing the annual benefit derived from employer contributions against the applicable limitation on benefits. However, these contributions are considered a separate defined contribution plan maintained by A's employer. Accordingly, with respect to the current limitation year: (1) the limitation on benefits (as described in paragraph (a)(1) of this section) is applicable to the annual benefit attributable to employer contributions to the defined benefit plan; (2) the limitation on contributions and other additions (as described in §1.415–6) is applicable to the defined contribution plan consisting of A's mandatory contributions; and (3) the provisions of §1.415–7 (relating to the limitations where the employer maintains a defined benefit and defined contribution plan for the same employee) are applicable to the defined benefit and defined contribution plan in which A participates. These same limitations would also apply. If, instead of providing for mandatory employee contributions the plan permitted voluntary employee contributions, since both voluntary and mandatory employee contributions are treated as separate defined contribution plans maintained by the employer.

(e) *Adjustment where benefit begins before age 55.* Where a defined benefit plan provides a retirement benefit beginning before age 55, the plan benefit is adjusted to the actuarial equivalent of a benefit beginning at age 55 in accordance with rules determined by the Commissioner. This adjustment is only for purposes of applying the dollar limitation described in section 415(b)(1)(A) to the annual benefit of the participant.

(f) *Total annual benefits not in excess of $10,000*—(1) *In general.* The annual benefit (without regard to the age at which benefits commence) payable with respect to a participant under any defined benefit plan is not considered to exceed the limitations on benefits described in section 415(b)(1) and in paragraph (a)(1) of this section if—

(i) The retirement benefits derived from employer contributions payable with respect to the participant under the plan and all other defined benefit plans of the employer do not in the aggregate exceed $10,000 for the limitation year, or for any prior limitation year, and

(ii) The employer has not at any time, either before or after the effective date of section 415, maintained a defined contribution plan in which the participant participated.

(2) *Special rule with respect to participants in multiemployer plans.* The special $10,000 exception set forth in subparagraph (1) of this paragraph is applicable to a participant in a multiemployer plan described in section 414(f) without regard to whether that participant ever participated in one or more other plans maintained by an employer who also maintains the multiemployer plan, provided that none of such other plans were maintained as a result of collective bargaining involving the same employee representative as the multiemployer plan.

(3) *Special rule with respect to employee contributions.* For purposes of subparagraph (1)(ii) of this paragraph, if a defined benefit plan provides for employee contributions, whether voluntary or mandatory, these contributions will not be considered a separate defined contribution plan maintained by the employer. Thus, a contributory defined benefit plan may utilize the special dollar limitation provided for in this paragraph.

(4) *Computation of $10,000 amount.* For purposes of subparagraph (1)(i) of this paragraph, the value of the retirement benefit payable under the plan is not adjusted upward for early retirement provisions and benefits which are not in the form of a straight life annuity (whether or not directly related to retirement benefits).

(5) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). B is a participant in a defined benefit plan maintained by this employer, X Corporation, which provides for a benefit payable in the form of a straight life annuity beginning at age 65. B's compensation for his high 3 years of service is $6,000. The plan does not provide for employee contributions and at no time has B been a participant in a defined contribution plan maintained by X. With respect to the current limitation year, B's retirement benefit under the plan is $9,500. Because B's retirement benefit does not exceed $10,000 and because B has at no time participated in a defined contribution plan maintained by X, the benefits payable under the plan are not considered to exceed the limitation on benefits otherwise applicable to B ($6,000). This result would remain the same, even if, under the terms of the plan, B's normal retirement age were age 50 or if the plan provided for employee contributions.

Example (2). Assume the same facts as in example (1), except that the plan provides for a benefit payable in the form of a life annuity with a 10 year certain feature. Assume that after the adjustment described in paragraph (c) of this section, B's annual benefit under the plan for the current limitation year is $10,500. However, for purposes of applying the special rule provided in this paragraph for total benefits not in excess of $10,000, there is no adjustment required if the retirement benefit payable under the plan is not in the form of a straight life annuity. Therefore, because B's retirement benefit does not exceed $10,000, B may receive the full $9,500 benefit without the otherwise applicable benefit limitations of this section being exceeded.

(g) *Special rule for service of less than 10 years*—(1) *In general.* Where a participant has less than 10 years of service with the employer at the time the participant begins to receive retirement benefits under the plan, the benefit limitations described in section 415(b)(1) and (4) and paragraphs (a)(1) and (f)(1) of this section are to be reduced

by multiplying the otherwise applicable limitation by a fraction—

(i) The numerator of which is the number of years of service with the employer as of, and including, the current limitation year, and

(ii) The denominator of which is 10. For purposes of this subparagraph, the term ''year of service'' is to be determined on a reasonable and consistent basis.

(2) *Examples*. The provision of this paragraph may be illustrated by the following examples:

Example (1). C begins employment with Acme Corporation on January 1, 1977, at the age of 58. Acme maintains only a noncontributory defined benefit plan which provides for a straight life annuity beginning at age 65 and uses the calendar year for the limitation and plan year. Acme has never maintained a defined contribution plan. C becomes a participant in Acme's plan on January 1, 1978 and works through December 31, 1983, when he is age 65. C begins to receive benefits under the plan in 1984. C's average compensation for his high 3 years of service is $20,000. Furthermore, under the terms of Acme's plan, for purposes of computing C's nonforfeitable percentage in his accrued benefit derived from employer contributions, C has only 7 years of service with Acme (1977–1983). Therefore, because C has less than 10 years of service with Acme at the time he begins to receive benefits under the plan, the maximum permissible annual benefit payable with respect to C is only $14,000 ($20,000×7/10).

Example (2). Assume the same facts as in example (1), except that C's average compensation for his high 3 years is $8,000. Because C has less than 10 years of service with Acme at the time he begins to receive benefits, the maximum benefit payable with respect to C would be reduced to $5,600 ($8,000 x 7/10). However, the special rule for total benefits not in excess of $10,000, provided in paragraph (f) of this section, is applicable in this case. Accordingly, C may receive an annual benefit of $7,000 ($10,000 x 7/10) without the benefit limitations of this section being exceeded.

Example (3). ABC corporation maintains a defined benefit plan. Instead of adjusting the benefit limitations in accordance with the method described in subparagraph (1) of this paragraph, the plan provides that the plan administrator may make the necessary adjustment by multiplying the otherwise applicable limitation by a fraction—(1) the numerator of which is the number of completed months of service with the employer, and (2) the denominator of which is 120. The plan further provides that a completed month of service with the employer is any calendar month in which the employee is credited with at least 83 hours of service. Provided that an hour of service is determined in a manner that is reasonable and consistent, the plan may use this alternative rule for making the adjustment required when a participant has less than 10 years of service with the employer at the time he begins to receive benefits under the plan.

(h) *Benefits under certain collectively bargained plans*. For a special rule affecting the compensation limitation described in section 415(b)(1)(B) and paragraph (a)(1)(ii) of this section, see section 415(b)(7). For a special effective date with respect to this rule, see § 1.415–1(f)(5).

[T.D. 7748, 46 FR 1700, Jan. 7, 1981]

§ 1.415–4 Transitional rule for defined benefit plans.

(a) *In general*. If all of the conditions described in paragraph (b) of this section are satisfied, the annual benefit payable to an individual who was a participant in a defined benefit plan at any time before October 3, 1973, will not be considered to exceed the limitations of section 415(b) and § 1.415–3(a). In the case of an individual who was a participant in more than one defined benefit plan at any time before October 3, 1973, the annual benefit payable to that individual from each plan will be deemed not to exceed the limitations of section 415(b) and § 1.415–3(a) if the benefit from each plan satisfies all of the conditions described in paragraph (b) of this section.

(b) *Conditions for application of transitional rule*. The conditions are—

(1) The annual benefit payable to the participant does not exceed 100 percent of that participant's annual rate of compensation (as defined in paragraph (c) of this section) on October 2, 1973, or, if earlier, as of the date the participant separated from the service of the employer.

(2) The annual benefit payable to the participant does not exceed the annual benefit which would have been payable to the participant at any time if—

(i) All the terms and conditions of the plan which were actually in effect on October 2, 1973 (or if earlier, on the date the participant separated from the

service of the employer) had remained in effect, and

(ii) The participant's compensation taken into account for determining benefits under the plan for any period after October 2, 1973, did not exceed his annual rate of compensation (as defined in paragraph (c) of this section) on that date.

(3) The annual benefit payable to a participant who separated from the service of the employer before October 2, 1973, does not exceed the participant's nonforfeitable accrued benefit under the plan as of the date he separated from service.

(c) *Special rules*—(1) *Annual rate of compensation*. For purposes of this section, a participant's annual rate of compensation for a particular calendar year shall be the greater of—

(i) The participant's compensation for that calendar year as determined in accordance with the rules provided in §1.415–2(d), or

(ii) The compensation which would be used to determine benefits under the plan if the employee separated from the service of the employer on October 2, 1973, or, if earlier, the employee's actual date of separation from the service of the employer.

(2) *Cost-of-living adjustments*. (i) If the plan, as in existence on October 2, 1973, provided for a post-retirement cost of living adjustment to benefits, the adjustment may be taken into account in determining the participant's allowable benefit under paragraph (b) of this section. However, under paragraph (b)(2) of this section, if a plan is amended after October 2, 1973 to provide for cost-of-living benefit increases for retired participants, the transitional rule of this section will not apply to any increased benefit attributable to the amendment.

(ii) Any cost-of-living increase in the dollar limitation described in section 415(b)(1)(A) under section 415(d) and §1.415–5(a) may be taken advantage of by an individual who is otherwise using the transitional rule set forth in this section. Thus, for example, if, due to cost-of-living increases under section 415(d) and §1.415–5(a), the dollar limitation for 1981 is greater than $110,625, to the extent allowed under section 415(b), a plan may provide that an individual who is otherwise receiving a benefit of $110,625 per year under the transitional rule of this section, may receive the greater amount in 1981.

(3) *Retirement benefit beginning before age 55*. If a defined benefit plan provides a retirement benefit beginning before age 55, no actuarial adjustment of the benefit which can be provided under the transitional rule of this section is required to be made.

(4) *Retirement benefit payable in a form other than a straight life annuity*. If a defined benefit plan, as in existence on October 2, 1973, provided a retirement benefit in a form other than a straight life annuity, no actuarial adjustment (as otherwise required under §1.415–3(c)) of the benefit which can be provided under the transitional rule of this section is required to be made. However, if the plan is amended after October 2, 1973, to provide a benefit of greater value than the benefit provided under the plan as of October 2, 1973, the transitional rule of this section will not apply to the increase in the value of the benefit attributable to the amendment. (See paragraph (b)(2)(i) of this section.)

(d) *Examples*. The provisions of this section may be illustrated by the following examples:

Example (1). N, a participant in a noncontributory defined benefit plan maintained by his employer, retired on February 17, 1969, and became eligible to receive benefits under the plan. At that time, N had attained age 65, the normal retirement age under the plan. N's annual rate of compensation on February 17, 1969, was $90,000. Under the terms of the plan, as in effect on February 17, 1969, N was entitled to an annual benefit of $86,000, which was N's accrued nonforfeitable benefit as of that date. Because the annual benefit payable with respect to N (i) does not exceed 100 percent of N's compensation on February 17, 1969, (ii) does not exceed the annual benefit to which N was entitled on retirement, and (iii) did not exceed N's nonforfeitable accrued benefit on retirement, the plan may provide an annual benefit of $86,000 with respect to N for limitation years to which section 415 applies without violating the limitations imposed by section 415(b) and §1.415–3.

Example (2). Assume the same facts as in example (1) except that on February 17, 1969, when N retired and became eligible to receive benefits under the plan, N had not attained the age of 55. Because the adjustment

required under section 415(b)(2)(C) for retirement benefits beginning before age 55 is only applicable to the dollar limitation described in section 415(b)(1)(A), under paragraph (c)(3) of this section, no actuarial adjustment of the annual benefit of $86,000 payable with respect to N is required to be made. Therefore, the plan may pay annual benefits of $86,000 to N, even though N retires and is eligible to receive benefits before age 55.

[T.D. 7748, 46 FR 1703, Jan. 7, 1981]

§ 1.415–5 Cost of living adjustments for defined benefit plans.

(a) *Dollar limitation*—(1) *In general.* Under section 415(d)(1)(A), the dollar limitation described in section 415(b)(1)(A) applicable to defined benefit plans for limitation years to which section 415 applies is adjusted annually to take into account increases in the cost of living. The adjustment of the dollar limitation is made by multiplying an annual adjustment factor by $75,000. For purposes of this paragraph, the annual adjustment factor is to be determined by the Commissioner.

(2) *Effective date of adjustment.* The adjusted dollar limitation applicable to defined benefit plans is effective as of January 1 of each calendar year and applies with respect to limitation years ending with or within that calendar year.

(3) *Application of adjusted figure.* The adjusted dollar limitation is applicable to employees who are participants in a defined benefit plan and to employees who have retired or otherwise terminated their service under the plan with a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive such benefits. However, for purposes of this subparagraph, the annual benefit payable to a terminated participant, which is otherwise limited by the dollar limitation, may only be increased in accordance with cost-of-living adjustments of the dollar limitation if the plan specifically provides for such post-retirement adjustments.

(b) *Average compensation for high 3 years of service limitation*—(1) *In general.* Under section 415(d)(1)(C), with regard to participants who have separated from service with a nonforfeitable right to an accrued benefit, the compensation limitation described in section 415(b)(1)(B) applicable to limitation years to which section 415 applies may be adjusted annually to take into account increases in the cost of living. For any limitation year beginning after the separation occurs, the adjustment of the compensation limitation is made by multiplying the annual adjustment factor (as defined in paragraph (b)(2) of this section) by the compensation limitation applicable to the participant in the limitation year he separated from the service of the employer. In the case of a participant who has separated from service prior to the first limitation year to which section 415 applies, the cost-of-living adjustment of the compensation limitation under this paragraph for all limitation years prior to the effective date of section 415 is to be determined as provided by the Commissioner. For purposes of the adjustment described in this subparagraph, the annual benefit payable to a terminated participant, which is otherwise limited by the compensation limitation, may only be increased in accordance with cost-of-living adjustments of the compensation limitation if the plan specifically provides for such post-retirement adjustments.

(2) *Annual adjustment factor for compensation limitation.* For any limitation year beginning after the separation occurs, the annual adjustment factor is a fraction, the numerator of which is the adjusted dollar limitation for the limitation year in which the compensation limitation is being adjusted and the denominator of which is the adjusted dollar limitation for the limitation year in which the participant separated from service. In determining the adjusted dollar limitation for purposes of computing the annual adjustment factor under this subparagraph, the rule provided in paragraph (a)(2) of this section (relating to the effective date of the adjusted dollar limitation) shall be applicable.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. X is a participant in a qualified defined benefit plan maintained by his employer. The plan has a calendar year limitation year. Under the terms of the plan, X is entitled to a benefit consisting of a straight life annuity equal to 100 percent of X's compensation for his high 3 years of service. X's average compensation for his high 3 years is

$20,000. X separates from the service of his employer on October 3, 1980, with a nonforfeitable right to his accrued benefit, and begins to receive benefit payments on November 1, 1980. Assume that the adjusted dollar limitation for 1980 is $100,000 and that the adjusted dollar limitation for 1981 is $110,000. For the limitation year beginning January 1, 1981 (the first limitation year beginning after X separates from service), the compensation limitation applicable to X may be adjusted for cost of living increases by multiplying the annual adjustment factor by $20,000. The annual adjustment factor for this limitation year is a fraction, the numerator of which is $110,000 (the adjusted dollar limitation for the limitation year in which the compensation limitation is being adjusted) and the denominator of which is $100,000 (the adjusted dollar limitation for the limitation year in which X separates from service). Thus, for the limitation year beginning January 1, 1981, if the plan provides for post-retirement cost of living adjustments, X's maximum annual benefit could be increased to $22,000 ($110,000/$100,000×$20,000).

(c) *Automatic cost of living adjustments of dollar limitation*—(1) *General rule.* A defined benefit plan may include a provision which provides for an annual automatic cost-of-living adjustment of the dollar limitation described in section 415(b)(1)(A) in accordance with paragraph (a) of this section. However, the provision may only provide for scheduled annual increases in the dollar limitation which become effective no sooner than the date determined in accordance with paragraph (a)(2) of this section.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Plan A is a defined benefit plan. Effective January 1, 1976, the plan was amended to limit all participants' annual plan benefits, determined on a straight life annuity basis, to $75,000. The amendment also provides that, ''as of January 1 of each calendar year, the dollar limitation as determined by the Commissioner of Internal Revenue for that calendar year will become effective as the Maximum Permissible Dollar Amount of the plan for that calendar year. The Maximum Permissible Dollar Amount for a calendar year applies to limitation years ending with or within that calendar year.'' The amendment providing for an automatic cost-of-living adjustment of the dollar limitation of Plan A is an example of a provision which satisfies the requirements of subparagraph (1) of this paragraph.

[T.D. 7748, 46 FR 1704, Jan. 7, 1981]

§ 1.415–6 Limitation for defined contribution plans.

(a) *General rules*—(1) *Maximum limitations.* Under section 415(c) and this section, to satisfy the provisions of section 415(a) for any limitation year, the annual additions (as defined in paragraph (b) of this section credited to the account of a participant in a defined contribution plan (as defined in section 414(i))) for the limitation year may not exceed the lesser of—

(i) $25,000, or

(ii) 25 percent of the participant's compensation (as defined in subparagraph (3) of this paragraph) for the limitation year.

(2) *Adjustment to dollar limitation.* The dollar limitation described in section 415(c)(1)(A) and subparagraph (1)(i) of this paragraph is adjusted for cost of living increases under section 415(d) and paragraph (d) of this section. The adjusted figure is effective as of January 1 of each calendar year and applies to limitation years that end during that calendar year.

(3) *Participant's compensation.* For purposes of this section, the term ''participant's compensation'' for any limitation year has the same meaning as set forth in §1.415–2(d). The term ''participant's compensation'' includes all compensation actually paid or made available to the individual for the entire limitation year even though the individual may not have been a participant for the entire limitation year.

(4) *Section 403(b) annuity contracts.* For special rules with respect to section 403(b) annuity contracts purchased by educational organizations, hospitals and home health service agencies, see paragrpah (e) of this section.

(b) *Annual additions*—(1) *In general*—(i) *Limitation years beginning after December 31, 1986.* For limitation years beginning after December 31, 1986, or such later date provided in paragraph (b)(1)(iii) of this section, the term ''annual addition'' means, for purposes of this section, the sum, credited to a participant's account for any limitation year, of:

(A) Employer contributions;

(B) Employee contributions; and

(C) Forfeitures.

Contributions do not fail to be annual additions merely because they are excess deferrals, excess contributions, or excess aggregate contributions or merely because excess contributions or excess aggregate contributions are corrected through distribution or recharacterization. Excess deferrals that are distributed in accordance with §1.402(g)–1(e) (2) or (3) are not annual additions.

(ii) *Limitation years beginning before January 1, 1987.* For limitation years beginning before January 1, 1987, or such later date provided in paragraph (b)(1)(iii) of this section, the term ''annual addition'' means, for purposes of this section, the sum, credited to a participant's account for any limitation year, of:

(A) Employer contributions;

(B) The lesser of the amount of employee contributions in excess of 6 percent of compensation (as defined in paragraph (a)(3) of this section) for the limitation year, or one-half of the employee contributions for that year; and

(C) Forfeitures.

(iii) *Certain collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, for contributions or benefits pursuant to a collective bargaining agreement, the date specified in this paragraph is:

(A) September 31, 1991, in the case of paragraph (b)(1)(i) of this section; and

(B) October 1, 1991, in the case of paragraph (b)(1)(ii) of this section.

(2) *Employer contributions.* (i) For purposes of paragraph (b)(1)(i) of this section, the term ''annual additions'' includes employer contributions which are made under the plan. Furthermore, the Commissioner may in an appropriate case, considering all of the facts and circumstances treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

(ii) If, in a particular limitation year, an employer contributes an amount to a participant's account because of an erroneous forfeiture in a prior limitation year, or because of an erroneous failure to allocate amounts in a prior limitation year, the contribution will not be considered an annual addition with respect to the participant for that particular limitation year, but will be considered an annual addition for the limitation year to which it relates. An example of a situation in which an employer contribution might occur under the circumstances described in the preceding sentence is a retroactive crediting of service for an employee under 29 CFR 2530.200(b)–2(a)(3) (regulations promulgated by the Department of Labor) in accordance with an award of back pay. For purposes of this subdivision, if the amount so contributed in the particular limitation year takes into account actual investment gains attributable to the period subsequent to the year to which the contribution relates, the portion of the total contribution which consists of such gains is not considered as an annual addition for any limitation year. The rule described in this subdivision is only applicable for purposes of applying the limitations of section 415.

(iii) The restoration of an employee's accrued benefits by the employer in accordance with section 411(a)(3)(D) or section 411(a)(7)(C) will not be considered an annual addition for the limitation year in which the restoration occurs. (See §1.411(a)–7(d)(6)(iii)(B).)

(iv) The transfer of funds from one qualified plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.

(v) In the case of a defined contribution plan (such as a money purchase pension plan) to which an employer makes a contribution in order to reduce an accumulated funding deficiency (as defined in section 412(a)), the contribution will be considered an annual addition for the limitation year when the contribution was otherwise required to have been made. The special rule provided in the preceding sentence is available however, only if the contribution is allocated to those participants who would have received an addition if the contribution had been timely made. For purposes of determining the amount of the annual addition under this subdivision, any reasonable amount of interest paid by the employer is disregarded. However, any

interest paid by the employer that is in excess of a reasonable amount, as determined by the Commissioner, is taken into account as an annual addition for the limitation year when the contribution was otherwise required to have been made.

(vi) In the case of a defined contribution plan (such as a money purchase pension plan) for which there has been a waiver of the minimum funding standard in a prior limitation year in accordance with section 412(d), that portion of an employer contribution in a subsequent limitation year which, if not for the waiver, would have otherwise been required in the prior limitation year under section 412(a) will be considered an annual addition for the prior limitation year. For purposes of determining the amount of such annual addition for the prior limitation year, any reasonable amount of interest paid by the employer in addition to the actual make-up contribution is disregarded. However, any interest paid by the employer that is in excess of a reasonable amount, as determined by the Commissioner, is taken into account as an annual addition for the prior limitation year.

(3) *Employee contributions.* For purposes of paragraph (b)(1)(ii) of this section, the term ''annual additions'' includes, to the extent employee contributions would otherwise be taken into account under this section as an annual addition, mandatory employee contributions (as defined in section 411(c)(2)(C) and the regulations thereunder) as well as voluntary employee contributions. The term ''annual additions'' does not include—

(i) Rollover contributions (as defined in section 402(a)(5), 403(a)(4), 408(d)(3) and 409(b)(3)(C)),

(ii) Repayments of loans made to a participant from the plan,

(iii) Repayments of amounts described in section 411(a)(7)(B) (in accordance with section 411(a)(7)(C)) and section 411(a)(3)(D) (see §1.411(a)–7(d)(6)(iii)(B)),

The direct transfer of employee contributions from one qualified plan to another.

However, the Commissioner may in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employee or certain allocations to participants' accounts as giving rise to annual additions.

(4) *Contributions other than cash.* For purposes of this paragraph, a contribution by the employer or employee of property other than cash will be considered to be a contribution in an amount equal to the fair market value (as defined in §20.2031–1 of the Estate Tax Regulations) of the property on the date the contribution is made. The contribution described in this subparagraph may, however, constitute a prohibited transaction within the meaning of section 4975(c)(1).

(5) *Forfeitures.* With respect to a particular limitation year, forfeitures (as well as any income attributable to the forfeiture) will be considered to be an annual addition to the plan if such forfeitures are allocated to the account of the participant as of any day within that limitation year.

(6) *Excess annual additions.* If, as a result of the allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, a reasonable error in determining the amount of elective deferrals (within the meaning of section 402(g)(3)) that may be made with respect to any individual under the limits of section 415, or under other limited facts and circumstances that the Commissioner finds justify the availability of the rules set forth in this paragraph (b)(6), the annual additions under the terms of a plan for a particular participant would cause the limitations of section 415 applicable to that participant for the limitation year to be exceeded, the excess amounts shall not be deemed annual additions in that limitation year if they are treated in accordance with any one of the following:

(i) The excess amounts in the participant's account must be allocated and reallocated to other participants in the plan. However, if the allocation or reallocation of the excess amounts pursuant to the provisions of the plan causes the limitations of section 415 to be exceeded with respect to each plan participant for the limitation year, then these amounts must be held unallocated in a suspense account. If a suspense account is in existence at any

time during a particular limitation year, other than the limitation year described in the preceding sentence, all amounts in the suspense account must be allocated and reallocated to participants' accounts (subject to the limitations of section 415) before any employer contributions and employee contributions which would constitute annual additions may be made to the plan for that limitation year.

(ii) The excess amounts in the paticipant's account must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for that participant if that participant is covered by the plan of the employer as of the end of the limitation year. However, if that participant is not covered by the plan of the employer as of the end of the limitation year, then the excess amounts must be held unallocated in a suspense account for the limitation year and allocated and reallocated in the next limitation year to all of the remaining participants in the plan in accordance with the rules set forth in paragraph (b)(6)(i) of this section. Furthermore, the excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all of the remaining participants in the plan. For purposes of this subdivision, excess amounts may not be distributed to participants or former participants.

(iii) The excess amounts in the participant's account must be held unallocated in a suspense account for the limitation year and allocated and reallocated in the next limitation year to all of the participants in the plan in accordance with the rules provided in paragraph (b)(6)(i) of this section. The excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all of the participants in the plan. For purposes of this subdivision, excess amounts may not be distributed to participants or former participants.

(iv) Notwithstanding paragraph (b)(6)(i), (ii), or (iii) of this section, the plan may provide for the distribution of elective deferrals (within the meaning of section 402(g)(3)) or the return of employee contributions (whether voluntary or mandatory), and for the distribution of gains attributable to those elective deferrals and employee contributions, to the extent that the distribution or return would reduce the excess amounts in the participant's account. These distributed or returned amounts are disregarded for purposes of section 402(g), the actual deferral percentage test of section 401(k)(3), and the actual contribution percentage test of section 401(m)(2). However, the return of mandatory employee contributions may result in discrimination in favor of highly compensated employees. If the plan does not provide for the return of gains attributable to the returned employee contributions, such earnings will be considered as an employee contribution for the limitation year in which the returned contribution was made. For limitation years beginning after December 31, 1995, if a plan does not provide for the distribution of gains attributable to the distributed elective deferrals, such earnings will be considered as an employer contribution for the limitation year in which the distributed elective deferral was made. If a suspense account is in existence at any time during the limitation year in accordance with this subparagraph, investment gains and losses and other income may, but need not, be allocated to the suspense account. To the extent that investment gains or other income or investment losses are allocated to the suspense account, the entire amount allocated to participants from the suspense account, including any such gains or other income or less any such losses, is considered as the annual addition. See §1.401(a)–2(b) for provisions relating to the disposition of a suspense account in existence upon termination of a plan.

(7) *Time when annual additions credited.* (i) For purposes of this paragraph, an annual addition is credited to the account of a participant for a particular limitation year if it is allocated to the participant's account under the terms of the plan as of any date within that limitation year. However, an amount is not deemed allocated as of any date within a limitation year if

such allocation is dependent upon participation in the plan as of any date subsequent to such date.

(ii) For purposes of this subparagraph, employer contributions shall not be deemed credited to a participant's account for a particular limitation year, unless the contributions are actually made to the plan no later than 30 days after the end of the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. If, however, contributions are made by an employer exempt from Federal income tax under section 501(a), the contributions must be made to the plan no later than the 15th day of the sixth calendar month following the close of the taxable year (or fiscal year, if no taxable year) with or within which the particular limitation year ends.

(iii) For purposes of this subparagraph, employee contributions, whether voluntary or mandatory, shall not be deemed credited to a participant's account for a particular limitation year, unless the contributions are actually made to the plan no later than 30 days after the close of that limitation year. However, in the case of employee contributions to an employee stock ownership plan which meets the requirements of either section 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38, §1.46–7) and the regulations thereunder (§1.46–8) or section 409A and the regulations thereunder, such contributions shall be deemed credited to a participant's account in the limitation year for which the contribution is allocated to that account under the terms of the plan, provided that the contributions, or pledges to make the contributions, are actually made no later than the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends.

(iv) For purposes of this paragraph, amounts contributed to an individual retirement plan (as described in section 7701(a)(37)) are treated as allocated to the individual's account as of the last day of the limitation year ending with or within the taxable year for which the contribution is made.

(c) *Examples*. The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). P is a participant in a qualified profit-sharing plan maintained by his employer, ABC Corporation. The limitation year for the plan is the calendar year. P's compensation (as defined in paragraph (a)(3) of this section) for the current limitation year is $20,000 consisting exclusively of salary. Because the compensation limitation described in section 415(c)(1)(B) applicable to P for the current limitation year is lower than the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost of living increases), the maximum annual addition which can be allocated to P's account for the current limitation year is $5,000 (25 percent of $20,000).

Example (2). Assume the same facts as in Example (1), except that P's compensation for the current limitation year is $140,000. The maximum amount of annual additions that may be allocated to P's account in the current limitation year may not exceed the lesser of $35,000 (25 percent of $140,000) or the dollar limitation as in effect as of January 1 of the calendar year in which the current limitation year ends.

Example (3). Assume the same facts as in Example (1), except that P's compensation for the current limitation year consists of $20,000 salary and a bonus which is paid to P after the end of the current limitation year. Because the bonus was not actually paid or made available to P within the current limitation year, P's compensation for that year, for purposes of computing the compensation limitation described in section 415(c)(1)(B), may not include the bonus. However, if ABC Corporation had elected under §1.415–2(d)(4) to use the compensation accrued for the current limitation year, then the amount of the bonus which accrued within the current limitation year could have been taken into account.

Example (4). Employer N maintains a qualified profit-sharing plan which uses the calendar year as its plan year and its limitation year. N's taxable year is a fiscal year beginning June 1 and ending May 31. Under the terms of the profit-sharing plan maintained by N, employer contributions are made to the plan two months after the close of N's taxable year and are allocated as of the last day of the plan year ending within the taxable year. Thus, employer contributions for the 1977 calendar year limitation year are made on July 31, 1978 (the date that is two months after the close of N's taxable year ending May 31, 1978) and are allocated as of December 31, 1977. Because the employer contributions are actually made to the plan no later than 30 days after the end of the period described in section 404(a)(6) with respect to

N's taxable year ending May 31, 1978, the contributions will be considered annual additions for the 1977 calendar year limitation year.

Example (5). Assume the same facts as in example (4), except that the plan year for the profit-sharing plan maintained by N is the 12-month period beginning on March 1 and ending on February 28. Under the terms of the plan, an employer contribution which is made to the plan on July 31, 1978, is allocated to participants' accounts as of February 28, 1978. Because the last day of the plan year is in the 1978 calendar year limitation year, and because, under the terms of the plan, employer contributions are allocated to participants' accounts as of the last day of the plan year, the contributions are considered annual additions for the 1978 calendar year limitation year.

Example (6). XYZ Corporation maintains a profit-sharing plan to which a participant may make voluntary employee contributions for any year not to exceed 10 percent of the participant's compensation for the year. The plan permits a participant to make retroactive make-up contributions for any year for which he contributed less than 10 percent of compensation. XYZ uses the calendar year as the plan year and the limitation year. Under the terms of the plan, voluntary employee contributions are credited to a participant's account for a particular limitation year if such contributions are allocated to the participant's account as of any date within that limitation year. Participant A's compensation is as follows:

Limitation year and compensation

1976	$10,000
1977	$12,000
1978	$14,000
1979	$16,000

Participant A makes no voluntary employee contributions during limitation years 1976, 1977 and 1978. On October 1, 1979, participant A makes a voluntary employee contribution of $5,200 (10 percent of A's aggregate compensation for limitation years 1976, 1977, 1978 and 1979 of $52,000). Under the terms of the plan, $1,000 of this 1979 contribution is allocated to A's account as of limitation year 1976; $1,200 is allocated to A's account of limitation year 1977; $1,400 is allocated to A's account as of limitation year 1978, and $1,600 is allocated to A's account as of limitation year 1979. However, under the rule set forth in paragraph (b)(7)(iii) of this section, employee contributions will not be considered credited to a participant's account for a particular limitation year for section 415 purposes unless the contributions are actually made to the plan no later than 30 days after the close of that limitation year. Thus, A's voluntary employee contribution of $5,200 made on October 1, 1979 would be considered as credited to A's account only for the 1979 calendar year limitation year, notwithstanding the plan provisions. (See section 415(c)(2)(B) and paragraph (b)(1)(ii) of this section for provisions relating to the amount of A's contribution that would be considered an annual addition to A's account for the 1979 calendar year limitation year.)

(d) *Cost-of-living adjustment for defined contribution plans*—(1) *In general.* Under section 415(d)(1)(B), the dollar limitation described in section 415(c)(1)(A) applicable to limitation years to which section 415 applies is adjusted annually to take into account increases in the cost of living. See §1.415–5(a) for the procedure for making this adjustment and the effective date of the adjusted dollar limitation.

(2) *Automatic adjustments with respect to dollar limitation.* A defined contribution plan may include a provision which provides for an annual automatic cost of living adjustment of the dollar limitation described in section 415(c)(1)(A).

(e) *Special election for section 403(b) contracts purchased by educational organizations, hospitals and home health service agencies*—(1) *In general.* (i) An annuity contract described in section 403(b) is treated as a defined contribution plan for purposes of the limitations on contributions imposed by section 415. Thus, section 403(b) annuity contracts are subject to the rules regarding the amount of annual additions which may be made to a participant's account for any limitation year under section 415(C)(1) and paragraph (a)(1) of this section. Section 403(b) annuity contracts are also subject to the limitations imposed by section 403(b)(2)(A) with respect to the amount of employer contributions for the purchase of an annuity contract that may be excluded from the gross income of the employee on whose behalf the annuity contract is purchased. Therefore, unless a special election has been made as described in section 415(c)(4) and subparagraph (2) of this paragraph, the excludable amount of a contribution toward the purchase of a section 403(b) annuity contract for a particular taxable year is the lesser of the exclusion allowance computed under section 403(b)(2)(A) for that taxable year or the limitation imposed by section 415(c)(1)

for the limitation year ending with or within that taxable year.

(ii) If the amount of contributions for an individual under a section 403(b) annuity contract for a taxable year exceeds the limitation of section 415(c)(1), then for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years, the excess contribution is considered as an amount contributed by the employer for an annuity contract which was excludable from the employee's gross income for a prior taxable year under section 403(b)(2)(A)(ii). Thus, for future taxable years the exclusion allowance under section 403(b)(2)(A) is reduced by the amount of the excess contribution even though that amount was not excludable from the employee's gross income in the taxable year when it was made. For a special effective date for the rule provided in this subdivision, see §1.415–1(f)(6).

(iii) For purposes of the limitation imposed by section 415(c)(1), the amount contributed toward the purchase of a section 403(b) annuity contact is treated as allocated to the employee's account as of the last day of the limitation year ending with or within the taxable year during which the contribution is made.

(iv) For rules relating to the limitation year applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased, see §1.415–2(b)(7).

(2) *Alternative limitations.* (i) Under section 415(c)(4) and this paragraph, a special election is permitted with respect to section 403(b) annuity contracts (including custodial accounts treated as section 403(b) annuity contracts) purchased by educational organizations (as described in section 170(b)(1)(A)(ii)), home health service agencies (as described in paragraph (e)(2)(vi) of this section) and hospitals. Instead of the compensation limitation described in section 415(c)(1)(B) otherwise applicable to the amount of annual additions that may be made to the account of a participant in a defined contribution plan in any limitation year, an individual on whose behalf a section 403(b) annuity contract has been purchased may elect to have substituted for such limitation the amounts described in subparagraph (3) (''(A) election limitation'') or (4) (''(B) election limitation'') of this paragraph. Instead of the exclusion allowance determined under section 403(b)(2)(A) otherwise applicable for the taxable year with or within which the limitation year ends to an individual on whose behalf a section 403(b) annuity contract has been purchased, an individual may elect to have substituted for such exclusion allowance the amount described in paragraph (e)(5) (''(C) election limitation'') of this section. The election shall be made at the time and in the manner prescribed in subparagraph (6) of this paragraph.

(ii) With respect to any limitation or taxable year, an election by an individual to have any one of the alternative limitations described in paragraph (e) (3), (4) or (5) of this section apply to contributions made on his behalf by the employer with respect to any section 403(b) annuity contract precludes an election to have any other of the alternative limitations apply for any future limitation or taxable year with respect to any section 403(b) annuity contract purchased by any employer of such individual.

(iii) With respect to any limitation year, an election by an individual to have paragraph (e)(3) of this section (''(A) election limitation'') apply to contributions made on his behalf by the employer with respect to any section 403(b) annuity contract precludes an election to have any of the alternative limitations apply for any future limitation or taxable year with respect to any section 403(b) annuity contract purchased by any employer of such individual.

(iv) Any election made under this paragraph is irrevocable.

(v) The election made by the individual under this paragraph shall be controlling for all prior taxable years in which, in accordance with §11.415(c)(4)–1(b), the individual had taken advantage of an alternative limitation, even if inconsistent with the alternative limitation used in determining income tax liability for those taxable years under that section. An individual, who took advantage of an alternative limitation under §11.415(c)(4)–1(b) which is inconsistent

with the one finally elected, may correct this inconsistency for each prior open taxable year in either of two ways. The individual may redetermine income tax liability as though none of the alternative limitations applied for that taxable year. Alternatively, the individual may recompute income tax liability for the particular taxable year in a manner consistent with the alternative limitation elected by the individual under this paragraph rather than the limitation originally used in accordance with §11.415(c)(4)–1(b). Furthermore, if an individual, who had taken advantage of an alternative limitation in prior taxable years under §11.415(c)(4)–1(b), elects under this paragraph not to have any of the alternative limitations apply, the individual, will, nevertheless, be considered to have elected the alternative limitation used under §11.415(c)(4)–1(b). However, the rule described in the preceding sentence is not applicable if the individual recomputes income tax liability for all prior open taxable years in which an alternate limitation was taken advantage of under §11.415(c)(4)–1(b) as though none of the alternative limitations applied for those taxable years. For purposes of section 6654 (relating to the failure of an individual to pay estimated tax), a difference in tax for such years resulting from a difference in these limitations is not treated as an underpayment. This rule only applies to the extent the difference in tax is due to the election of one of the alternative limitations or to a final election not to use one of the alternative limitations.

(vi) For purposes of this paragraph, a home health service agency is an organization described in section 501(c)(3) which is exempt from tax under section 501(a) and which has been determined by the Secretary of Health, Education and Welfare to be a home health service agency under section 1395x(o) of Title 42 of the United States Code.

(3) ''*(A) election limitation.*'' For the limitation year that ends with or within the taxable year in which an individual eligible to make a special election separates from the service of his employer (and only for that limitation year), the ''(A) election limitation'' is the exclusion allowance computed under section 403(b)(2)(A) for the individual's taxable year in which the separation occurs (without regard to section 415). However, in determining this limitation, there may only be taken into account the individual's years of service for the employer (as defined in section 403(b)(4) and the regulations thereunder) and contributions made by the employer (as described in section 403(b)(2)(A)(ii) and regulations thereunder) during the period of years (not exceeding 10) ending on the date of separation. For purposes of this subparagraph, all service for the employer performed within the period beginning ten years before the date of separation and ending on the separation date must be taken into account. However, the ''(A) election limitation'' may not exceed the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section) applicable to the individual for the limitation year.

(4) ''*(B) election limitation.*'' For any limitation year with respect to an individual eligible to make a special election, the ''(B) election limitation'' is equal to the least of the following amounts—

(i) $4,000, plus 25 percent of the participant's includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for the taxable year with or within which the limitation year ends.

(ii) The amount of the exclusion allowance determined under section 403(b)(2)(A) and the regulations thereunder for the taxable year with or within which the limitation year ends.

(iii) $15,000.

(5) ''*(C) election limitation.*'' For any taxable year with respect to an individual eligible to make a special election, the ''(C) election limitation'' is the lesser of the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section) or the compensation limitation described in section 415(c)(1)(B) applicable to the individual for the limitation year ending with or within that taxable year. For purposes of determining the compensation limitation under this subparagraph for a

particular limitation year, the term ''compensation'' has the same meaning as set forth in § 1.415–2(d).

(6) *Time and method of making election.* (i) With respect to any taxable year, an election by an individual to take advantage of any of the alternative limitations described in subparagraphs (3), (4) or (5) of this paragraph is made by determining income tax liability for that taxable year in a way which is consistent with one of the alternative limitations. However, an individual is only considered to have made an election for a taxable year when the use of one of the alternative limitations is necessary to support the exclusion from gross income reflected in the individual's income tax return for that taxable year.

(ii) In the case of an individual who, in accordance with § 11.415(c)(4)–1(b), took advantage of one of the alternative limitations for prior taxable years, the election described in this paragraph to take advantage of an alternative limitation will be effective only if the following two conditions are satisfied. The first condition is that the election must be made (in the manner described in subdivision (i) of this subparagraph) in the individual's income tax return for the taxable year immediately following the taxable year in which final regulations under section 415 are published in the FEDERAL REGISTER. The second condition is that if the individual's election is different from the limitation used under § 11.415(c)(4)–1(b) in determining income tax liability for prior taxable years, the individual must correct this inconsistency by recomputing income tax liability for all such prior open taxable years in accordance with paragraph (e)(2)(v) of this section. See paragraph (e)(2)(v) of this section for rules relating to an individual who had taken advantage of an alternative limitation in prior taxable years under § 11.415(c)(4)–1(b) but does not elect any of the alternative limitations for the taxable year immediately following the taxable yar in which final regulations under section 415 are published in the FEDERAL REGISTER.

(iii) This subdivision provides a special rule for those individuals who, in accordance with § 11.415(c)(4)–1(b), took advantage of one of the alternative limitations for prior taxable years, but who are not participating in a section 403(b) annuity program in the taxable year following the taxable year in which final regulations under section 415 are published in the FEDERAL REGISTER. In such a situation, the election described in this paragraph to take advantage of an alternative limitation (or, alternatively, not to elect any of the alternative limitations) is made by the individual by attaching a statement to the income tax return for the taxable year following the taxable year in which final section 415 regulations are published in the FEDERAL REGISTER. The statement must include the individual's name, address, Social Security number, the name of the section 403(b) annuity program in which the individual participated and a statement indicating the election being made. See paragraph (e)(2)(v) of this section for rules relating to the situation where the individual described in this subdivision chooses not to elect any of the alternative limitations.

(7) *Examples:* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Doctor M is an employee of H Hospital (an organization described in section 501(c)(3) and exempt from taxation under section 501(a)) for the entire 1976 calendar year. M is not in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h). M uses the calendar year as the taxable year and limitation year. M has includable compensation (as defined in section 403(b)(3) and the regulations thereunder) and compensation (as defined in paragraph (a)(3) of this section) for taxable year 1976 of $30,000, and M has 4 years of service (as defined in § 1.403(b)–1(f)) with H as of December 31, 1976. During M's prior service with H, H had contributed a total of $12,000 on M's behalf for annuity contracts described in section 403(b), which amount was excludable from M's gross income for such prior years. Thus, for the limitation year ending with or within taxable year 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $12,000 ((.20 × $30,000 4) — $12,000). The limitation imposed by section 415(c)(1) that is applicable to M for limitation year 1976 is the lesser of $26,825 (the amount described in section 415(c)(1)(A) adjusted under section 415(d)(1)(b) for limitation year 1976) or $7,500 (the amount described in section 415(c)(1)(B)). Absent the special elections provided in section

415(c)(4) and this paragraph, $7,500 would be the maximum contribution H could make for annuity contracts described in section 403(b) on M's behalf for limitation year 1976 without increasing M's gross income for taxable year 1976. However, because H is an organization described in section 415(c)(4), M may make a special election with respect to amounts contributed by H on M's behalf for section 403(b) annuity contracts for 1976. Assume that M does not separate from the service of H during 1976 and that, therefore, the ''(A) election limitation'' described in section 415(c)(4)(A) and subparagraph (3) of this paragraph is not available to M. If M elects the ''(B) election limitation'' for 1976, H could contribute $11,500 on M's behalf for annuity contracts described in section 403(b) for that year (the least of $11,500 (the amount described in section 415(c)(4)(B)(i))); $12,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii)). If M elects the ''(C) election limitation'' for 1976, H could only contribute up to $7,500 (the lower of the amounts described in section 415(c)(1)(A) or (B)) for section 403(b) annuity contracts on M's behalf for 1976 without increasing M's gross income for that year.

Example (2). Assume the same facts as in example (1) except that H had contributed a total of $18,000 on M's behalf for annuity contracts in prior years, which amount was excludable from M's gross income for such prior years. Accordingly, for 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $6,000 ((.20 × $30,000 × 4)—$18,000). The limitation imposed by section 415(c)(1) applicable to M for 1976 is $7,500 (the lesser of the amount described in section 415(c)(1) (A) or (B)). Absent the special elections provided in section 415(c)(4) and this paragraph, $6,000 would be the maximum amount H could contribute for annuity contracts described in section 403(b) on M's behalf for 1976 without increasing M's gross income for that year. However, if M elects the ''(c) election limitations'' for 1976, H may contribute up to $7,500 without increasing M's gross income for that year.

Example (3). G, a teacher, is an employee of E, an educational organization described in section 170(b)(1)(A)(ii). G uses the calendar year as the taxable year and G uses the 12-month consecutive period beginning July 1 as the limitation year. G has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for taxable year 1976 of $12,000 and G has compensation (as defined in paragraph (a)(3) of this section) for the limitation year ending with or within taxable year 1976 of $12,000. G has 20 years of service (as defined in §1.403(b)–1(f)) as of May 30, 1976, the date G separates from the service of E. During G's service with E before taxable year 1976, E had contributed $34,000 toward the purchase of a section 403(b) annuity contract on G's behalf, which amount was excludable from G's gross income for such prior years. Of this amount, $19,000 was so contributed and excluded during the 10 year period ending on May 30, 1976. For the taxable year 1976, G's exclusion allowance determined under section 403(b)(2)(A) is $14,000 ((.20 × $12,000 × 20) — $34,000). Absent the special elections described in section 415(c)(4) and this paragraph, $3,000 (the lesser of G's exclusion allowance for taxable year 1976 or the section 415(c)(1) limitation applicable to G for the limitation year ending with or within such taxable year) would be the maximum excludable contribution E could make for section 403(b) annuity contracts on G's behalf for the limitation year ending with or within taxable year 1976. However, because E is an organization described in section 415(c)(4), G may make a special election with respect to amounts contributed on G's behalf by E for section 403(b) annuity contracts for the limitation year ending with or within taxable year 1976.

Because G has separated from the service of E during such taxable year, G may elect the ''(A) election limitation'' as well as the ''(B) election limitation'' or the ''(C) election limitation.'' If G elects the ''(A) election limitation'' for the limitation year ending with or within taxable year 1976, E could contribute up to $5,000 ((.20 × $12,000 × 10) −$19,000) on G's behalf for section 403(b) annuity contracts for such limitation year without increasing G's gross income for the taxable year with or within which such limtation year ends. If G elects the ''(B) election limitation'' for such limitation year, E could contribute $7,000 (the least of $7,000 (the amount described in section 415(c)(4)(B)(i)); $14,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii)). If G elects the ''(C) election limitation'' for taxable year 1976, E could contribute $3,000 (the lesser of the amounts described in section 415(c)(1) (A) or (B)).

(f) *Special rules with respect to the application of section 415(c)(1)(B) with section 404(e)(4).* For special rules relating to the application of the compensation limitation described in section 415(c)(1)(B) with the minimum allowable deduction described in section 404(e)(4) in the case of a plan which provides contributions for employees, some or all of whom are employees within the meaning of section 401(c)(1), see the regulations under section 404(e).

(g) *Special rules for employee stock ownership plans*—(1) *General definitions.* For purposes of this paragraph—(i) An employee stock ownership plan is a

plan which meets the requirements of either section 4975(e)(7) and the regulations thereunder, or whichever of the following is applicable: section 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38, 26 CFR 1.46–7) and the regulations thereunder (26 CFR 1.46–8) or section 409A and the regulations thereunder.

(ii) The term ''employer securities'' means, in the case of an employee stock ownership plan within the meaning of section 4975(e)(7) and the regulations thereunder, qualifying employer securities within the meaning of section 4975(e)(8), that are also described in section 301(d)(9)(A) of the Tax Reduction Act of 1975 and the regulations thereunder or section 409A(l) and the regulations thereunder, whichever is applicable. In the case of an employee stock ownership plan described in section 301(d)(2) of the Tax Reductions Act of 1975 or section 409A, whichever is applicable, such term means employer securities within the meaning of section 301(d)(9)(A) of that Act and the regulations thereunder or section 409A(l) and the regulations thereunder, which ever is applicable.

(iii) An individual is considered to own more than 10 percent of the employer's stock if, without regard to stock held under the employee stock ownership plan, the individual owns (after application of section 1563(e), relating to constructive ownership of stock) more than 10 percent of the total combined voting power of all classes of stock entitled to vote or more than 10 percent of the total value of shares of all classes of stock.

(2) *Special dollar limitation*. In the case of an employee stock ownership plan which meets the requirements of paragraph (g)(3) of this section, the applicable dollar limitation for a limitation year equals the sum of—

(i) The dollar amount described in section 415(c)(1)(A) (as so adjusted for that limitation year), and

(ii) The lesser of the amount determined under paragraph (g)(2)(i) of this section or the amount of employer securities within the meaning of paragraph (g)(1)(ii) of this section contributed to the employee stock ownership plan.

(3) *Employee stock ownership plans to which the special dollar limitation applies*. For purposes of this paragraph, the special dollar limitation is only applicable to an employee stock ownership plan for a particular limitation year for which no more than one-third of the employer contributions for the limitation year are allocated to employees who are officers, shareholders owning more than 10 percent of the employer's stock (as determined under subparagraph (1)(iii) of this paragraph), or whose compensation for the limitation year exceeds twice the dollar amount described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section).

(4) *Cash contributions treated as contributions of employer securities*. For purposes of the special dollar limitation—

(i) In the case of an employee stock ownership plan in which the employer makes cash contributions which are used in a direct acquisition of employer securities, the cash contributions are treated as a contribution of employer securities for the limitation year, provided that the securities are employer securities within the meaning of paragraph (g)(1)(ii) of this section and are allocated to participants under the terms of the plan as of any date within that limitation year. However, this subdivision is not applicable unless the following two conditions are satisfied. The first condition is that the employer must contribute the cash to the plan no later than 30 days after the end of the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. The second condition is that the employer securities must be purchased no later than 60 days after the end of the period described in the preceding sentence.

(ii) In the case of an employee stock ownership plan to which an exempt loan as described in § 54.4975–7(b) has been made, the employer's contribution of both principal and interest used to repay the exempt loan for the limitation year will be treated as a contribution of employer securities for that limitation year, provided that the securities allocated to participants are employer securities within the meaning of paragraph (g)(1)(ii) of this section.

(5) *Amounts considered as annual additions*. For purposes of applying the limitations of section 415(c)(1) and this section and for the special dollar limitation, in the case of an employee stock ownership plan to which an exempt loan as described in § 54.4975–7(b) has been made, the amount of employer contributions which is considered an annual addition for the limitation year is calculated with respect to employer contributions of both principal and interest used to repay the exempt loan for that limitation year.

(6) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Employee N is a participant in an employee stock ownership plan maintained by his employer, M Corporation, which meets the requirements of section 4975(e)(7) and the regulations thereunder. The plan also meets the requirements set forth in subparagraph (3) of this paragraph. M does not maintain any other qualified plan. The limitation year for the plan is the calendar year. For 1977, N has compensation (as defined in paragraph (a)(3) of this section) of $160,000. Without the special dollar limitation described in subparagraph (2) of this paragraph, under section 415(c)(1), N could only have annual additions of $28,175 (the lesser of the dollar limitation described in section 415(c)(1)(A) as adjusted for cost of living increases ($28,175) or the compensation limitation described in section 415(c)(1)(B) (25% of $160,000=$40,000)) made to his account for the 1977 limitation year. Under the special dollar limitation, N would be able to have annual additions of $56,350 ($28,175×2) made to his account for the 1977 limitation year, provided that amounts contributed in excess of $28,175 consist solely of employer securities. However, N is also subject to the compensation limitation described in section 415(c)(1)(B). Therefore, even under the special dollar limitation, N may only have annual additions of $40,000 made to his account for the 1977 limitation year: *Provided*, That amounts contributed in excess of $28,175 consist solely of employer securities within the meaning of paragraph (g)(1)(ii) of this section.

Example (2). Assume the same facts as in example (1), except that N's compensation for 1977 is $300,000. Because the compensation limitation (25% of $300,000=$75,000) is greater than the special dollar limitation of $56,350, N can have annual additions of $56,350 made to his account for the 1977 limitation year, provided that amounts contributed in excess of $28,175 consist solely of employer securities.

(h) *Special rules for level premium annuity contracts under plans benefiting owner-employees*—(1) *In general*. The compensation limitation described in section 415(c)(1)(B) will not be less than the contribution described in section 401(e) which is made for the benefit of an owner-employee (within the meaning of section 401(c)(3)) for a limitation year provided that—

(i) The annual additions with respect to such owner-employee for the limitation year consist solely of the contributions described in this paragraph, and

(ii) The owner-employee is not a participant at any time during the limitation year in a defined benefit plan maintained by the employer.

(2) *Application of the non-discrimination rules*. In the case of a plan which provides contributions for employees who are not owner-employees, that plan will not be treated as failing to satisfy the non-discrimination rules of section 401(a)(4) merely because contributions made on behalf of employees who are not owner-employees are not permitted to exceed the compensation limitation described in section 415(c)(1)(B).

(3) *Additional rules*. For additional rules concerning contributions described in section 401(e), see § 1.401(e)–4.

[T.D. 7748, 46 FR 1705, Jan. 7, 1981, as amended by T.D. 8357, 56 FR 40549, Aug. 15, 1991; 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66181, Dec. 23, 1994]

§ 1.415–7 Limitation in case of defined benefit and defined contribution plan for same employee.

(a) *Overall limitation*—(1) *In general*. Under section 415(e) and this section, in any case in which an individual has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan maintained by the same employer, to satisfy the provisions of section 415(a), the sum of the defined benefit plan fraction (as defined in paragraph (b) of this section) and the defined contribution plan fraction (as defined in paragraph (c) of this section) with respect to that participant for any limitation year may not exceed 1.4.

(2) *Application of overall limitation to employee stock ownership plan.* An employee stock ownership plan which qualifies for, and takes advantage of, the special dollar limitation provided in section 415(c)(6) and §1.415–6(g) is still subject to the 1.4 limitation of paragraph (a)(1) of this section.

(b) *Defined benefit plan fraction*—(1) *In general.* For purposes of paragraph (a) of this section, the defined benefit plan fraction applicable to a participant for any limitation year is a fraction—

(i) The numerator of which is the projected annual benefit (as defined in subparagraph (3) of this paragraph) of the participant under the plan (determined as of the close of the limitation year), and

(ii) The denominator of which is the projected annual benefit (as defined in subparagraph (3) of this paragraph) of the participant under the plan (determined as of the close of the limitation year) if the plan provided such participant the maximum benefit allowable under §1.415–3.

In the event a participant has participated in more than one defined benefit plan maintained by the employer, the numerator of the defined benefit plan fraction is the sum of the projected annual benefits under all of the defined benefit plans.

(2) *Participants described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974.* For purposes of this paragraph, in the case of a participant described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 987), the defined benefit plan fraction applicable to such participant is deemed not to exceed 1.0 for any limitation year to which section 415 and this section apply.

(3) *Projected annual benefit.* For purposes of this section, a participant's ''projected annual benefit'' is equal to the annual benefit (as defined in §1.415–3(b)(1)(i)) to which a participant in a defined benefit plan would be entitled under the terms of the plan based upon the following assumptions:

(i) The participant will continue employment until reaching normal retirement age as determined under the terms of the plan (or current age, if that is later).

(ii) The participant's compensation for the limitation year under consideration will remain the same until the date the participant attains the age described in subdivision (i) of this subparagraph.

(iii) All other relevant factors used to determine benefits under the plan for the limitation year under consideration will remain constant for all future limitation years.

(c) *Defined contribution plan fraction*—(1) *In general.* For purposes of paragraph (a) of this section, the defined contribution plan fraction applicable to a participant for any limitation year is a fraction—

(i) The numerator of which is the sum of the annual additions to the participant's account as of the close of the limitation year and for all prior limitation years, and

(ii) The denominator of which is the sum of the maximum amount of annual additions which could have been made under section 415(c) §1.1415–6(a) (determined without regard to the special dollar limitation provided for employee stock ownership plans under section 415(c)(6) and §1.415–6(g)) for the limitation year and for each prior limitation year of the participant's service with the employer (regardless of whether a plan was in existence during those years).

For purposes of this paragraph, the term ''annual additions'' has the same meaning as set forth in §1.415–6(b).

(2) *Special rules for certain annuity contracts and individual retirement plans.* (i) Except as provided in subdivision (ii) of this subparagraph, in computing the defined contribution plan fraction applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased, the amount which is included in the denominator of such fraction for a particular limitation year is the maximum amount which could have been contributed under the limitations of section 415(c) and §1.415–6(a) applicable to the individual for the particular limitation year. However, if the individual elects an alternative limitation described in either section 415(c)(4)(A) or section 415(c)(4)(B) for a particular limitation year, the denominator of the fraction for such limitation year is the maximum amount

which could have been contributed under the applicable limitations of section 415(c) and § 1.415–6(a), as modified by the alternative limitation elected.

(ii) This subdivision provides a rule for computing the defined contribution plan fraction with respect to an individual on whose behalf a section 403(b) annuity has been purchased prior to commencing employment with an employer which the individual controls (within the meaning of section 414 (b) or (c), as modified by section 415(h)) and which maintains a defined benefit plan. In this situation, the controlled employer is considered to be maintaining the section 403(b) annuity contract as a defined contribution plan under the rules of paragraph (h)(2)(i) of this section. However, for all years prior to commencing employment with the controlled employer, the individual does not have any years of service (within the meaning of subparagraph (1)(ii) of this paragraph) with that employer. Thus, for each limitation year in which such individual did not have a year of service with the controlled employer, the denominator of the defined contribution plan fraction applicable to the individual is deemed to equal the numerator of that fraction.

(iii) The rules described in this paragraph also apply to an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) has been maintained.

(iv) See paragraph (h)(4) of this section for special rules relating to the aggregation of a section 403(b) annuity contract and a qualified plan.

(d) *Special transitional rules for defined contribution plan fraction.* For purposes of determining the defined contribution plan fraction under paragraph (c) of this section for any limitation year beginning after December 31, 1975, the following rules shall apply with respect to limitation years before the first limitation year to which section 415 and this section apply.

(1) The aggregate amount taken into account under paragraph (c)(1)(i) of this section in determining the numerator of the defined contribution plan fraction is deemed not to exceed the aggregate amount taken into account under paragraph (c)(1)(ii) of this section in determining the denominator of the fraction. Thus, for example, if the aggregate amount of actual annual additions to the plan for all such limitation years is $500,000, while the aggregate amount in the denominator is $250,000, under the rule set forth in this subparagraph, the defined contribution plan fraction is $250,000 divided by $250,000, or 100 percent.

(2) The amount taken into account under section 415(c)(2)(B)(i) for each such limitation year is an amount equal to—

(i) The amount by which the aggregate amount of employee contributions (whether voluntary or mandatory) for all limitation years beginning before January 1, 1976, during which the employee was a participant in the plan exceeds 10 percent of the employee's aggregate compensation from the employer for all such limitation years, divided by

(ii) The number of full limitation years (counting any part of a limitation year as a full limitation year) beginning before January 1, 1976, during which the employee was a participant in the plan. Therefore, for purposes of computing the numerator of a participant's defined contribution plan fraction for limitation years beginning after December 31, 1975, no employee contributions made to the plan before the first limitation year to which section 415 and this section apply are taken into account as annual additions if the aggregate amount of the contributions does not exceed 10 percent of the employee's aggregate compensation from the employer for all limitation years prior to the first such limitation year.

(3) The special transitional rule concerning employee contributions provided for in paragraph (d)(2) of this section does not apply to any employee contributions (whether voluntary or mandatory) made on or after October 2, 1973, to the extent that these contributions exceed the maximum amount of employee contributions permitted under the plan as in effect on October 2, 1973. For purposes of the preceding sentence, plan amendments approved by the Internal Revenue Service before October 2, 1973, and actually put into effect before January 1, 1974, are considered in effect on October 2, 1973.

Therefore, for purposes of computing the numerator of the defined contribution plan fraction for limitation years beginning after December 31, 1975, employee contributions made between October 2, 1973 and prior to the first limitation year to which section 415 and this section apply which exceed the maximum amount the employee was permitted to contribute under the provisions of the plan as in effect on October 2, 1973, are taken into account as annual additions (within the meaning of § 1.415–6(b)(1)(ii)).

(4) For purposes of this paragraph, the participant's aggregate compensation for all years (whichever are applicable under either paragraph (d)(1) or (2) of this section) with the employer before the first limitation year to which section 415 applies equals the product of the participant's compensation during the first limitation year to which section 415 applies times the number of such applicable years. However, this special rule is available only if records necessary for the determination of the participant's aggregate compensation for all such applicable years with the employer before the first limitation year to which section 415 applies are not available.

(e) *Examples*. The provisions of paragraphs (a) through (d) of this section may be illustrated by the following examples:

Example (1). (i) S is an employee of T Corporation and is a participant in both the noncontributory defined benefit plan and noncontributory defined contribution plan maintained by the corporation. S became an employee of T on July 1, 1966. S became a participant in the defined benefit plan maintained by T on January 1, 1968 and he became a participant in the defined contribution plan maintained by T on January 1, 1970. T uses the calendar year as the limitation year for both plans. The current limitation year is 1978. S's compensation (as defined in § 1.415–2(d)) from T is as follows:

Limitation year	Compensation
1966	$3,000
1967	6,000
1968	6,000
1969	8,000
1970	8,000
1971	8,000
1972	9,000
1973	10,000
1974	10,000
1975	11,000
1976	11,000
1977	12,000
1978	12,000

(ii) S's projected annual benefit (as defined in paragraph (b)(3) of this section) as of the close of the current limitation year under the terms of the plan is $9,000. S's compensation for the current limitation year is $12,000. Therefore, the defined benefit plan fraction applicable to S for the current limitation year is .75 or 75 percent (9,000 ÷ 12,000). S's defined contribution compensation limitation (as described in section 415(c)(1)(B)) for the current limitation year is $3,000 (25 percent of $12,000). For all limitation years beginning before January 1, 1978, the maximum aggregate amount of annual additions which could have been allocated to S's account under the defined contribution plan is $25,500 (aggregate compensation of $102,000 for all years of service with T Corporation × 25 percent). Assume that annual additions totaling $11,400 have been allocated to S's account as of the end of the current limitation year. Therefore, S's defined contribution plan fraction as of the end of the current limitation year equals

$$\frac{\$11,400}{\$25,500 + \$3,000} = \frac{\$11,400}{\$28,500} = 40 \text{ or } 40 \text{ percent}$$

Because the sum (115 percent) of the defined benefit plan fraction (75 percent) and the defined contribution plan fraction (40 percent) applicable to S for the current limitation year does not exceed 140 percent, the limitations of section 415(e) and this section are not exceeded.

Example (2). Assume the same facts as in example (1) except that the defined contribution plan maintained by T Corporation provides for mandatory employee contributions of 6% of compensation and voluntary employee contributions of 10% of compensation. Assume further that S made the maximum allowable employee contributions under the plan for each limitation year (including the current limitation year) during which he was a participant. For limitation years beginning

before January 1, 1976, S made total employee contributions of $8,960. However, because of the special transitional rule applicable to the defined contribution plan fraction with respect to employee contributions for limitation years beginning before January 1, 1976 (as described in paragraph (d)(2) of this section), only $560 of the total employee contributions of $8,960 made by S will be considered an annual addition for each of those limitation years in which S was a participant in the plan total employee contributions for limitation years in which S participated in the plan beginning before January 1, 1976 of $8,960 minus $5,600 (10 percent of total compensation of $56,000 for such years) divided by 6 (the number of such years in which S was a participant in the plan). Thus, in determining the numerator of the defined contribution plan fraction applicable to S, because S was a participant in the plan for 6 limitation years beginning before January 1, 1976, the total amount of employee contributions that must be taken into account as annual additions for such limitation years is $3,360 ($560 × 6). For limitation years beginning after January 1, 1976, S made contributions of $1,760 (for limitation year 1976), $1,920 (for limitation year 1977) and $1,920 (for limitation year 1978, the current limitation year). The amount of annual additions attributable to such contributions under section 415(c)(2)(B) is $880 (for limitation year 1976), $960 (for limitation year 1977) and $960 (for the current limitation year), for a total of $2,800. Thus, the defined contribution plan fraction applicable to S for the current limitation year is

$$\frac{\$3{,}360 + \$2{,}800 + \$11{,}400}{\$28{,}500} = \frac{\$17{,}560}{\$28{,}500} = 62 \text{ or } 62 \text{ percent}$$

Because the sum (137 percent) of the defined benefit plan fraction (75 percent) and the defined contribution plan fraction (62 percent) applicable to S for the current limitation year does not exceed 140 percent, the limitations of section 415(e) and this section are not exceeded.

Example (3). (i) A is an employee of M Corporation and is a participant in both the noncontributory defined benefit plan and noncontributory defined contribution plan maintained by the corporation. A became an employee of M on January 1, 1969 and immediately became a participant in both plans. M uses the calendar year as the limitation year for both plans. The current limitation year is 1978. A's compensation (as defined in § 1.415–2(d)) from M is as follows:

Limitation year	Compensation
1969	$100,000
1970	120,000
1971	130,000
1972	160,000
1973	200,000
1974	240,000
1975	280,000
1976	320,000
1977	400,000
1978	460,000

(ii) A is a participant described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974. A's projected annual benefit (as defined in paragraph (b)(3) of this section) as of the close of the current limitation year under the terms of the defined benefit plan is $100,000. The defined benefit dollar limitation (as described in section 415(b)(1)(A)) applicable to A for the current limitation year is $90,150. Absent the provisions of paragraph (b)(2) of this section, the defined benefit plan fraction applicable to A for the current limitation year would be 1.11 or 111 percent. However, under the provisions of paragraph (b)(2) of this section, for purposes of computing the overall 1.4 limitation imposed by section 415(e) and this section applicable to A for the current limitation year and all future limitation years, A's defined benefit plan fraction is considered to equal 1.0 or 100 percent.

(iii) A's defined contribution dollar limitation (as described in section 415(c)(1)(A)) for the current limitation year is $30,050. For the 9 limitation years ending before January 1, 1978, the maximum amount of annual additions which could have been allocated to A's account under the defined contribution plan is $230,000 ($25,000 × 7, plus $26,825 (adjusted figure for 1976) and $28,175 (adjusted figure for 1977)). Assume that annual additions totaling $60,000 ($10,000 of this amount being attributable to the current limitation year) have been allocated to A's account as of the close of the current limitation year. A's defined contribution plan fraction computed as of the end of the current limitation year is .23 or 23 percent

$$\frac{\$60{,}000}{\$230{,}000 + \$30{,}050} = 23 \text{ or } 23 \text{ percent}$$

Because the sum (123 percent) of the defined benefit plan fraction (1.0 or 100 percent) and the defined contribution plan fraction (.23 or 23 percent) for the current limitation year

does not exceed 1.4 or 140 percent, the limitations of section 415(e) and this section are not violated.

Example (4). (i) J is an employee of M Corporation and is the only participant in the defined contribution plan maintained by the corporation. M uses the calendar year as the limitation year for the plan. The current limitation year is 1980. For all limitation years prior to 1980, the maximum allowable contribution was made to the plan. Thus, J's defined contribution plan fraction as of the end of 1979 is 1.0 or 100 percent. In 1980, before any contributions had been made to the defined contribution plan, the defined contribution plan is converted into a defined benefit plan. The defined benefit plan provides a benefit in the form of a straight life annuity equal to 50% of a participant's compensation for the high 3 years of service, but not less than the amount purchasable by J's account balance. J's average compensation for the high 3 years is $50,000.

(ii) As a result of the conversion of the defined contribution plan into the defined benefit plan, J becomes subject to the 1.4 limitation of section 415(e) and this section because he has at one time participated in a defined contribution plan and has at one time participated in a defined benefit plan maintained by M. Although the defined contribution plan is no longer in existence, J must still take the defined contribution plan fraction into account. A defined contribution plan fraction must continue to be taken into account regardless of whether the plan has been converted into another plan or whether the plan is terminated and distributions are made to participants.

(iii) Even though J is subject to the limitations of section 415(e) and this section, in computing the defined benefit plan fraction, the special rule set forth in §1.415–3(b)(1)(iv) is applicable based on the facts of this example. That rule provides that when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. (For purposes of section 415, a conversion of a defined contribution plan into a defined benefit plan is considered such a transfer.) Assume that one-half of J's annual benefit under the defined benefit plan is attributable to the assets transferred from the defined contribution plan. This means that by applying the special rule set forth in §1.415–3(b)(1)(iv), only one-half of J's projected annual benefit must be taken into account in computing J's defined benefit plan fraction. Accordingly, because J's defined benefit plan fraction is only 25 percent (½ of 50% of high 3 years of compensation ($12,500) divided by 100% of high 3 years of compensation ($50,000)) and not 50 percent (which would have been the case absent the special rule of §1.415–3(b)(1)(iv), the 140 percent limitation of section 415(e) and this section is not violated.

(f) *Special rules where records are not available for past periods*—(1) *In general.* The rules described in paragraph (f) (2) and (3) of this section apply only if the plan is unable to compute the defined contribution plan fraction because of the unavailability of records with respect to limitation years ending before the first limitation year to which section 415 applies to the plan.

(2) *Defined contribution plan fraction for first limitation year to which section 415 applies to a plan.* For purposes of paragraph (c) of this section, the defined contribution plan fraction for the first limitation year to which section 415 and this section apply to a plan equals the following fraction:

(i) The numerator of the fraction is the sum of the participant's account balance as of the valuation date under the plan immediately preceding November 2, 1975, plus any additions to the participant's account made subsequent to that valuation date and through the end of the first limitation year to which section 415 applies to the plan. In determining the participant's account balance as of the valuation date under the plan immediately preceding November 2, 1975, for purposes of this subdivision, one-half of all employee contributions (whether voluntary or mandatory) are not taken into account.

(ii) The denominator of the fraction is the sum of the maximum allowable annual additions under section 415(c) and §1.415–6 for each limitation year, including the first limitation year to which section 415 applies to the plan, in which the participant had a year of service with the employer (see §1.415–3(g)(1) for rules relating to the determination of a year of service). In determining the maximum allowable annual additions for purposes of this subdivision, the compensation limitation (as described in section 415(c)(1)(B)) taken into account for all of such limitation years is the applicable compensation limitation for the first limitation year to which section 415 applies to the plan and the dollar limitation taken into account for each such limitation year is the dollar limitation described in

section 415(c)(1)(A), as adjusted for cost-of-living increases under section 415(d)(1)(B).

(3) *Defined contribution plan fraction for future limitation years.* For purposes of paragraph (c) of this section, with respect to all limitation years after the first limitation year to which section 415 applies to the plan, the defined contribution plan fraction for the current limitation year equals a fraction. The numerator of the fraction is the amount determined under paragraph (g)(2)(i) of this section, plus any subsequent annual additions made to the participant's account through the end of the current limitation year. The denominator of the fraction equals the sum of—

(i) The amount determined under subparagraph (2)(ii) of this paragraph, plus

(ii) The sum of the maximum allowable annual additions under section 415(c) and §1.415–6 for the current limitation year and all prior limitation years beginning after the end of the first limitation year to which section 415 applies to the plan.

(g) *Special rule for certain plans in effect on date of enactment.* In the case of an individual who, on September 2, 1974, was a participant in a defined benefit and defined contribution plan maintained by the same employer and with respect to whom the sum of the defined benefit plan fraction and the defined contribution plan fraction for the limitation year during which such date falls (determined as of the close of that limitation year) exceeded 140 percent, the sum of such fractions may continue to exceed 140 percent for any particular future limitation year, but only if the conditions set forth in paragraph (g) (1) and (2) of this section are satisfied:

(1) The defined benefit plan fraction of the participant computed as of the close of the particular limitation year does not exceed such fraction computed as of the close of the limitation year during which September 2, 1974, falls.

(2) After September 2, 1974,

(i) No employer contributions are allocated to the participant's account under any defined contribution plan,

(ii) No forfeitures arising under any defined contribution plan are allocated to the participant's account,

(iii) No voluntary employee contributions are made by the participant under any defined contribution or defined benefit plan, and

(iv) No mandatory employee contributions are made by the participant under any defined contribution plan.

(h) *Special rules for section 403(b) annuity contracts*—(1) *In general.* For purposes of section 415, the following rules shall apply:

(i) In the case of an annuity contract described in section 403(b), the participant, on whose behalf the annuity contract is purchased, is considered to have exclusive control of the annuity contract. Accordingly, the participant, and not the participant's employer who purchased the section 403(b) annuity contract, is deemed to maintain the annuity contract.

(ii) Any contributions by the employer for an annuity contract described in this subparagraph are not taken into account in computing the defined contribution plan fraction applicable to the participant for the limitation year.

(2) *Special rules under which the employer is deemed to maintain the annuity contract.* (i) The provisions of this paragraph and not paragraph (h)(1) of this section apply for a particular limitation year with respect to a participant on whose behalf a section 403(b) annuity contract is purchased, if that participant is in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h). Under these circumstances, the section 403(b) annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year.

(ii) The provisions of this paragraph also apply for a particular limitation year if a participant on whose behalf a section 403(b) annuity contract is purchased has elected, under section 415(c)(4)(D) and §1.415–6(e)(6), to have the provisions of section 415(c)(4)(C) and §1.415–6(e)(5) apply for the taxable year with or within which such limitation year ends. In such a case, the exclusion allowance determined under

section 403(b)(2)(A) is not applicable to the annuity contract for the particular limitation year, and the annuity contract is treated as a defined contribution plan maintained by both the employer and the participant for that limitation year.

(iii) For purposes of the limitations of section 415(e) and this section, where a section 403(b) annuity contract is treated as a defined contribution plan maintained by the employer under this subparagraph, any contributions made for the annuity contract for a participant are taken into account in computing the defined contribution plan fraction applicable to that participant for the limitation year. Thus, for example, if a doctor is employed by an educational organization which provides him with a section 403(b) annuity contract and also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, any qualified defined benefit plan of the professional corporation must be aggregated with the section 403(b) annuity contract for purposes of applying the limitations of section 415(e) and this section.

(3) *Special rule with respect to salary reduction agreements*. The rules provided in this paragraph are applicable whether or not the section 403(b) annuity contract is purchased in connection with a salary reduction agreement between the employer and participant.

(4) *Special rules relating to the aggregation of the annuity contract with a qualified plan*. (i) Where a section 403(b) annuity contract is aggregated with a qualified defined benefit plan in a limitation year because of the application of the rules of paragraph (h)(2) of this section, all contributions made to the annuity contract for a participant in prior limitation years shall be taken into account in computing the participant's defined contribution plan fraction. However, the rule described in the preceding sentence is not applicable if the aggregation is solely attributable to the participant's election to have the provisions of section 415(c)(4)(C) apply. Accordingly, in any case in which aggregation is required as a result of the application of paragraph (h)(2)(ii) of this section, all contributions made to the annuity contract for a participant in prior limitation years in which paragraph (h)(1) of this section was applicable do not have to be taken into account in computing the defined contribution plan fraction applicable to the participant.

(ii) Any contributions made to a section 403(b) annuity contract for a participant in any limitation year in which the rules of paragraph (h)(2)(ii) of this section are applicable shall be taken into account in subsequent limitation years even though the rules of such paragraph are no longer applicable.

(iii) See paragraph (c)(2) of this section for special rules relating to the defined contribution plan fraction for a participant on whose behalf a section 403(b) annuity contract has been purchased.

(5) *Examples*. The application of this paragraph may be illustrated by the following examples:

Example (1). A is employed by a hospital which is described in section 501(c)(3) and exempt from tax under section 501(a). The hospital purchases an annuity contract described in section 403(b) on A's behalf for the current limitation year. The hospital also maintains a qualified defined benefit plan during the current limitation year in which A is a participant, but it does not maintain a qualified defined contribution plan during that limitation year. With respect to the annuity contract. A does not elect to have the provisions of section 415(c)(4)(C) apply for the current limitation year. Also, A is not in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h). For purposes of section 415, under subparagraph (1) of this paragraph, A is considered to have exclusive control of the annuity contract. Therefore, because A (and not the hospital) is treated as maintaining the annuity contract and because the hospital does not maintain any defined contribution plan, the limitations of section 415(e) and this section are not applicable to A for either the annuity contract or the hospital's defined benefit plan for the current limitation year.

Example (2). Assume the same facts as in example (1), except that the hospital also maintains a qualified defined contribution plan during the limitation year in which A is a participant. Because the hospital is not considered to be maintaining the section 403(b) annuity contract, contributions made to the annuity contract on behalf of A during the current limitation year by the hospital are not taken into account in computing the defined contribution plan fraction

applicable to A for the plans maintained by the hospital for that limitation year.

Example (3). Assume the same facts as in example (1), except that A has elected to have the provisions of section 415(c)(4)(C) apply to the annuity contract for the current limitation year. Under the special rules contained in subparagraph (2) of this paragraph, the annuity contract is treated as a defined contribution plan maintained by the hospital as well as a defined contribution plan maintained by A. Accordingly, because the hospital is also maintaining a qualified defined benefit plan, the limitations of section 415(e) and this section are applicable to A for the annuity contract and the defined benefit plan maintained by the hospital in the current limitation year.

Example (4). J is employed by a hospital which is described in section 501(c)(3) and exempt from tax under section 501(a). The hospital purchases an annuity contract described in section 403(b) on J's behalf for the current limitation year. The hospital does not maintain any qualified plans during that limitation year. However, for the limitation year, J is in control (within the meaning of section 414 (b) or (c), as modified by section 415(h)) of employer M. M maintains a qualified defined benefit plan during that limitation year. Under the special rules contained in subparagraph (2) of this paragraph, the annuity contract is treated as a defined contribution plan maintained by M (the controlled employer) as well as a defined contribution plan maintained by J. Therefore, because M is also maintaining a qualified defined benefit plan, the limitations of section 415(e) and this section are applicable to J for the annuity contract and the defined benefit plan maintained by M in the current limitation year.

(i) *Special rules for individual retirement plans.* For purposes of section 415, an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) is maintained is considered to have exclusive control of such plan. Therefore, the individual is treated as maintaining such plan. However, if that individual is in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h), the individual retirement plan for the benefit of such individual is treated as a defined contribution plan maintained by both the controlled employer and such individual.

[T.D. 7748, 46 FR 1711, Jan. 7, 1981]

§ 1.415–8 Combining and aggregating plans.

(a) *In general.* Under section 415(f) and this section, for purposes of applying the limitations of section 415 (b), (c), and (e) applicable to a participant for a particular limitation year—

(1) All qualified defined benefit plans (without regard to whether a plan has been terminated) ever maintained by the employer will be treated as one defined benefit plan, and

(2) All qualified defined contribution plans (without regard to whether a plan has been terminated) ever maintained by the employer will be treated as one defined contribution plan.

(b) *Annual compensation taken into account where employer maintains more than one defined benefit plan.* If more than one qualified defined benefit plan is being aggregated under paragraph (a) of this section for a particular limitation year, in applying the defined benefit compensation limitation (as described in section 415(b)(1)(B)) to the annual benefit of a participant under each plan, the participant's high 3 years of compensation is determined in accordance with § 1.415–3(a)(3).

(c) *Affiliated employers.* Any qualified defined benefit plan or qualified defined contribution plan maintained by any member of a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or by any trade or business (whether or not incorporated) under common control (within the meaning of section 414(c) as modified by section 415(h)) is deemed maintained by all such members or such trades or businesses.

(d) *Section 403(b) annuity contracts*—(1) *In general.* In the case of an annuity contract described in section 403(b), except as provided in subparagraph (2) of this paragraph, the participant on whose behalf the annuity contract is purchased is considered to have exclusive control of the annuity contract. Accordingly, the participant, and not the participant's employer who purchased the section 403(b) annuity contract, is deemed to maintain the annuity contract.

(2) *Special rules under which the employer is deemed to maintain the annuity*

contract. If a participant on whose behalf a section 403(b) annuity contract is purchased has elected to have the provisions of section 415(c)(4)(C) and §1.415–6(e)(5) apply for a taxable year, the annuity contract is treated as a defined contribution plan maintained by both the employer that purchased the annuity contract and the participant on whose behalf it was purchased for the limitation year which ends during such taxable year. Even if the election under section 415(c)(4)(C) is not made, where a participant, on whose behalf a section 403(b) annuity contract is purchased, is in control of any employer within the meaning of section 414 (b) or (c) as modified by section 415(h) for a limitation year, the annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year. Thus, for example, if a doctor is employed by an educational organization which provides him with a section 403(b) annunity contract and also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, any qualified defined contribution plan of the professional corporation must be combined with the section 403(b) annuity contract for purposes of applying the limitations of section 415(c) and §1.415–6. For purposes of this paragraph, it is immaterial whether the section 403(b) annuity contract is purchased as a result of a salary reduction agreement between the employer and the participant.

(e) *Multiemployer plans*. Multiemployer plans, as defined in section 414(f), shall not be aggregated with other multiemployer plans. However, where an employer maintains both a plan which is not a multiemployer plan and a multiemployer plan, the plan which is not a multiemployer plan shall be aggregated (based on its limitation year) with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided by such employer with respect to a common participant. See §1.415–1(e)(2) for a rule relating to the computation of the benefits provided by an employer under a section 414(f) multiemployer plan.

(f) *Special rules for combining certain plans, etc*. If a plan, annuity contract or arrangement is subject to a special limitation in addition to, or instead of, the regular limitations described in section 415 (b) or (c), and is combined under this section with a plan which is subject only to the regular section 415 (b) or (c) limitations, the following rules shall apply:

(1) Each plan, annuity contract or arrangement which is subject to a special limitation must meet its own applicable limitation and each plan subject to the regular limitations of section 415 must meet its applicable limitation.

(2) The combined limitations shall be the larger of the applicable limitations.

(g) *Special priority rule for TRASOP's*. For a special rule concerning allocations to a participant's account under an Employee Stock Ownership Plan under section 301(d) of the Tax Reduction Act of 1975, see §1.46–6(d)(6)(v).

(h) *Examples*. The provisions of this section may be illustrated by the following examples:

Example (1). M is an employee of ABC Corporation and XYZ Corporation. ABC maintains a qualified noncontributory defined benefit plan in which M participates and XYZ maintains a qualified defined contribution plan in which M participates. ABC Corporation and XYZ Corporation are members of a controlled group of corporations within the meaning of section 414(b) as modified by section 415(h). Because ABC Corporation and XYZ Corporation are members of a controlled group of corporations within the meaning of section 414(b) as modified by section 415(h), M is treated as being employed by a single employer. Thus, M's annual benefit under the defined benefit plan maintained by ABC may not exceed the limitations of section 415(b) and §1.415–3; the annual additions to M's account under the defined contribution plan maintained by XYZ may not exceed the limitations of section 415(c) and §1.415–6; and, in addition, the two plans may not exceed the limitations of section 415(e) and §1.415–7.

Example (2). Assume the same facts as in example (1), except that the qualified defined benefit plan maintained by ABC Corporation provides for employee contributions (whether mandatory or voluntary). Under §1.415–3(d), ABC Corporation will be considered to be maintaining a defined contribution plan consisting of M's contributions to the defined benefit plan. For purposes of applying the limitations of section 415(e) and §1.415–7, the qualified defined benefit plan maintained

by ABC must be combined with the defined contribution plan which ABC is considered to maintain. In addition, because corporations ABC and XYZ are members of a controlled group of corporations (within the meaning of section 414(b), as modified by section 415(h)), for purposes of applying the limitations of section 415(c) and §1.415–6, the qualified defined contribution plan maintained by XYZ must be combined with the define contribution plan which ABC is considered to be maintaining and the defined contribution plans (as combined) must be aggregated with the qualified defined benefit plan maintained by ABC for purposes of the limitations imposed by section 415(e) and §1.415–7.

[T.D. 7748, 46 FR 1715, Jan. 7, 1981]

§1.415–9 Disqualification of plans and trusts.

(a) *In general.* Under section 415(g) and this section, with respect to a particular limitation year, a plan (and the trust forming part of the plan) is disqualified in accordance with the rules provided in paragraph (b) of this section, if any of the following conditions exist:

(1) Annual additions (as defined in §1.415–6(b)) with respect to the account of any participant in a qualified defined contribution plan maintained by the employer exceed the limitations of section 415(c) and §1.415–6.

(2) The annual benefit (as defined in §1.415–3(b)(1)) of a participant in a qualifed defined benefit plan maintained by the employer exceeds the limitations of section 415(b) and §1.415–3.

(3) The combination of annual additions with respect to the account of any participant in a qualified defined contribution plan and the projected annual benefit payable with respect to such participant in a qualified defined benefit plan maintained by the employer exceeds the limitations of section 415(e) and §1.415–7.

For purposes of this paragraph, the determination of whether a plan or a combination of plans exceeds the limitations imposed by section 415 for a particular limitation year is, except as otherwise provided, made by taking into account the aggregation of plan rules provided in sections 415(f) and 414 (b) and (c) (as modified by section 415(h)).

(b) *Rules for disqualification of plans and trusts*—(1) *In general.* Any plan (including a trust which forms part of such plan) that is disqualified in a particular limitation year under the rules set forth in this paragraph, shall be disqualified as of the first day of the first plan year containing any portion of the particular limitation year.

(2) *Single plan.* In the case of a single qualified defined benefit plan maintained by the employer that provides an annual benefit (as defined in §1.415–3(b)(1)) in excess of the limitations of section 415(b) and §1.415–3 for any particular limitation year, such plan is disqualifed in that limitation year. Similarly, if the employer only maintains a single defined contribution plan under which annual additions (as defined in §1.415–6(b)) allocated to the account of any participant exceed the limitations of section 415(c) and §1.415–6 for any particular limitation year, such plan is also disqualifed in that limitation year.

(3) *More than one plan.* In the event that the limitations of section 415(b) and §1.415–3, or section 415(c) and §1.415–6 are exceeded for a particular limitation year with respect to any participant because of the application of the aggregation rules of section 415(f)(1) or section 414 (b) or (c), as modified by section 415(h), one or more of the plans shall be disqualifed in accordance with the rules set forth in this subparagraph. Similarly, if the limitations of section 415(e) and §1.415–7 are exceeded for a particular limitation year with respect to any participant because of the application of such aggregation rules (although if an individual participates in a defined contribution and defined benefit plan maintained by the same employer, these limitations may be exceeded even without the application of such aggregation rules), one or more of the plans shall be disqualified in accordance with the following rules:

(i) If there are two plans and one of the plans has been terminated at any time including the last day of the particular limitation year, the plan which has not been so terminated (whether or not that plan is a multiemployer plan described in section 414(f)) is disqualified in that limitation year.

(ii) If there are two plans and neither plan has been terminated at any time including the last day of the particular limitation year, and if one of the plans is a multiemployer plan described in section 414(f), the plan which is not a multiemployer plan is disqualified in that limitation year. For purposes of the preceding sentence, the determination of whether a plan is a multiemployer plan described in section 414(f) is made as of the last day of the particular limitation year.

(iii) If there are two plans of an employer and neither plan has either been terminated at any time including the last day of the particular limitation year or determined to be a multiemployer plan described in section 414(f) as of such day, the employer may elect, in a manner determined by the Commissioner, the plan that is disqualified. If the two plans described in this subdivision are involved because of the application of section 414 (b) or (c), as modified by section 415(h), the employers of the controlled group may elect, in a manner determined by the Commissioner, the plan that is disqualified. However, the election described in the preceding sentence is not effective unless made by all of the employers within the controlled group. For purposes of this subdivision, the elected plan is disqualified in the particular limitation year.

(iv) If the election described in subdivision (b)(3)(iii) of this paragraph is not made with respect to the two plans described in such subdivision, the Commissioner, taking into account all of the facts and circumstances, shall have the discretion to determine the plan that is disqualified in the particular limitation year. In making this determination, some of the factors that will be taken into account include, but are not limited to, the number of participants in each plan and the amount of benefits provided on an overall basis by each plan.

(v) If more than two plans are involved, a plan or plans shall be disqualified in the particular limitation year in accordance with the principles contained in this subparagraph.

(4) *Special rules for simplified employee pension.* If there are two or more plans and if one of the plans is a simplified employee pension (as defined in section 408(k)), the simplified employee pension shall not be disqualified until all of the other plans have been disqualified. However, if one of the plans has been terminated, the simplified employee pension shall be disqualified before the terminated plan. For purposes of this subparagraph, the disqualification of a simplified employee pension means that the simplified employee pension is no longer described under section 408(k).

(c) *Special rules concerning section 403(b) annuity contracts*—(1) *In general.* If aggregating or combining a section 403(b) annuity contract and a qualified plan causes the applicable limitations of section 415 to be exceeded, the exclusion allowance under section 403(b)(2) shall be adjusted first to the extent necessary to satisfy such limitations.

(2) *Aggregating section 403(b) annuity contract and qualified defined benefit plan.* In the event that aggregating a section 403(b) annuity contract and a qualified defined benefit plan causes the limitations of section 415(e) and §1.415–7 to be exceeded with respect to a participant for a particular limitation year, the amount of the contribution to the annuity contract in excess of such limitations is treated as a disqualified contribution and therefore includable in the gross income of the participant for the taxable year with or within which that limitation year ends. Furthermore, for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years with respect to such participant, the disqualified contribution is treated as an amount contributed by the employer for an annuity contract which was excludable from the participant's gross income under section 403(b)(2)(A)(ii). Thus, for future taxable years, the exclusion allowance will be reduced by the amount of the disqualified contribution even though such amount was not excludable from the participant's gross income in the taxable year when it was made. See §1.415–7(c)(2) for special rules relating to the defined contribution plan fraction applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased.

(3) *Combining section 403(b) annuity contract and qualified defined contribution plan.* In the event that combining a section 403(b) annuity contract and a qualified defined contribution plan under the provisions of section 415(f)(1)(B) causes the limitations of section 415(c) and § 1.415–6 applicable to a participant under the defined contribution plan to be exceeded for a particular limitation year, the excess of the contributions to the annuity contract plus the annual additions to the plan over such limitations is treated as a disqualified contribution to the annuity contract and therefore includable in the gross income of the participant for the taxable year with or within which that limitation year ends. Furthermore, for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years with respect to such participant, the disqualified contribution is treated as an amount contributed by the employer for an annuity contract which was excludable from the participant's gross income under section 403(b)(2)(A)(ii). Thus, for future taxable years, the exclusion allowance will be reduced by the amount of the disqualified contribution even though such amount was not excludable from the participant's gross income in the taxable year when it was made.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). N is employed by a hospital which purchases an annuity contract described in section 403(b) on N's behalf for the current limitation year. The current limitation year is N's first year of service with the hospital. Solely for the purpose of illustrating the rules set forth in this paragraph, assume that N is in control of the hospital within the meaning of section 414 (b) or (c), as modified by section 415(h). Therefore, under section 415(e)(5), the section 403(b) annuity contract is treated as a defined contribution plan maintained by the hospital and N. The hospital also maintains a qualified defined contribution plan during the current limitation year in which N participates, but it does not maintain any other qualified plan. N's compensation (within the meaning of § 1.415–2(d)) from the hospital for the current limitation year is $20,000. N does not elect any of the alternative limitations provided in section 415(c)(4) for the section 403(b) annuity contract. For the current limitation year, the hospital contributes $3,000 for the section 403(b) annuity contract on N's behalf, which is within the limitations applicable to N under the annuity contract (i.e., the lesser of the exclusion allowance under section 403(b)(2)(A) ($4,000) or the limitations of section 415(c)(1) ($5,000)). The hospital also contributes $3,000 to the qualified plan on N's behalf for the current limitation year (which represents the only annual additions allocated to N's account under the plan for such year), which is within the $5,000 limitation of section 415(c)(1) applicable to N under the plan. However, under section 415(f)(1)(B), for purposes of applying the limitations of section 415(c) and § 1.415–6, the hospital is considered to maintain only one defined contribution plan and thus, all contributions to the annuity contract and to the regular plan must be combined. Because the total combined contributions ($6,000) exceed the section 415(c) limitation applicable to N under the plan ($5,000), under the special rules contained in this paragraph, $1,000 of the $3,000 contributed to the section 403(b) annuity contract is considered a disqualified contribution and therefore currently includable in N's gross income. Furthermore, in computing N's exclusion allowance for the section 403(b) annuity contract for future taxable years, besides the $3,000 contributed to the qualified plan, the $3,000 contributed for the section 403(b) annuity contract is also considered an amount contributed by the employer and excludable from N's gross income for purposes of section 403(b)(2)(A)(ii), even though only $2,000 of this amount was excludable from N's gross income.

Example (2). Assume the same facts as in example (1), except that instead of the defined contribution plan the hospital maintains a qualified defined benefit plan during the current limitation year in which N participates. Because the hospital is considered to be maintaining a defined contribution plan (in the form of a section 403(b) annuity contract) in addition to its defined benefit plan, the limitations of section 415(e) and § 1.415–7 are applicable to N for the current limitation year. If N's defined benefit plan fraction for the current limitation year is 1.0, then to satisfy the limitations of section 415(e) and § 1.415–7, N's defined contribution plan fraction may not exceed .4 for the current limitation year. This means that only $2,000 (i.e. 40% of $5,000—the applicable limitation to N for the annuity contract under the special rule set forth in § 1.415–7(c)(2)(i)) could have been contributed to the annuity contract on N's behalf for the current limitation year without violating the 1.4 limitation of section 415(e) and § 1.415–7. However, because the hospital contributed $3,000 to the section 403(b) annuity contract on N's behalf, under the special rules contained in this

paragraph, $1,000 of this amount is considered a disqualified contribution and therefore currently includable in N's gross income. Furthermore, in computing N's exclusion allowance for the section 403(b) annuity contract for future taxable years, the $3,000 contributed to the annuity contract is considered the amount contributed by the employer and excludable from N's gross income for purposes of section 403(b)(2)(A)(ii), even through only $2,000 of this amount was excludable from N's gross income.

[T.D. 1716, 46 FR 1716, Jan. 7, 1981]

§ 1.415–10 Special aggregation rules.

(a) *General rules relating to aggregation of plans during limitation year*—(1) *Scope of aggregation rules.* This section provides rules for those situations in which two or more existing plans, which previously were unaggregated, are aggregated during a particular limitation year on or after the effective date of section 415 and these regulations, and as a result, the limitations of section 415 (b), (c) or (e) are exceeded for that limitation year. The rules described in this section are also applicable with respect to the aggregation of benefits under a multiemployer plan described in section 414(f) that previously were not required to be aggregated.

(2) *Controlling date of aggregation.* For purposes of this section, plans which are not aggregated as of the first day of a limitation year will not be considered aggregated for that limitation year. Notwithstanding the preceding sentence, if a section 403(b) annuity contract is aggregated with a qualified plan because of the election by the individual on whose behalf the annuity contract is purchased to have the provisions of section 415(c)(4)(C) apply for the taxable year, the annuity contract and the plan are deemed to be aggregated as of the first day of the limitation year ending with or within such taxable year.

(3) *Aggregation of additions and benefits.* If plans are aggregated under this section, the following rules shall apply:

(i) All annual additions credited to a participant's account under a defined contribution plan prior to the aggregation of such plan shall be taken into account in computing the participant's defined contribution plan fraction for purposes of applying the limitations of section 415(e) to the aggregated plans.

(ii) The annual benefit or projected annual benefit (whichever is applicable) of a participant under a defined benefit plan prior to the aggregation of such plan shall be taken into account for purposes of applying the limitations of section 415(b) or section 415(e) to the aggregated plans.

(iii) For a special rule relating to the aggregation of contributions to a section 403(b) annuity contract upon the aggregation of the annuity contract with a qualified plan, see § 1.415–7(h)(4)(i).

(b) *Aggregation of defined benefit plans.* In the case of an individual who is a participant in two or more defined benefit plans and with respect to whom the limitations of section 415(b) and § 1.415–3 are exceeded for a particular limitation year because of the aggregation of the plans for that limitation year, the limitations of section 415(b) and § 1.415–3 may be exceeded for that limitation year and for future limitation years provided that there is no increase in the participant's accrued benefit derived from employer contributions during the period within which these limitations are being exceeded.

(c) *Aggregation of defined benefit and defined contribution plan.* In the case of an individual who has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan and with respect to whom the limitations of section 415(e) and § 1.415–7 are exceeded for a particular limitation year because of the aggregation of the plans for that limitation year, the limitations of section 415(e) and § 1.415–7 may be exceeded for that limitation year and for future limitation years provided that the following conditions are complied with during that period:

(1) The participant's accrued benefit derived from employer contributions in the defined benefit plan is not increased.

(2) No employer contributions are allocated to the participant's account under any defined contribution plan.

(3) No forfeitures arising under any defined contribution plan are allocated to the participant's account.

(4) No voluntary employee contributions are made by the participant under any defined benefit or defined contribution plan.

(5) No mandatory employee contributions are made by the participant under any defined contribution plan.

(d) *Limitation year for aggregated plans*. If the plans which are aggregated under this section have different limitation years, subparagraph (1) or (2) of this paragraph must be complied with.

(1) The relevant employer or employers must elect the limitation year that is to be controlling. This election shall be made by the adoption of a written resolution by the employer or employers. See §1.415–2(b)(4) for rules relating to a change in the limitation year.

(2) The employer or employers may continue to use different limitation years for each plan in accordance with rules determined by the Commissioner. If, in accordance with paragraph (d)(1) of this section, one limitation year is elected, and if the plans which are aggregated covered at least one common participant prior to being aggregated, that limitation year shall be applicable for past years for purposes of computing the defined contribution fraction for those years. For special rules relating to the computation of the defined contribution plan fraction where records are not available for past periods, see §1.415–7(f).

(e) The provisions of this section may be illustrated by the following examples:

Example (1). J is an employee of two unrelated corporations, N and M. Each corporation has a qualified defined benefit plan in which J participates. Each plan provides a benefit which is equal to 75 percent of a participant's average compensation for his high 3 years of service and is payable in the form of a straight life annuity beginning at age 65. J's average compensation (within the meaning of §1.415–2(d)) for his high three years of service from each corporation is $80,000. Each plan uses the calendar year for the limitation and plan year. In July, 1978, N Corporation becomes a wholly owned subsidiary of M Corporation, and as a result, J is treated as being employed by a single employer under section 414(b). Therefore, because section 415(f)(1)(A) requires that all defined benefit plans of an employer be treated as one defined benefit plan, the two plans must be aggregated for purposes of applying the limitations of section 415. (Although, under paragraph (a)(2) of this section, since the plans were not aggregated as of the first day of the 1978 limitation year (January 1, 1978), they will not be considered aggregated until the limitation year beginning January 1, 1979.) As a result of such aggregation, J becomes entitled to a combined benefit which is equal to $120,000, which is in excess of the section 415(b) dollar limitation for 1979 of $98,100. However, under paragraph (b) of this section, the limitations of section 415(b) and §1.415–3 applicable to J may be exceeded in this situation without plan disqualification, so long as J's accrued benefit derived from employer contributions is not increased during the period within which the limitations are being exceeded.

Example (2). A, age 30, owns all of the stock of X Corporation and also owns 10 percent of the stock of Z Corporation. F, A's father, directly owns 75 percent of the stock of Z corporation. Both corporations have qualified defined contribution plans in which A participates and both plans use the calendar year for the limitation and plan year. A's compensation (within the meaning of §1.415–6(a)(3)) for 1976 is $40,000 from Z Corporation and $150,000 from X Corporation. During 1976, annual additions of $10,000 are credited to A's account under the plan of Z Corporation, while annual additions of $26,825 are credited to A's account under the plan of X Corporation. In both instances, the amount of annual additions represent the maximum allowable under section 415(c) and §1.415–6. On July 15, 1976, F dies, and A inherits all of F's stock in Z in 1976. Because under section 414(b), A is considered to be in control of X and Z Corporations, the two plans must be aggregated for purposes of applying the limitations of section 415. However, even though A's total annual additions for 1976 are $36,825, the limitations of section 415(c) and §1.415–6 are not violated for 1976, because, under paragraph (a)(2) of this section, the two plans are considered separate plans for that year since they were not aggregated as of the first day of that year.

[T.D. 1718, 46 FR 1718, Jan. 7, 1981]

§1.416–1 Questions and answers on top-heavy plans.

The following questions and answers relate to special rules for top-heavy plans under section 416 of the Internal Revenue Code of 1954, as added by section 240 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97–248) (TEFRA), and amended by sections 524 and 713(f) of the Tax Reform Act of 1984 (Pub. L. 98–369):

TABLE OF CONTENTS

G—General Provisions

T—Top-Heaviness Determinations
V—Vesting Rules for Top-Heavy Plans
M—Minimum Benefits Under Top-Heavy Plans

G. GENERAL PROVISIONS

G–1 Q. What requirement plans are subject to the top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act of 1984?

A. All stock bonus, pension, or profit-sharing plans intended to qualify under section 401(a), annuity contracts described in section 403(a), and simplified employee pensions described in section 408(k) are subject to the new top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act (''TRA'') of 1984.

G–2 Q. Is a multiple employer plan subject to the top-heavy requirements of section 416?

A. A multiple employer plan is subject to the requirements of section 416, but only with respect to each individual employer. Thus, if twelve employers contribute to a multiple employer plan and the accrued benefits for the key employees of one employer exceed 60 percent of the accrued benefits of all employees for such employer, the plan is top-heavy with respect to that employer. A failure by the multiple employer plan to satisfy section 416 with respect to the employees of such employer means that all employers are maintaining a plan that is not a qualified plan.

G–3 Q. As of what date must plan amendments to comply with top-heavy rules be effective?

A. Amendments required to comply with the top-heavy rules must be effective as of the first day of the first plan year which begins after 1983. See §1.401(b)–1 for the date by which such amendments must be adopted.

T. TOP-HEAVINESS DETERMINATIONS

T–1 Q. What factors must be considered in determining whether a plan is top-heavy?

A. (a) In order to determine whether a plan is top-heavy for a plan year, it is necessary to determine which employers will be treated as a single employer for purposes of section 416; what the determination date is for the plan year; which employees are or formerly were key employees; which former employees have not performed any service for the employer maintaining the plan at any time during the five-year period ending on the determination date; which plans of such employers are required or permitted to be aggregated to determine top-heavy status; and the present value of the accrued benefits (including distributions made during the plan year containing the determination date and the four preceding plan years) of key employees, former key employees, and non-key employees.

(b) All employers that are aggregated under section 414 (b), (c), and (m) must be taken into account as a single employer for the plan year in question, and those employees in all plans maintained by the employers that are aggregated must be categorized as key employees, as former key employees, or as non-key employees. See Question and Answer T–12 for the determination of which employees are or were key employees. All plans maintained by the employers in which a key employee participates, and certain other plans, must then be aggregated (the required aggregation group). See Question and Answer T–6 for rules concerning required aggregation. Other plans may in some cases be aggregated with the required aggregation group. See Question and Answer T–7 for rules concerning such permissive aggregation.

(c) Once aggregated, all plans that are required to be aggregated will either be top-heavy or not top-heavy, depending upon whether the aggregation group is top-heavy. A plan or aggregation group will be considered top-heavy if the sum of the present value of the accrued benefits for key employees is more than 60 percent of the sum of the present value of accrued benefits of all employees.

(d) Except as otherwise stated, for purposes of section 416(g), an employee is an individual currently or formerly employed by an employer. Former key employees are non-key employees and are excluded entirely from the calculation to determine top-heaviness. In all

cases, the present value of accrued benefits includes distributions made during the plan year containing the determination date and the preceding four plan years. See Questions and Answers T–24 and T–25 for rules concerning the account balances and present value of accrued benefits. For plan years beginning after December 31, 1984, the accrued benefit of an employee who has not performed any sevice for the employer maintaining the plan at any time during the five-year period ending on the determination date is excluded from the calculation to determine top-heaviness. However, if an employee performs no services for five years and then performs sevices, such employee's total accrued benefit is included in the calculation for top-heaviness.

T–2 Q. To what extent are multiemployer plans and multiple employer plans to which an employer makes contributions on behalf of its employees treated as plans of that employer for top-heavy purposes?

A. Multiemployer plans described in section 414(f) and multiple employer plans described in section 413(c) to which an employer makes contributions on behalf of its employees are treated as plans of that employer to the extent that benefits under the plan are provided to employees of the employer because of service with that employer.

T–3 Q. Must a collectively-bargained plan be aggregated with other plans of the employer to determine whether some or all of the employer's plans are top-heavy?

A. A collectively-bargained plan that includes a key employee of an employer must be included in the required aggregation group for that employer. See Question and Answer T–6 for rules concerning required aggregation. A collectively-bargained plan that does not include a key employee may be included in a permissive aggregation group. See Question and Answer T–7 for rules concerning permissive aggregation. However, the special rules in section 416 (b), (c), or (d) applicable to top-heavy plans do not apply with respect to any employee included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective-bargaining agreement between employee representatives and one or more employers if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. In determining whether there is a collective-bargaining agreement between employee representatives and one or more employers, the additional condition of section 7701(a)(46) must be satisfied after March 31, 1984.

T–4 Q. How is a terminated plan treated for purposes of the top-heavy rules?

A. A terminated plan is treated like any other plan for purposes of the top-heavy rules. For purposes of section 416, a terminated plan is one that has been formally terminated, has ceased crediting service for benefit accruals and vesting, and has been or is distributing all plan assets to participants or their beneficiaries as soon as administratively feasible. Such a plan must be aggregated with other plans of the employer if it was maintained within the last five years ending on the determination date for the plan year in question and would, but for the fact that it terminated, be part of a required aggregation group for such plan year. Distributions which have taken place within the five years ending on the determination date must be accounted for in accordance with section 416(g)(3). No additional vesting, benefit accruals or contributions must be provided for participants in a terminated plan.

T–5 Q. How are frozen plans treated for purposes of the top-heavy rules?

A. For purposes of section 416, a frozen plan is one in which benefit accruals have ceased but all assets have not been distributed to participants or their beneficiaries. Such plans are treated, for purposes of the top-heavy rules, as any non-frozen plan. That is, such plans must provide minimum contributions or benefit accruals, limit the amount of compensation which can be taken into account in providing benefits, and provide top-heavy vesting. A frozen defined contribution plan may not be required to provide additional contributions because of the rule in section 416(c)(2)(B).

T–6 Q. What is a required aggregation group?

A. For purposes of determining whether the plans of an employer are top-heavy for a particular plan year, the required aggregation group includes each plan of the employer in which a key employee participates in the plan year containing the determination date, or any of the four preceding plan years. In addition, each other plan of the employer which, during this period, enables any plan in which a key employee participates to meet the requirements of section 401(a)(4) or 410 is part of the required aggregation group. This concept may be illustrated by the following examples:

Example (1). An employer maintains two plans. Key employees participate in one plan, but not in the other. If the plan containing key employees independently satisfies the coverage and non-discrimination rules of sections 410 and 401(a)(4), it may be tested independently to determine whether it is top-heavy. Also, the plan not covering key employees would not be part of a required aggregation group and would not need to be tested to determine whether it is top-heavy. However, if the plan containing key employees satisfies the coverage requirements of section 410(b) or the non-discrimination requirements of section 401(a)(4) only when it is considered together with the other plan in accordance with § 1.410(b)–1(d)(3), the plan not covering key employees would be part of the required aggregation group.

Example (2). A sole proprietor terminated a Keogh plan in 1981. In 1982, the sole proprietor incorporated and established a corporate plan with a calendar-year plan year. For purposes of determining whether the corporate plan is top-heavy for its 1984 plan year, the terminated Keogh plan and the corporate plan would be part of a required aggregation group. The sole proprietor and the corporation would be treated as a single employer under section 414(c). Under Question and Answer T–4, the terminated plan would be aggregated with the corporate plan because it was maintained within the five-year period ending on the determination date for the 1984 plan year and because, but for the fact that it terminated, it would be aggregated with the corporate plan because it covered a key employee.

T–7 Q. What is a permissive aggregation group?

A. A permissive aggregation group consists of plans of the employer that are required to be aggregated, plus one or more plans of the employer that are not part of a required aggregation group but that satisfy the requirements of sections 401(a)(4) and 410 when considered together with the required aggregation group. This concept may be illustrated by the following examples:

Example (1). (a) An employer maintains two plans:

1. Plan A covers key employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan B covers no key employees. It also independently satisfies the requirements of sections 410 and 401(a)(4).

(b) As indicated in Question and Answer T–6, Plan B is not required to be aggregated with Plan A. Further, if Plan B provided contributions or benefits that were not at least comparable to the contributions or benefits provided under Plan A, then Plan B could not be permissively aggregated with Plan A because the contributions and benefits would discriminate if the two plans were considered as a unit. However, if the benefits or contributions under Plan B were comparable to those under Plan A, the two plans would be permitted to be aggregated to determine whether or not the group consisting of both plans is top-heavy. If Plan A and Plan B are permitted to be aggregated, and if the permissive aggregation group is not top-heavy, then neither Plan A nor Plan B would be considered top-heavy.

Example (2). (a) Employer W maintains two plans.

1. Plan C covers salaried employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan D covers employees who are included in a unit of employees covered by an agreement which the Secretary of Labor has found to be a collective-bargaining agreement between employee representatives and the employer and retirement benefits were bargained for between employee representatives and the employer.

(b) The fact that Plan D is a collectively-bargained plan does not necessarily mean that it may be permissively aggregated with Plan C. In order to be permissively aggregated with Plan C, Plan D must provide contributions or benefits with respect to service with Employer W that are at least comparable to the contributions or benefits provided under Plan C.

T–8 Q. May an employer permissively aggregate multiemployer plans, multiple employer plans and simplified employee pension plans to which the employer contributes with a plan covering key employees or a required aggregated group?

A. Yes. Multiemployer plans, multiple employer plans and simplified employee pensions to which an employer makes contributions may be permissively aggregated with a plan covering key employees or with a required aggregation group if the contributions or benefits provided under the multiemployer plan, multiple employer plan or simplified employee pension by the employer are comparable to the contributions or benefits provided under the plan covering key employees or the plans in the required aggregation group. In making this determination, only the employer's contribution to the simplified employee pension may be used.

T–9 Q. What plans will be treated as top-heavy if they are part of a required aggregation group that is top-heavy?

A. In the case of plans that are required to be aggregated, each plan in the required aggregation group will be top-heavy if the group is top-heavy. No plan in the required aggregation group will be top-heavy if the group is not top-heavy.

T–10 Q. If a required aggregation group is top-heavy, and one plan of the group satisfies the requirements of sections 416 (b), (c), and (d), may other plans in the group include provisions which do not satisfy sections 416 (b), (c) and (d)?

A. No. Each plan in a required aggregation group is top-heavy if the group is top-heavy. Thus, each plan must contain provisions satisfying the requirements of sections 416 (b) and (d). If all the plans are defined contribution plans, only one plan need satisfy the requirements of section 416(c)(2) with respect to any non-key employee who participates in more than one of the plans. If all the plans are defined benefit plans, only one plan need satisfy the requirements of section 416(c)(1) with respect to any non-key employee who participates in more than one of the plans. However, in the case of non-key employees who do not participate in more than one plan, each plan must separately provide the applicable minimum contribution or benefit with respect to each such employee. See Question and Answer M–12 in the case of employees who are covered under both a defined benefit and a defined contribution plan.

T–11 Q. What plans will be treated as top-heavy if a permissive aggregation group is top-heavy?

A. If a permissive aggregation group is top-heavy, only those plans that are part of the required aggregation group will be subject to the requirements of section 416 (b), (c) and (d). Plans that are not part of the required aggregation group will not be subject to these requirements. Thus, if an employer wishes to demonstrate that the plans maintained by the employer are not top-heavy, the employer need consider only the required aggregation group. If, after considering the required aggregation group, it is determined that the plans are not top-heavy, the requirements of section 416 (b), (c) and (d) will not apply to any of the plans. If, on the other hand, the plans required to be aggregated are top-heavy, the employer may wish to determine whether there are any plans that may be permissively aggregated to demonstrate that the plans are not top-heavy. Assuming that there are plans that are eligible for permissive aggregation, the employer may take these plans into consideration. If, after taking such plans into consideration, the net result is that the entire group is not top-heavy, the top-heavy requirements do not apply to any plan in the group.

T–12 Q. For purposes of determining whether a plan is top-heavy for a plan year, who is a key employee?

A. Under section 416(i)(1), a key employee is any employee (including any deceased employee) who at any time during the plan year containing the determination date for the plan year in question or the four preceding plan years (including plan years before 1984) is:

1. An officer of the employer having annual compensation from the employer for a plan year greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends (see Questions and Answers T–13, T–14, and T–15),

2. One of the ten employees having annual compensation from the employer for a plan year greater than the

dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends and owning (or considered as owning within the meaning of section 318) both more than a ½ percent interest and the largest interests in the employer (see Question and Answer T–19),

3. A 5-percent owner of the employer, or

4. A 1-percent owner of the employer having annual compensation from the employer for a plan year more than $150,000 (see Questions and Answers T–16 and T–21).

An individual may be considered a key employee in a plan year for more than one reason. For example, an individual may be both an officer and one of the ten largest owners. However, in testing whether a plan or group is top-heavy, an individual's accrued benefit is counted only once. The terms key employee, former key employee, and non-key employee include the beneficiaries of such individuals. This Question and Answer is illustrated by the following examples:

Example (1). An employer maintains a calendar-year plan. An individual who was an employee of the employer and a 5-percent owner of the employer in 1986 was neither an employee nor an owner in 1987 or thereafter. Even though the individual is no longer an employee or owner of the employer, the individual would be treated as a key employee for purposes of determining whether the plan is top-heavy for each plan year through the 1991 plan year. However, for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years, the individual would be treated as a former key employee.

Example (2). The facts are the same as in example (1), except that the individual died in early 1987 and his total benefit under the plan was distributed to his beneficiary in 1987. Such distribution would be treated as the accrued benefit of the individual for each year through the 1991 plan year. However, such individual would be treated as a former key employee for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years. The conclusions are not affected by whether the beneficiary of the individual is a non-key employee or a key employee of the employer.

T–13 Q. For purposes of defining a key employee, who is an officer?

A. Whether an individual is an officer shall be determined upon the basis of all the facts, including, for example, the source of his authority, the term for which elected or appointed, and the nature and extent of his duties. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction. An employee who merely has the title of an officer but not the authority of an officer is not considered an officer for purposes of the key employee test. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of the key employee test. In the case of one or more employers treated as a single employer under sections 414(b), (c), or (m), whether or not an individual is an officer shall be determined based upon his responsibilities with respect to the employer or employers for which he is directly employed, and not with respect to the controlled group of corporations, employers under common control or affiliated service group. A partner of a partnership will not be treated as an officer for purposes of the key employee test merely because he owns a capital or profits interest in the partnership, exercises his voting rights as a partner, and may, for limited purposes, be authorized and does in fact act as an agent of the partnership.

T–14 Q. For purposes of determining whether a plan is top-heavy for a plan year, how many officers must be taken into account?

A. There is no minimum number of officers that must be taken into account. Only individuals who are in fact officers within the meaning of Question and Answer T–13 must be considered. For example, a corporation with only one officer and two employees would have only one officer for purposes of section 416(i)(1)(A)(i). After aggregating all employees (including leased employees within the meaning of section 414(n)) of employers required to be aggregated under section 414(b), (c) or (m), there is a maximum limit to the number of officers that are to be taken into account as officers for the entire

group of employers that are so aggregated. The number of employees an employer (including all employers required to be aggregated under section 414(b), (c), or (m)) has for the plan year containing the determination date is the greatest number of employees it had during that plan year or any of the four preceding plan years. For purposes of this Question and Answer, employees include only those individuals who perform services for the employer during a plan year. If the number of employees (including part-time employees) of all the employers aggregated under section 414(b), (c) or (m) is less than 30 employees, no more than three individuals shall be treated as key employees for the plan year containing the determination date by reason of being officers. If the number of employees of all organizations aggregated under section 414(b), (c) or (m) is greater than 30 but less than 500, no more than 10% of the number of employees will be treated as key employees by reason of being officers. (If 10% of the number of employees is not an integer, the maximum number of individuals to be treated as key employees by reason of being officers shall be increased to the next integer). If the number of employees of employers aggregated under section 414 (b), (c) and (m) exceeds 500, no more than 50 employees are to be considered as key employees by reason of being officers. This limited number of officers is comprised of the individual officers, selected from the group of all individuals who were officers in the plan year containing the determination date or any one of the four preceding plan years, who had annual plan year compensation (in the officer year) in excess of 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends and who had the largest annual plan-year compensation in that five-year period. (The definition of compensation contained in Question and Answer T–21 is to be used for this purpose.) In determining the officers of an employer, an employee who is an officer shall be counted as an officer for key employee purposes without regard to whether the employee is a key employee for any other reason. However, in testing whether the plan(s) is top-heavy, an individual's present value of accrued benefits is counted only once.

Example. A company is testing to see if its plan is top-heavy for the 1985 plan year. In each year from 1980 through 1984 it has more than 500 employees. Assume that (1) because of rapid turnover among officers, the individuals who are officers each year are different from the individuals who are officers in any preceding year, and (2) the annual plan year compensation of each officer exceeds 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends. Under the limitations, only a total of 50 individuals would be considered to be key employees by virtue of being officers in testing for top-heaviness for the 1985 plan year. Further, the 50 individuals considered as key employees under this test would be determined by selecting the 50 out of 250 individuals (50 different officers each year) who had the highest annual plan-year compensation during the 1980–1984 period (while officers).

T–15 Q. For purposes of section 416, do organizations other than corporations have officers?

A. Yes. For purposes of the top-heavy rules, sole proprietorships, partnerships, associations, trusts, and labor organizations may have officers. This rule is effective for purposes of determining whether a plan is top-heavy for plan years which begin after February 28, 1985.

T–16 Q. Who is a 1-percent owner of the employer?

A. (a) If the employer is a corporation, a 1-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 1 percent of the value of the outstanding stock of the corporation or stock possessing more than 1 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 1-percent owner is any employee who owns more than 1 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 1-percent owner.

(b) For purposes of determining who is a 1-percent owner, 5-percent owner, or top-ten owner, value means fair market value taking into account all facts and circumstances.

T–17 Q. Who is a 5-percent owner of the employer?

A. If the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner.

T–18 Q. How do the rules of section 318 apply for purposes of determining ownership in an entity other than a corporation?

A. For purposes of determining ownership is an entity other than a corporation, the rules of section 318 apply in a manner similar to the way in which they apply for purposes of determining ownership in a corporation. For non-corporate interests, capital or profits interest must be substituted for stock.

T–19 Q. Which employees will be considered one of the top ten owners?

A. (a) For purposes of determining whether a plan is top-heavy for a plan year, the top ten owners are the ten employees who (1) own (or are considered as owning within the meaning of section 318) during the plan year containing the determination date or any of the four preceding plan years both more than a ½ percent ownership interest in value and the largest percentage ownership interests in value of any of the employers required to be aggregated under section 414(b), (c), or (m), and (2) have during the plan year of ownership annual plan year compensation from the employer more than the limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends. The five years for which the test is made will be referred to as the ''testing period.'' An employee whose annual plan year compensation exceeds the section 415(c)(1)(A) limit in effect for the calendar year in which a plan year in the testing period ends who has an ownership interest greater than ½ percent in that plan year is considered to be one of the top ten owners unless at least ten other employees own a greater interest in the employer during any year of the testing period and have annual plan year compensation during such plan year of ownership greater than the section 415(c)(1)(A) limit in effect for the calendar year in which such plan year ends. Ownership each plan year is determined on the basis of percentage of ownership interest in total ownership value and not dollar amounts. Thus, an employee whose stock interest is valued at 15 percent of the total stock value of a corporation in year one that was worth $15,000 is ranked higher than an employee whose stock interest is valued at 5 percent of the total stock value of the same corporation in year three which is now worth $50,000.

(b) If an employee's ownership interest changes during a plan year, his ownership interest for the year is the largest interest owned at any time during the year. If two employees have the same ownership interest in the employer during the testing period, the employee having the largest annual compensation from the employer for the plan year during any part of which that ownership interest existed shall be treated as having a larger interest. Thus, if 25 employees each own 4 percent in value of the employer during the testing period, the 10 employees with the largest single plan year compensation during this period will be considered the top ten owners. For purposes of this Question and Answer, compensation has the meaning set forth in Question and Answer T–21. This Question and Answer is illustrated by the following examples:

Example 1. Corporation K maintains a calendar year defined contribution plan. On January 1, 1986, Corporation K has five owners who owned the following value percentages of K stock: A=50%, B=20%, C=15%, D=10%, and E=5%. On June 30, 1987, the five owners of Corporation K sold all of their shares of stock. The new owners and their respective ownership percentages were: F=40%, G=30%, H=10%, I=10%, and J=10%. Assume that, for 1986, A, B, C, D, and E had annual compensation from Corporation K greater than the section 415(c)(1)(A) limit and that, for 1987, F, G, H, I, and J also had compensation from Corporation K greater than the section 415(c)(1)(A) limit. For purposes of determining whether the plan is top-heavy for

the 1991 plan year, the top ten owners will include A, B, C, D, E, F, G, H, I, and J because no 10 individuals during the testing period, 1986–1990, had a greater ownership interest than these individuals.

Example 2. Assume the same facts in *Example 1*, except that on June 1, 1988, F, G, H, I, and J sold their interests to new owners, K, L, M, N, and O. K, L, M, N, and O owned, respectively, 30%, 30%, 30%, 5% and 5% of the value of the shares of X. Assume also that for 1988 K, L, M, N, and O earned more than the section 415(c)(1)(A) limitation. For purposes of determining whether the plan is top-heavy for the 1991 plan year, the top ten owners will include: A, B, F, K, G, L, M, and C because these eight individuals owned the highest value percentages of the Corporation K stock. Since D, H, I, and J owned equal 10% interests in value, the two employees of this group who had the largest annual plan year compensation during the plan years of their ownership will be the last 2 top ten owners.

T–20 Q. For purposes of determining whether an employee is a key employee under section 416(i)(1)(A), what aggregation rules apply?

A. In the case of ownership percentages, each employer that would otherwise be aggregated under section 414 (b), (c) and (m) is treated as a separate employer. (See section 416(i)(1)(C).) However, for purposes of determining whether an individual has compensation of $150,000, or whether an individual is a key employee by reason of being an officer or a top ten owner, compensation from each entity required to be aggregated under sections 414 (b), (c) and (m) is taken into account. These rules may be illustrated by the following example:

Example. An individual owns two percent of the value of a professional corporation, which in turn owns a 1/10th of 1 percent interest in a partnership. The entities must be aggregated in accordance with section 414(m). The individual performs services for the professional corporation and for the partnership. The individual receives compensation of $125,000 from the professional corporation and $26,000 from the partnership. The individual is considered to be a key employee with respect to the employer that comprises both the professional corporation and the partnership because he has a two percent interest in the professional corporation and because his combined compensation from both the professional corporation and the partnership is more than $150,000.

T–21 Q. For purposes of testing whether an individual has compensation of more than $150,000, what definition of compensation must be used?

A. The definition of compensation to be used is the definition in §1.415–2(d). In the case of an individual, including a self-employed individual, §1.415–2(d)(2)(i) excludes from compensation amounts contributed to a plan of deferred compensation. Alternatively, compensation that would be stated on an employee's Form W–2 for the calendar year that ends with or within the plan year may be used. A plan must use the same definition of compensation for all top-heavy purposes for which the definition in this Question and Answer must be used.

T–22 Q. In the case of an employer who maintains a single plan, when must the determination whether the plan is top-heavy be made?

A. Whether a plan is top-heavy for a particular plan year is determined as of the determination date for such plan year. The determination date with respect to a plan year is defined in section 416(g)(4)(C) as (1) the last day of the preceding plan year, or (2) in the case of the first plan year, the last day of such plan year. Distributions made and the present value of accrued benefits are generally determined as of the determination date. (See Questions and Answers T–24 and T–25 for more specific rules.)

T–23 Q. In the case of an aggregation group, when must the determination whether the group is top-heavy be made?

A. When two or more plans constitute an aggregation group in accordance with section 416(g)(2), the following procedures are used to determine whether the plans are top-heavy for a particular plan year. First, the present value of the accrued benefits (including distributions for key employees and all employees) is determined separately for each plan as of each plan's determination date. The plans are then aggregated by adding together the results for each plan as of the determination dates for such plans that fall within the same calendar year. The combined results will indicate whether or not the plans so aggregated are top-heavy. These rules may

be illustrated by the following example:

Example. An employer maintains Plan A and Plan B, each containing a key employee. Plan A's plan year commences July 1 and ends June 30. Plan B's plan year is the calendar year. For Plan A's plan year commencing July 1, 1984, the determination date is June 30, 1984. For Plan B's plan year in 1985, the determination date is December 31, 1984. These plans are required to be aggregated. For each of these plans as of their respective determination dates, the present value of the accrued benefits for key employees and all employees are separately determined. The two determination dates, June 30, 1984, and December 31, 1984, fall within the same calendar year. Accordingly, the present values of accrued benefits as of each of these determination dates are combined for purposes of determining whether the group is top-heavy. If, after combining the two present values, the total results show that the group is top-heavy, Plan A will be top-heavy for the plan year commencing July 1, 1984, and Plan B will be top-heavy for the 1985 calendar year.

T–24 Q. How is the present value of an accrued benefit determined in a defined contribution plan?

A. The present value of accrued benefits as of the determination date for any individual is the sum of (a) the account balance as of the most recent valuation date occurring within a 12-month period ending on the determination date, and (b) an adjustment for contributions due as of the determination date. In the case of a plan not subject to the minimum funding requirements of section 412, the adjustment in (b) is generally the amount of any contributions actually made after the valuation date but on or before the determination date. However, in the first plan year of the plan, the adjustment in (b) should also reflect the amount of any contributions made after the determination date that are allocated as of a date in that first plan year. In the case of a plan that is subject to the minimum funding requirements, the account balance in (a) should include contributions that would be allocated as of a date not later than the determination date, even though those amounts are not yet required to be contributed. Thus, the account balance will include contributions waived in prior years as reflected in the adjusted account balance and contributions not paid that resulted in a funding deficiency. The adjusted account balance is described in Rev. Rul. 78–223, 1978–1 C.B. 125. Also, the adjustment in (b) should reflect the amount of any contribution actually made (or due to be made) after the valuation date but before the expiration of the extended payment period in section 412(c)(10).

T–25. Q. How is the present value of an accrued benefit determined in a defined benefit plan?

A. The present value of an accrued benefit as of a determination date must be determined as of the most recent valuation date which is within a 12-month period ending on the determination date. In the first plan year of a plan, the accrued benefit for a current employee must be determined either (i) as if the individual terminated service as of the determination date or (ii) as if the individual terminated service as of the valuation date, but taking into account the estimated accrued benefit as of the determination date. For the second plan year of a plan, the accrued benefit taken into account for a current participant must not be less than the accrued benefit taken into account for the first plan year unless the difference is attributable to using an estimate of the accrued benefit as of the determination date for the first plan year and using the actual accrued benefit as of the determination date for the second plan year. For any other plan year, the accrued benefit for a current employee must be determined as if the individual terminated service as of such valuation date. For this purpose, the valuation date must be the same valuation date for computing plan costs for minimum funding, regardless of whether a valuation is performed that year.

T–26. Q. What actuarial assumptions are used for determining the present value of accrued benefits for defined benefit plans?

A. (a) There are no specific prescribed actuarial assumptions that must be used for determining the present value of accrued benefits. The assumptions used must be reasonable and need not relate to the actual plan and investment experience. The assumptions need not be the same as those used for

minimum funding purposes or for purposes of determining the actuarial equivalence of optional benefits under the plan. The accrued benefit for each current employee is computed as if the employee voluntarily terminated service as of the valuation date. The present value must be computed using an interest and a post-retirement mortality assumption. Pre-retirement mortality and future increases in cost of living (but not in the maximum dollar amount permitted by section 415) may also be assumed. However, assumptions as to future withdrawals or future salary increases may not be used. In the case of a plan providing a qualified joint and survivor annuity within the meaning of section 401(a)(11) as a normal form of benefit, for purposes of determining the present value of the accrued benefit, the spouse of the participant may be assumed to be the same age as the participant.

(b) Except in the case where the plan provides for a nonproportional subsidy, the present value should reflect a benefit payable commencing at normal retirement age (or attained age, if later). Thus, benefits not relating to retirement benefits, such as pre-retirement death and disability benefits and post-retirement medical benefits, must not be taken into account. Further, subsidized early retirement benefits and subsidized benefit options must not be taken into account unless they are nonproportional subsidies. See Question and Answer

T–27.

(c) Where the plan provides for a nonproportional subsidy, the benefit should be assumed to commence at the age at which the benefit is most valuable. In the case of two or more defined benefit plans which are being tested for determining whether an aggregation group is top-heavy, the actuarial assumptions used for all plans within the group must be the same. Any assumptions which reflect a reasonable mortality experience and an interest rate not less than five percent or greater than six percent will be considered as reasonable. Plans, however, are not required to use an interest rate in this range.

T–27 Q. In determining the present value of accrued benefits in a defined benefit plan, what standards are applied toward determining whether a subsidy is nonproportional?

A. A subsidy is nonproportional unless the subsidy applies to a group of employees that would independently satisfy the requirements of section 410(b). If two or more plans are considered as a unit for comparability purposes under §1.410(b)–1(d)(3), subsidies may be necessary in both plans or else the subsidy may be nonproportional. Thus, for example, in the case of a plan which provides an early retirement benefit after age 55 and 20 years of service equal to the normal retirement benefit without actuarial reduction and if the employees who may conceivably reach age 55 with 20 years of service would, as a group, satisfy the requirements of section 410(b), that subidy is proportional. However, in contrast, consider a plan that provides an early retirement benefit that is the actuarial equivalent of the normal retirement benefit. In determining the early retirement benefit, the plan imposes the section 415 limits only on the early retirement benefit (not on the normal retirement benefit before applying the early retirement reduction factors). In such a plan, a participant with a normal retirement benefit (before limitation by section 415) in excess of the section 415 limits will receive a subsidized early retirement benefit, whereas a participant with a lower normal retirement benefit will not. Thus, such a benefit would be a nonproportional subsidy if the group of individuals who are limited by the limitations under section 415 do not, by themselves, constitute a cross section of employees that could satisfy section 410(b).

T–28 Q. For purposes of determining the present value of accrued benefits in either a defined benefit or defined contribution plan, are the accrued benefits attributable to employee contributions considered to be part of the accrued benefits?

A. The accrued benefits attributable to employee contributions are considered to be part of the accrued benefits without regard to whether such contributions are mandatory or voluntary. However, the amounts attributable to deductible employee contributions (as

defined in section 72(o)(5)(A)) are not considered to be part of the accrued benefits.

T–29 Q. How are plans described in section 401(k) treated for purposes of the top-heavy rules?

A. No special top-heavy rules are provided for plans described in section 401(k), except a transitional rule. For plan years beginning after December 31, 1984, amounts which an employee elects to defer are treated as employer contributions for purposes of determining minimum required contributions under section 416(c)(2). However, for plan years beginning prior to January 1, 1985, amounts which an employee elects to have contributed to a plan described in section 401(k) are not treated as employer contributions for these purposes. A plan described in section 401(k) which is top-heavy must provide minimum contributions by the employer and limit the amount of compensation which can be taken into account in providing benefits under the plan.

T–30 Q. What distributions are added to the present value of accrued benefits in determining whether a plan is top-heavy for a particular plan year?

A. Under section 416(g)(3)(A), distributions made within the plan year that includes the determination date and within the four preceding plan years are added to the present value of accrued benefits of key employees and non-key employees in testing for top-heaviness. However, in the case of distributions made after the valuation date and prior to the determination date, such distributions are not included as distributions in section 416(g)(3)(A) to the extent that such distributions are included in the present value of the accrued benefits as of the valuation date. In the case of the distribution of an annuity contract, the amount of such distribution is deemed to be the current actuarial value of the contract, determined on the date of the distribution. Certain distributions that are rolled over by the employee are not included as distributions. See Question and Answer T–32. A distribution will not fail to be considered in determining the present value of accrued benefits merely because it was made before the effective date of section 416. For purposes of this question and answer, distributions mean all distributions made by a plan, including all distributions of employee contributions made during and before the plan year.

T–31 Q. Are benefits paid on account of death treated as distributions for purposes of section 416(g)(3)?

A. Benefits paid on account of death are treated as distributions for purposes of section 416(g)(3) to the extent such benefits do not exceed the present value of accrued benefits existing immediately prior to death; benefits paid on account of death are not treated as distributions for purposes of section 416(g)(3) to the extent such benefits exceed the present value of accrued benefits existing immediately prior to death. The distribution from a defined contribution plan (including the cash value of life insurance policies) of a participant's account balance on account of death will be treated as a distribution for purposes of section 416(g)(3).

T–32 Q. How are rollovers and plan-to-plan transfers treated in testing whether a plan is top-heavy?

A. The rules for handling rollovers and transfers depend upon whether they are unrelated (both initiated by the employee and made from a plan maintained by one employer to a plan maintained by another employer) or related (a rollover or transfer either not initiated by the employee or made to a plan maintained by the same employer). Generally, a rollover or transfer made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans will not be treated as being initiated by the employee. The fact that the employer initiated the distribution does not mean that the rollover was not initiated by the employee. For purposes of determining whether two employers are to be treated as the same employer, all employers aggregated under section 414(b), (c) or (m) are treated as the same employer. In the case of unrelated rollovers and transfers, (1) the plan making the distribution or transfer is to count the distribution as a distribution under section 416(g)(3), and (2) the plan accepting the rollover or transfer is not to consider the rollover or transfer as

part of the accrued benefit if such rollover or transfer was accepted after December 31, 1983, but is to consider it as part of the accrued benefit if such rollover or transfer was accepted prior to January 1, 1984. In the case of related rollovers and transfers, the plan making the distribution or transfer is not to count the distribution or transfer under section 416(g)(3) and the plan accepting the rollover or transfer counts the rollover or transfer in the present value of the accrued benefits. Rules for related rollovers and transfers do not depend on whether the rollover or transfer was accepted prior to January 1, 1984.

T–33 Q. How are the aggregate defined benefit and defined contribution limits under section 415(e) affected by the top-heavy rules?

A. Section 416(h) modifies the aggregate limits in section 415(e) for super top-heavy plans and for top-heavy plans that are not super top-heavy but do not provide for an additional minimum contribution or benefit. A plan is a super top-heavy plan if the present value of accrued benefits for key employees exceeds 90% of the present value of the accrued benefits for all employees. In the case of a top-heavy aggregation group, the test is applied to all plans in the group as a whole. These present values are computed using the same rules as are used for determining whether the plan is top-heavy. In the case of a super top-heavy plan, in computing the denominators of the defined benefit and defined contribution fractions under section 415(e), a factor of 1.0 is used instead of 1.25 for all employees. In the case of a top-heavy plan that is not super top-heavy, the same rule applies unless each non-key employee who is entitled to a minimum contribution or benefit receives an additional minimum contribution or benefit. In the case of a defined benefit plan, the additional minimum benefit is one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2. In the case of a defined contribution plan, the additional minimum contribution is one percent of the participant's compensation. If a plan does not provide the applicable additional one percent minimum or if a plan is super top-heavy, the factor of 1.25 may be used for an individual only if there are both no further accruals for that individual under any defined benefit plan and no further annual additions for that individual under any defined contribution plan until the combined fraction satisfies the rules of section 415(e) using the 1.0 factor for that individual. The rules contained in this Question and Answer apply for each limitation year that contains any portion of a plan year for which the plan is top-heavy. This Question and Answer may be illustrated by the following example:

Example. A Corporation maintains a profit-sharing plan and a defined benefit plan, and these plans constitute a required aggregation group. Both plans use the calendar year for the plan year and the limitation year under section 415. The plans were determined to be top-heavy for plan year 1986. The plans use the 1.25 factor under section 415(e), and non-key employees covered by both the profit-sharing and the defined benefit plan accrue, under the defined benefit plan, 3% of compensation for each year of service (up to a maximum of 30%). The plans become super top-heavy for the 1990 plan year. In order to satisfy section 415, no further accruals and no further annual additions may take place for any employee covered by both plans until the combined defined benefit-defined contribution fraction for such employee is less than 1.0, using the 1.0 factor in place of 1.25.

T–34 Q. May plans be permissively aggregated to avoid being super top-heavy?

A. Yes, plans may be permissively aggregated to avoid being super top-heavy.

T–35 Q. What provisions must be contained in a plan to comply with the top-heavy requirements?

A. Section 401(a)(10)(B) provides that a plan will qualify only if it contains provisions which will take effect if the plan becomes top-heavy and which meet the requirements of section 416. See Questions and Answers T–39 and T–40 for rules on what provisions must be included. Under section 401(a)(10)(B)(ii), regulations may waive this requirement for some plans. See Question and Answer T–38 for a description of plans that need not include such provisions.

T–36 Q. For an employer who has no employee who has participated or is eligible to participate in both a defined benefit and defined contribution plan (or a simplified employee pension, ''SEP'') of that employer, what provisions must be in the plan(s) to comply with the top-heavy requirements?

A. (a) If the defined benefit plan has no participants who are or could be participants in a defined contribution plan of the employer (or vice versa), the defined benefit plan (or defined contribution plan) need not include provisions describing the defined benefit or defined contribution fractions for purposes of section 415 and, thus, the plan need not contain provisions to determine whether the plan is super top-heavy or to change any plan provisions if the plan becomes super top-heavy. Furthermore, if the plan contains a single benefit structure that satisfies the requirements of section 416 (b), (c), and (d) for each plan year without regard to whether the plan is top-heavy for such year, the plan need not include separate provisions to determine whether the plan is top-heavy or that apply if the plan is top-heavy. If the plan's single benefit structure does not assure that section 416 (b), (c), and (d) will be satisfied in all cases, then the plan must include three types of provisions.

(b) First, the plan must contain provisions describing how to determine whether the plan is top-heavy. These provisions must include (1) the criteria for determining which employees are key employees (or non-key employees), (2) in the case of a defined benefit plan, the actuarial assumptions and benefits considered to determine the present value of accrued benefits, (3) a description of how the top-heavy ratio is computed, (4) a description of what plans (or types of plans) will be aggregated in testing whether the plan is top-heavy, and (5) a definition of the determination date and the valuation date applicable to the determination date. These determinations must be based on standards that are uniformly and consistently applied and that satisfy the rules set forth in section 416 and these Questions and Answers. The provisions in (1) and (3) above may be incorporated in the plan by reference to the applicable sections of the Internal Revenue Code without adversely affecting the qualification of the plan. However, the plan must state the definition of compensation for purposes of determining who is a key employee.

(c) Second, the plan must specifically contain the following provisions that will become effective if the plan becomes top-heavy: vesting that satisfies the minimum vesting requirements of section 416(b), benefits that will not be less than the minimum benefits set forth in section 416(c), and the compensation limitation described in section 416(d). The compensation limitation described in section 416(d) may be incorporated by reference. If a plan always meets the requirements of either section 416(b), (c) or (d), the plan need not include additional provisions to meet any such requirements.

(d) Third, the plan must include provisions insuring that any change in the plan's benefit structure (including vesting schedules) resulting from a change in the plan's top-heavy status will not violate section 411(a)(10). Thus, if a plan ceases being top-heavy, certain restrictions apply with respect to the change in the applicable vesting schedule.

T–37 Q. For an employer who maintains or has maintained both a defined benefit and a defined contribution plan (or a simplified employee pension, ''SEP'') and some participants do or could participate in both types of plan, what provisions must be in the plans to comply with the top-heavy requirements?

A. If an employer maintains (or has maintained) both a defined benefit plan and a defined contribution plan (or SEP), and the plans have or could have participants who participate in both types of plans, then the plans must contain more provisions than those described in Question and Answer T-36. First, the plans may exclude rules to determine whether the plan is top-heavy (or to apply when the plan is top-heavy) only if both plans contain a single benefit structure that satisfies sections 416 (b), (c), and (d) without regard to whether the plans are top-heavy. Second, unless the plans always satisfy the requirements of section 415(e) using the 1.0 factor in the defined

benefit and defined contribution fractions as described in section 416(h)(i), the plans must include provisions similar to those in Question and Answer T–36 (for top-heavy) to determine whether the plan is super top-heavy and to satisfy section 416(h) if it is.

T–38 Q. Are any plans exempted from including top-heavy provisions?

A. Section 401(a)(10)(B) exempts governmental plans (as defined in section 414(d)) from the top-heavy requirements and provides that regulations may exempt certain plans from including the top-heavy provisions. A plan need not include any top-heavy provisions if the plan: (1) is not top-heavy, and (2) covers only employees who are included in a unit of employees covered by a collective-bargaining agreement (if retirement benefits were the subject of good faith bargaining) or employees of employee representatives. The requirement set forth in section 7701(a)(46) must be met before an agreement will be considered a collective-bargaining agreement after March 31, 1984.

T–39 Q. Must ratios be computed each year to determine whether a plan is top-heavy?

A. No. In order to administer the plan, the plan administrator must know whether the plan is top-heavy. However, precise top-heavy ratios need not be computed every year. If, on examination, the Internal Revenue Service requests a demonstration as to whether the plan is top-heavy (or super top-heavy; see Question and Answer T–33) the employer must demonstrate to the Service's satisfaction that the plan is not operating in violation of section 401(a)(10)(B). For purposes of any demonstration, the employer may use computations that are not precisely in accordance with this section but which mathematically prove that the plan is not top-heavy. For example, if the employer determined the present value of accrued benefits for key employees in a simplified manner which overstated that value, determined the present value for non-key employees in a simplified manner which understated that value, and the ratio of the key employee present value divided by the sum of the present values was less than 60 percent, the plan would not be considered top-heavy. This would be a sufficient demonstration because the simplified fraction could be shown to be greater than the exact fraction and, thus, the exact fraction must also be less than 60 percent.

Several methods that may be used to simplify the determinations are indicated below.

(1) If the top-heavy ratio, computed considering all the key employees and only some of the non-key employees, is less than 60 percent, then it is not necessary to accumulate employee data on the remaining non-key employees. Inclusion of additional non-key employees would only further decrease the ratio.

(2) If the number of key employees is known but the identity of the key employees is not known (i.e. if the only key employees are officers and the limit on officers is applicable), the numerator may be determined by using a hypothetical ''worst case'' basis. Thus, in the case of a defined benefit plan, if the numerator of the top-heavy ratio were determined assuming each key employee's present value of accrued benefits were equal to the maximum section 415 benefits at the age that would maximize such present value, that assumption would only overstate the present value of accrued benefits for key employees. Thus, if that ratio is less than 60 percent, the plan is not top-heavy and accurate data on the key employees need not be collected.

(3) If the employer has available present value of accrued benefit computations for key and non-key employees in a defined benefit plan, and these values differ from those that would be produced under Question and Answer T–25 only by inclusion of a withdrawal assumption, the present value for the key employees (but not the non-key employees) may be adjusted to a ''worst case'' value by dividing by the lowest possible probability of not withdrawing from plan participation before normal retirement age. If the top-heavy ratio based on this inflated key employee value is less than 60 percent, the present value need not be recomputed without the withdrawal assumption. The methods set forth in this answer may also be used to determine whether a plan is super top-heavy by

inserting ''90%'' for ''60%'' in the appropriate places.

T–40 Q. Will a plan fail to qualify if it provides that the $200,000 maximum amount of annual compensation taken into account under section 416(d) for any plan year that the plan is top-heavy may be automatically increased in accordance with regulations under section 416?

A. No.

T–41 Q. If a plan provides benefits based on compensation in excess of $200,000 and the plan becomes top-heavy, must any accrued benefits attributable to this excess compensation be eliminated?

A. No. For any year that a plan is top-heavy, section 416(d) provides that compensation in excess of $200,000 must not be taken into account. However, a top-heavy plan may continue to provide for any benefits attributable to compensation in excess of $200,000 to the extent such benefits were accrued before the plan was top-heavy. Furthermore, section 411(d)(6) will be violated if any individual's pre-top-heavy benefit is reduced by either (1) a plan amendment adding the $200,000 restriction, or (2) an automatic change in the plan benefits structure imposing the $200,000 restriction due to the plan's becoming top-heavy.

T–42 Q. Under a top-heavy defined benefit plan, are the requirements of section 416(d) satisfied if the annual compensation of an employee taken into account to determine plan benefits is limited to the amount currently described in section 416(d) for years during which the plan is top-heavy but higher compensation is taken into account for years before the plan became top-heavy?

A. No. For the top-heavy plan to meet the requrements of section 416(d), compensation for all years, including years before the plan became top-heavy, that is taken into account to determine plan benefits must not exceed the amount currently described in section 416(d). However, if the accrued benefit as of the end of the last plan year before the plan became top-heavy (ignoring any plan amendments after that date) is greater than the accrued benefit determined by limiting compensation in accordance with section 416(d), that higher accrued benefit as of the end of the last plan year before the plan became top-heavy must not be reduced. Providing such higher accrued benefit will not cause the plan to violate section 416(d).

T–43 Q. What happens to an individual who has ceased employment before a plan becomes top-heavy?

A. If an individual has ceased employment before a plan becomes top-heavy, such individual would not be required to receive any additional benefit accruals, contributions, or vesting, unless the individual returned to employment with the employer. See Questions and Answers V–3, M–4, and M–10. In addition, if the individual is receiving benefits based on annual compensation greater than $200,000, such benefits cannot be decreased.

V. Vesting Rules for Top-Heavy Plans

V–1 Q. What vesting must be provided under a top-heavy plan?

A. Under section 416(b), the accrued benefits attributable to employer contributions must be nonforfeitable in accordance with one of two statutory standards. Either such accrued benefits must be nonforfeitable after 3 years of service or the nonforfeitable portion of accrued benefits must be at least 20 percent after 2 years of service, 40 percent after 3 years of service, 60 percent after 4 years of service, 80 percent after 5 years of service, and 100 percent after 6 years of service. The accrued benefits attributable to employer contributions has the same meaning as under section 411(c) of the Code. As under section 411(a), the accrued benefits attributable to employee contributions must be nonforfeitable at all times.

V–2 Q. What service must be counted in determining vesting requirements?

A. All service required to be counted under section 411(a) must be counted for these purposes. All service permitted to be disregarded under section 411(a)(4) may similarly be disregarded under the schedules of section 416(b).

V–3 Q. What benefits must be subject to the minimum vesting schedule of section 416(b)?

A. All accrued benefits within the meaning of section 411(a)(7) must be

subject to the minimum vesting schedule. These accrued benefits include benefits accrued before the effective date of section 416 and benefits accrued before a plan becomes top-heavy. However, when a plan becomes top-heavy, the accrued benefits of any employee who does not have an hour of service after the plan becomes top-heavy are not required to be subject to the minimum vesting schedule. Accrued benefits which have been forfeited before a plan becomes top-heavy need not vest when a plan becomes top-heavy.

V–4 Q. May a top-heavy plan provide a minimum eligibility requirement of the later of age 21 or the completion of 3 years of service and provide that all benefits are nonforfeitable when accrued?

A. Yes. For plan years which begin after December 31, 1984, a top-heavy plan may provide a minimum eligibility requirement of the later of age 21, or the completion of 3 years of service, and provide that all benefits are nonforfeitable when accrued. For plan years which begin before January 1, 1985, ''25'' may be substituted for ''21'' in the preceding sentence.

V–5 Q. What does nonforfeitable mean?

A. In general, nonforfeitable has the same meaning as in section 411(a). However, the minimum benefits required under section 416 (to the extent required to be nonforfeitable under section 416(b)) may not be forfeited under section 411(a)(3) (B) or (D). Thus, if benefits are suspended (ceased) during a period of reemployment, the benefit payable upon the subsequent resumption of payments must be actuarially increased to reflect the nonpayment of benefits during such period of re-employment.

V–6 Q. Will a class-year plan automatically satisfy the minimum vesting requirements in section 416(b) if it provides that contributions with respect to any plan year become nonforfeitable no later than the end of the third plan year following the plan year for which the contribution was made?

A. No. Although this vesting schedule is similar to the 3-year minimum vesting schedule permitted by section 416(b)(1)(A), it does not satisfy that minimum. The 3-year vesting schedule in section 416(b)(1)(A) requires that, after completion of 3 years of service, the entire accrued benefit of a participant be nonforfeitable. Under the class-year vesting schedule described above, a portion of a participant's accrued benefit (that portion attributable to contributions for the prior 3 years) is forfeitable regardless of the participant's years of service.

V–7 Q. When a top-heavy plan ceases to be a top-heavy, may the vesting schedule be altered to a vesting schedule permitted without regard to section 416?

A. When a top-heavy plan ceases to be top-heavy, the vesting schedule may be changed to one that would otherwise be permitted. However, in changing the vesting schedule, the rules described in section 411(a)(10) apply. Thus, the nonforfeitable percentage of the accrued benefit before the plan ceased to be top-heavy must not be reduced; also, any employee with five or more years of service must be given the option of remaining under the prior (i.e., top-heavy) vesting schedule.

M. Minimum Benefits under Top-heavy Plans

M–1 Q. Which employees must receive minimum contributions or benefits in a top-heavy plan?

A. Generally, every non-key employee who is a participant in a top-heavy plan must receive minimum contributions or benefits under such plan. However, see Questions and Answers M–4 and M–10 for certain exceptions. Different minimums apply for defined benefit and defined contribution plans.

M–2 Q. What is the defined benefit minimum?

A. (a) The defined benefit minimum requires that the accrued benefit at any point in time must equal at least the product of (i) an employee's average annual compensation for the period of consecutive years (not exceeding five) when the employee had the highest aggregate compensation from the employer and (ii) the lesser of 2% per year of service with the employer or 20%.

(b) For purposes of the defined benefit minimum, years of service with the employer are generally determined under the rules of section 411(a) (4), (5)

and (6). However, a plan may disregard any year of service if the plan was not top-heavy for any plan year ending during such year of service, or if the year of service was completed in a plan year beginning before January 1, 1984.

(c) In determining the average annual compensation for a period of consecutive years during which the employee had the largest aggregate compensation, years for which the employee did not earn a year of service under the rules of section 411(a) (4), (5), and (6) are to be disregarded. Thus, if an employee has received compensation from the employer during years one two, and three, and for each of these years the employee earned a year of service, then the employee's average annual compensation is determined by dividing the employee's aggregate compensation for these three years by three. If the employee fails to earn a year of service in the next year, but does earn a year of service in the fifth year, the employee's average annual compensation is calculated by dividing the employee's aggregate compensation for years one, two, three, and five by four. The compensation required to be taken into account is the compensation described in Question and Answer T–21. In addition, compensation received for years ending in plan years beginning before January 1, 1984, and compensation received for years beginning after the close of the last plan year in which the plan is top-heavy may be disregarded.

(d) The defined benefit minimum is expressed as a life annuity (with no ancillary benefits) commencing at normal retirement age. Thus, if post-retirement death benefits are also provided, the 2% minimum annuity benefit may be adjusted. (See Question and Answer M–3.) The 2% minimum annuity benefit may not be adjusted due to the provision of pre-retirement ancillary benefits. Normal retirement age has the same meaning as under section 411(a)(8).

(e) Any accruals of employer-derived benefits, whether or not attributable to years for which the plan is top-heavy, may be used to satisfy the defined benefit minimums. Thus, if a non-key employee had already accrued a benefit of 20 percent of final average pay at the time the plan became top-heavy, no additional minimum accruals are required (although the accrued benefit would increase as final average pay increased). Accrued benefits attributable to employee contributions must be ignored. Accrued benefits attributable to employer and employee contributions have the same meaning as under section 411(c).

M–3 Q. What defined benefit minimum must be received if an employee receives a benefit in a form other than a single life annuity or a benefit other than at normal retirement age?

A. If the form of benefit is other than a single life annuity, the employee must receive an amount that is the actuarial equivalent of the minimum single life annuity benefit. If the benefit commences at a date other than at normal retirement age, the employee must receive at least an amount that is the acturial equivalent of the minimum single life annuity benefit commencing at normal retirement age. Thus, the employee may receive a lower benefit if the benefit commences before the normal retirement age and the employee must receive a higher benefit if the benefit commences after the normal retirement age. No specific actuarial assumptions are mandated providing different actuarial equivalents. However, the assumptions must be reasonable.

M–4 Q. Which employees must accrue a minimum benefit in a top-heavy defined benefit plan?

A. Each non-key employee who is a participant in a top-heavy defined benefit plan and who has at least one thousand hours of service (or equivalent service as determined under Department of Labor regulations, 29 CFR 2530.200b–3) for an accrual computation period must accrue a minimum benefit in a top-heavy defined benefit plan for that accrual computation period. If the accrual computation period does not coincide with the plan year, a minimum benefit must be provided, if required, for both accrual periods within the top-heavy plan year. For a top-heavy plan that does not base accruals on accrual computation periods, minimum benefits must be credited for all periods of service required to be credited for benefit accrual. (See §1.410(a)–

7). A non-key employee may not fail to accrue a minimum benefit merely because the employee was not employed on a specified date. Similarly, a non-key employee may not fail to accrue a minimum benefit because either (1) an employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions.

M–5 Q. Would the defined benefit minimum be satisfied if the plan provides a normal retirement benefit equal to the greater of the plan's projected formula or the projected minimum benefit and if benefits accrue in accordance with the fractional rule described in section 411(b)(1)(C)?

A. No. The fact that this fractional rule would not satisfy the defined benefit minimum may be illustrated by the following example. Consider a non-key employee, age 25, entering a top-heavy plan in which the projected minimum for the employee is greater than the projected benefit under the normal formula. Under the fractional rule, the employee's accrued benefit ten years later at age 35 would be 5% (20% ×(10/40)). Under section 416, the employee's minimum accrued benefit after ten years of service must be at least 20%. Thus, because the 5% benefit is less than the 20% benefit required under section 416, such benefit would not satisfy the required minimum.

M–6 Q. What benefit must an employer provide in a top-heavy defined benefit employee pay-all plan?

A. The defined benefit minimum in an employee pay-all top-heavy plan is the same as that for a plan which has employer contributions. That is, the employer must provide the benefits specified in Question and Answer M–2.

M–7 Q. What is the defined contribution minimum?

A. The sum of the contributions and forfeitures allocated to the account of any non-key employee who is a participant in a top-heavy defined contribution plan must equal at least 3% of such employee's compensation (see Question and Answer T–21 for the definition of compensation) for that plan year or for the calendar year ending within the plan year. However, a lower minimum is permissible where the largest contribution made or required to be made for key employees is less than 3%. The preceding sentence does not apply to any plan required to be included in an aggregation group if such plan enables a defined benefit plan required to be included in such group to meet the requirements of section 401(a)(4) or 410. The contribution made or required to be made on behalf of any key employee is equal to the ratio of the sum of the contributions made or required to be made and forfeitures allocated for such key employee divided by the compensation (not in excess of $200,000) for such key employee. Thus, the defined contribution minimum that must be provided for any non-key employee for a top-heavy plan year is the largest percentage of compensation (not in excess of $200,000) provided on behalf of any key employee for that plan year (if the largest percentage of compensation provided on behalf of any key employee for that plan year is less than 3%).

M–8 Q. If an employer maintains two top-heavy defined contribution plans, must both plans provide the defined contribution minimum for each non-key employee who is a participant in both plans?

A. No. If one of the plans provides the defined contribution minimum for each non-key employee who participates in both plans, the other plan need not provide an additional contribution for such employees. However, the other plan must provide the vesting required by section 416(b) and must limit compensation (based on all compensation from all aggregated employers) in providing benefits as required by section 416(d).

M–9 Q. In the case of the waiver of minimum funding standards of section 412(d), how does section 416 treat the defined contribution minimum?

A. For purposes of determining the contribution that is required to be made on behalf of a key employee, a waiver of the minimum funding requirements is disregarded. Thus, if a defined contribution plan receives a

waiver of the minimum funding requirement, and if the minimum contribution required under the plan without regard to the waiver exceeds 3%, the exception described in Question and Answer M–7 does not apply even though no key employee receives a contribution in excess of 3% and even though the amount required to be contributed on behalf of the key employee has been waived. Also, a waiver of the minimum funding requirements will not alter the requirements of section 416. Thus, in the case of the top-heavy defined contribution plan in which the non-key employee must receive an allocation, a waiver of the minimum funding requirements may eliminate a funding violation and such waiver will preclude a violation under section 416 even though the required contribution is not made. However, the adjusted account balance (as described in Rev. Rul. 78–223, 1978–1 C.B. 125) of the non-key employees must reflect the required minimum contribution even though such contribution was not made.

M–10 Q. Which employees must receive the defined contribution minimum?

A. Those non-key employees who are participants in a top-heavy defined contribution plan who have not separated from service by the end of the plan year must receive the defined contribution minimum. Non-key employees who have become participants but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the defined contribution minimum. A non-key employee may not fail to receive a defined contribution minimum because either (1) the employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions or, in the case of a cash or deferred arrangement, elective contributions.

M–11 Q. May either the defined benefit minimum or the defined contribution minimum be integrated with social security?

A. No.

M–12 Q. What minimum contribution or benefit must be received by a non-key employee who participates in a top-heavy plan?

A. In the case of an employer maintaining only one plan, if such plan is a defined benefit plan, each non-key employee covered by that plan must receive the defined benefit minimum. If such plan is a defined contribution plan (including a target benefit plan), each non-key employee covered by the plan must receive the defined contribution minimum. In the case of an employer who maintains more than one plan, employees covered under only the defined benefit plan must receive the defined benefit minimum. Employees covered under only the defined contribution plan must receive the defined contribution minimum. In the case of employees covered under both defined benefit and defined contribution plans, the rules are more complicated. Section 416(f) precludes, in the case of employees covered under both defined benefit and defined contribution plans, either required duplication or inappropriate omission. Therefore, such employees need not receive both the defined benefit and the defined contribution minimums.

There are four safe harbor rules a plan may use in determining which minimum must be provided to a non-key employee who is covered by both defined benefit and defined contribution plans. Since the defined benefit minimums are generally more valuable, if each employee covered under both a top-heavy defined benefit plan and a top-heavy defined contribution plan receives the defined benefit minimum, the defined benefit and defined contribution minimums will be satisfied. Another approach that may be used is a floor offset approach (see Rev. Rul. 76–259, 1976–2 C.B. 111) under which the defined benefit minimum is provided in the defined benefit plan and is offset by the benefits provided under the defined contribution plan. Another approach that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis (see Rev. Rul. 81–202, 1981–2 C.B. 93) that the plans are providing

benefits at least equal to the defined benefit minimum. Finally, in order to preclude the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan and the annual fluctuation of a comparability analysis, a safe haven minimum defined contribution is being provided. If the contributions and forfeitures under the defined contribution plan equal 5% of compensation for each plan year the plan is top-heavy, such minimum will be presumed to satisfy the section 416 minimums.

M–13 Q. An employer maintains a defined benefit plan and a profit-sharing plan. Both plans are top-heavy and are members of a required aggregation group. In order to meet the minimum contribution/minimum benefit requirements, the employer decides to contribute 5% of compensation to the profit-sharing plan. What happens if for a particular plan year there are no profits out of which to make contributions to the profit-sharing plan?

A. In this particular situation, in order to satisfy the requirements of section 416(c), the employer must provide the defined contribution minimum, 5% of compensation. This rule is an exception to the general rule that an employer cannot make a contribution to a profit-sharing plan if there are no profits. Alternatively, the employer may provide the defined benefit minimum for this year.

M–14 Q. What minimum contribution or benefit must be received by a non-key employee when he is covered under both a defined benefit plan and defined contribution plan (both of which are top-heavy) of an employer and the employer desires to use a factor of 1.25 in computing the denominators of the defined benefit and defined contribution fractions under section 415(e)?

A. In this particular situation, the employer may use one of the four rules set forth in Question and Answer M–12, subject to the following modifications. The defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2. The defined contribution minimum is increased to 7½ percent of compensation. If the floor offset or comparability analysis approach is used, the defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2.

M–15 Q. May an employer use a different method each year to meet the requirements of Question and Answer M–12 or Question and Answer M–14 without amending the plans each year?

A. No. An employer must set forth in the plan document the method he will use to meet the requirements of Question and Answer M–12 or M–14, as the case may be. If an employer desires to change the method, the plan document must be amended.

M–16 Q. Will target benefit plans be treated as defined benefit or defined contribution plans for purposes of the top-heavy rules?

A. Target benefit plans will be treated as defined contribution plans for purposes of the top-heavy rules.

M–17 Q. Can a plan described in section 412(i) (funded exclusively by level premium insurance contracts) also satisfy the minimum benefit requirements of section 416?

A. The accrued benefits provided for a non-key employee under most level premium insurance contracts might not provide a benefit satisfying the defined benefit minimum because of the lower cash values in early years under most level premium insurance contracts, and because such contracts normally provide for level premiums until normal retirement age. However, a plan will not be considered to violate the requirements of section 412(i) merely because it funds certain benefits through either an auxiliary fund or deferred annuity contracts, if the following conditions are met:

(1) The targeted benefit at normal retirement age under the level premium insurance contract is determined, taking into account the defined benefit minimum that would be required assuming the current top-heavy (or non top-heavy) status of the plan continues until normal retirement age; and

(2) The benefits provided by the auxiliary fund or deferred annuity contracts do not exceed the excess of the defined benefit minimum benefits over the benefits provided by the level premium insurance contract.

If the above conditions are satisfied, then the plan is still exempt from the minimum funding requirements under section 412 and may still utilize the special accrued benefit rule in section 411(b)(1)(F) subject to the following modifications: Although the portion of the plan funded by the level premium annuity contract is exempt from the minimum funding requirements, the portion funded by an auxiliary fund is subject to those requirements. (Thus, a funding standard account must be maintained and a Schedule B must be filed with the annual report). The accrued benefit for any participant may be determined using the rule in section 411(b)(1)(F) but must not be less than the defined benefit minimum.

M–18 Q. May qualified nonelective contributions described in section 401(m)(4)(C) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Yes. This is the case even if the qualified nonelective contributions are taken into account under the actual deferral percentage test of §1.401(k)–1(b)(2) or under the actual contribution percentage test of §1.401(m)–1(b).

M–19 Q. May matching contributions described in section 401(m)(4)(A) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Matching contributions allocated to key employees are treated as employer contributions for purposes of determining the minimum contribution or benefit under section 416. However, if a plan uses contributions allocated to employees other than key employees on the basis of employee contributions or elective contributions to satisfy the minimum contribution requirement, these contributions are not treated as matching contributions for purposes of applying the requirements of sections 401(k) and 401(m) for plan years beginning after December 31, 1988. Thus these contributions must meet the nondiscrimination requirements of section 401(a)(4) without regard to section 401(m). See §1.401(m)–1(f)(12)(iii).

M–20 Q. May elective contributions be treated as employer contributions for purposes of satisfying the minimum contribution or benefit requirement of section 416(c)(2)?

A. Elective contributions on behalf of key employees are taken into account in determining the minimum required contribution under section 416(c)(2). However, elective contributions on behalf of employees other than key employees may not be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416. See section 401(k)(4)(C) and the regulations thereunder. This Question and Answer is effective for plan years beginning after December 31, 1988.

[T.D. 7997, 49 FR 50646, Dec. 31, 1984, as amended by T.D. 8357, 56 FR 40550, Aug. 15, 1991]

§1.417(e)–1 Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417.

(a) *Scope*—(1) *In general.* A plan does not satisfy the requirements of sections 401(a)(11) and 417 unless it satisfies the consent requirements, the determination of present value requirements and the other requirements set forth in this section. See section 401(a)(11) and §1.401(a)–20 for other rules regarding the survivor annuity requirements.

(2) *Additional requirements.* See §1.411(a)–11 for other rules applicable to the consent requirements.

(3) *Accrued benefit.* The definition of ''accrued benefit'' in §1.411(a)–11 applies when that term is used in this section.

(b) *Consent, etc. requirements*—(1) *General rule.* Generally plans may not commence the distribution of any portion of a participant's accrued benefit in any form unless the applicable consent requirements are satisfied. No consent of the participant or spouse is needed for distribution of a QJSA or QPSA after the benefit is no longer immediately distributable (after the participant attains (or would have attained if not dead) the later of normal retirement age (as defined in section 411(a)(8)) or age 62). No consent of the

spouse is needed for distribution of a QJSA at any time. After the participant's death, a benefit may be paid to a nonspouse beneficiary without the beneficiary's consent. A distribution cannot be made at any time in a form other than a QJSA unless such QJSA has been waived by the participant and such waiver has been consented to by the spouse. A QJSA is an annuity that commences immediately. Thus, for example, a plan may not offer a participant separating from service at age 45 a choice only between a single sum distribution at separation of service and a joint and survivor annuity that satisfies all the requirements of a QJSA except that it commences at normal retirement age rather than immediately. To satisfy this section, the plan must also offer a QJSA (*i.e.*, an annuity that satisfies all the requirements for a QJSA including the requirement that it commences immediately).

(2) *Consent.* (i) Written consent of the participant and, if the participant is married at the annuity starting date and the benefit is to be paid in a form other than a QJSA, the participant's spouse (or, if either the participant or the spouse has died, the survivor) is required before the commencement of the distribution of any part of an accrued benefit if the present value of the nonforfeitable benefit is greater than the cash-out limit in effect under §1.411(a)–11(c)(3)(ii). No consent is valid unless the participant has received a general description of the material features, and an explanation of the relative values of, the optional forms of benefit available under the plan in a manner which would satisfy the notice requirements of section 417(a)(3). *See* §1.401(a)–20 Q&A 36. No consent is required before the annuity starting date if the present value of the nonforfeitable benefit is not more than the cash-out limit in effect under §1.411(a)–11(c)(3)(ii). After the annuity starting date, consent is required for the immediate distribution of the present value of the accrued benefit being distributed in any form, including a qualified joint and survivor annuity or a qualified preretirement survivor annuity, regardless of the amount of such present value.

(ii) In determining the present value of any nonforfeitable accrued benefit, a defined benefit plan is limited by the interest rate restriction as set forth in paragraph (d) of this section.

(iii) Paragraph (b)(2)(i) of this section applies to distributions made on or after October 17, 2000. For distributions prior to October 17, 2000, §1.417(e)–1(b)(2)(i) in effect prior to October 17, 2000 (as contained in 26 CFR part 1 revised as of April 1, 2000) applies.

(3) *Time of consent.* (i) Written consent of the participant and the participant's spouse to the distribution must be made not more than 90 days before the annuity starting date.

(ii) A plan must provide participants with the written explanation of the QJSA required by section 417(a)(3) no less than 30 days and no more than 90 days before the annuity starting date (except as otherwise provided by section 417(a)(7) for plan years beginning after December 31, 1996). However, if the participant, after having received the written explanation of the QJSA, affirmatively elects a form of distribution and the spouse consents to that form of distribution (if necessary), a plan will not fail to satisfy the requirements of section 417(a) merely because the annuity starting date is less than 30 days after the written explanation was provided to the participant, provided that the following requirements are met:

(A) The plan administrator provides information to the participant clearly indicating that (in accordance with the first sentence of this paragraph (b)(3)(ii)) the participant has a right to at least 30 days to consider whether to waive the QJSA and consent to a form of distribution other than a QJSA.

(B) The participant is permitted to revoke an affirmative distribution election at least until the annuity starting date, or, if later, at any time prior to the expiration of the 7-day period that begins the day after the explanation of the QJSA is provided to the participant.

(C) The annuity starting date is after the date that the explanation of the QJSA is provided to the participant (except as otherwise provided by section 417(a)(7) for plan years beginning after December 31, 1996). However, the

plan may permit the annuity starting date to be before the date that any affirmative distribution election is made by the participant and before the date that the distribution is permitted to commence under paragraph (b)(3)(ii)(D) of this section.

(D) Distribution in accordance with the affirmative election does not commence before the expiration of the 7-day period that begins the day after the explanation of the QJSA is provided to the participant.

(iii) The following example illustrates the provisions of this paragraph (b)(3):

Example. Employee E, a married participant in a defined benefit plan who has terminated employment, is provided with the explanation of the QJSA on November 28.

Employee E elects (with spousal consent) on December 2 to waive the QJSA and receive an immediate distribution in the form of a single life annuity. The plan may permit Employee E to receive payments with an annuity starting date of December 1, provided that the first payment is made no earlier than December 6 and the participant does not revoke the election before that date. The plan can make the remaining monthly payments on the first day of each month thereafter in accordance with its regular payment schedule.

(iv) The additional rules of this paragraph (b)(3) concerning the notice and consent requirements of section 417 apply to distributions on or after September 22, 1995. For distributions before September 22, 1995, the additional rules concerning the notice and consent requirements of section 417 in § 1.417(e)–1(b)(3) in effect prior to September 22, 1995 (see § 1.417(e)–1 (b)(3) in 26 CFR Part 1 revised as of April 1, 1995) apply.

(4) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may modify, or provide additional guidance with respect to, the notice and consent requirements of this section. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(c) *Permitted distributions.* A plan may not require that a participant or surviving spouse begin to receive benefits without satisfying paragraph (b) of this section while such benefits are immediately distributable, (see paragraph (b)(1) of this section). Once benefits are no longer immediately distributable, all benefits that the plan requires to begin must be provided in the form of a QJSA and QPSA unless the applicable written explanation, election and consent requirements of section 417 are satisfied.

(d) *Present value requirement*—(1) *General rule.* A defined benefit plan must provide that the present value of any accrued benefit and the amount (subject to sections 411(c)(3) and 415) of any distribution, including a single sum, must not be less than the amount calculated using the applicable interest rate described in paragraph (d)(3) of this section (determined for the month described in paragraph (d)(4) of this section) and the applicable mortality table described in paragraph (d)(2) of this section. The present value of any optional form of benefit cannot be less than the present value of the normal retirement benefit determined in accordance with the preceding sentence. The same rules used for the plan under this paragraph (d) must also be used to compute the present value of the benefit for purposes of determining whether consent for a distribution is required under paragraph (b) of this section.

(2) *Applicable mortality table.* The applicable mortality table is the mortality table based on the prevailing commissioners' standard table (described in section 807(d)(5)(A)) used to determine reserves for group annuity contracts issued on the date as of which present value is being determined (without regard to any other subparagraph of section 807(d)(5)), that is prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter). The Commissioner may prescribe rules that apply in the case of a change to the prevailing commissioners' standard table (described in section 807(d)(5)(A)) used to determine reserves for group annuity contracts, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Applicable interest rate*—(i) *General rule.* The applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified

by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Example*. This example illustrates the rules of this paragraph (d)(3):

Example. Plan A is a calendar year plan. For its 1995 plan year, Plan A provides that the applicable mortality table is the table described in Rev. Rul. 95–6 (1995–1 C.B. 80), and that the applicable interest rate is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for the first full calendar month preceding the calendar month that contains the annuity starting date. Participant P is age 65 in January 1995, which is the month that contains P's annuity starting date. P has an accrued benefit payable monthly of $1,000 and has elected to receive a distribution in the form of a single sum in January 1995. The annual interest rate on 30-year Treasury securities as published by the Commissioner for December 1994 is 7.87 percent. To satisfy the requirements of section 417(e)(3) and this paragraph (d), the single sum received by P may not be less than $111,351.

(4) *Time for determining interest rate*—(i) *General rule*. Except as provided in paragraph (d)(4)(iv) or (v) of this section, the applicable interest rate to be used for a distribution is the rate determined under paragraph (d)(3) of this section for the applicable lookback month. The applicable lookback month for a distribution is the lookback month (as described in paragraph (d)(4)(iii) of this section) for the month (or other longer stability period described in paragraph (d)(4)(ii) of this section) that contains the annuity starting date for the distribution. The time and method for determining the applicable interest rate for each participant's distribution must be determined in a consistent manner that is applied uniformly to all participants in the plan.

(ii) *Stability period*. A plan must specify the period for which the applicable interest rate remains constant. This stability period may be one calendar month, one plan quarter, one calendar quarter, one plan year, or one calendar year.

(iii) *Lookback month*. A plan must specify the lookback month that is used to determine the applicable interest rate. The lookback month may be the first, second, third, fourth, or fifth full calendar month preceding the first day of the stability period.

(iv) *Permitted average interest rate*. A plan may apply the rules of paragraph (d)(4)(i) of this section by substituting a permitted average interest rate with respect to the plan's stability period for the rate determined under paragraph (d)(3) of this section for the applicable lookback month for the stability period. For this purpose, a permitted average interest rate with respect to a stability period is an interest rate that is computed by averaging the applicable interest rates determined under paragraph (d)(3) of this section for two or more consecutive months from among the first, second, third, fourth, and fifth calendar months preceding the first day of the stability period. For this paragraph (d)(4)(iv) to apply, a plan must specify the manner in which the permitted average interest rate is computed.

(v) *Additional determination dates*. The Commissioner may prescribe, in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*)), other times that a plan may provide for determining the applicable interest rate.

(vi) *Example*. This example illustrates the rules of this paragraph (d)(4):

Example. Employer X maintains Plan A, a calendar year plan. Employer X wishes to amend Plan A so that the applicable interest rate will remain fixed for each plan quarter, and so that the applicable interest rate for distributions made during each plan quarter can be determined approximately 80 days before the beginning of the plan quarter. To comply with the provisions of this paragraph (d)(4), Plan A is amended to provide that the applicable interest rate is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for the fourth calendar month preceding the first day of the plan quarter during which the annuity starting date occurs.

(5) *Use of alternative interest rate and mortality table*. If a plan provides for use of an interest rate or mortality table other than the applicable interest rate or the applicable mortality table, the plan must provide that a participant's benefit must be at least as great as the benefit produced by using the applicable interest rate and the applicable mortality table. For example, if a plan provides for use of an interest rate of

7% and the UP–1984 Mortality Table (see §1.401(a)(4)–12, *Standard mortality table*) in calculating single-sum distributions, the plan must provide that any single-sum distribution is calculated as the greater of the single-sum benefit calculated using 7% and the UP–1984 Mortality Table and the single-sum benefit calculated using the applicable interest rate and the applicable mortality table.

(6) *Exceptions.* This paragraph (d) (other than the provisions relating to section 411(d)(6) requirements in paragraph (d)(10) of this section) does not apply to the amount of a distribution paid in the form of an annual benefit that—

(i) Does not decrease during the life of the participant, or, in the case of a QPSA, the life of the participant's spouse; or

(ii) Decreases during the life of the participant merely because of—

(A) The death of the survivor annuitant (but only if the reduction is to a level not below 50% of the annual benefit payable before the death of the survivor annuitant); or

(B) The cessation or reduction of Social Security supplements or qualified disability benefits (as defined in section 411(a)(9)).

(7) *Defined contribution plans.* Because the accrued benefit under a defined contribution plan equals the account balance, a defined contribution plan is not subject to the requirements of this paragraph (d), even though it is subject to section 401(a)(11).

(8) *Effective date*—(i) *In general.* This paragraph (d) is effective for distributions with annuity starting dates in plan years beginning after December 31, 1994.

(ii) *Optional delayed effective date of Retirement Protection Act of 1994 (RPA '94)(108 Stat. 5012) rules for plans adopted and in effect before December 8, 1994.* For a plan adopted and in effect before December 8, 1994, the application of the rules relating to the applicable mortality table and applicable interest rate under paragraphs (d)(2) through (4) of this section is delayed to the extent provided in this paragraph (d)(8)(ii), if the plan provisions in effect on December 7, 1994, met the requirements of section 417(e)(3) and §1.417(e)–1(d) as in effect on December 7, 1994 (as contained in 26 CFR part 1 revised April 1, 1995). In the case of a distribution from such a plan with an annuity starting date that precedes the optional delayed effective date described in paragraph (d)(8)(iv) of this section, and that precedes the first day of the first plan year beginning after December 31, 1999, the rules of paragraph (d)(9) of this section (which generally apply to distributions with annuity starting dates in plan years beginning before January 1, 1995) apply in lieu of the rules of paragraphs (d)(2) through (4) of this section. The interest rate under the rules of paragraph (d)(9) of this section is determined under the provisions of the plan as in effect on December 7, 1994, reflecting the interest rate or rates published by the Pension Benefit Guaranty Corporation (PBGC) and the provisions of the plan for determining the date on which the interest rate is fixed. The above described interest rate or rates published by the PBGC are those determined by the PBGC (for the date determined under those plan provisions) pursuant to the methodology under the regulations of the PBGC for determining the present value of a lump sum distribution on plan termination under 29 CFR part 2619 that were in effect on September 1, 1993 (as contained in 29 CFR part 2619 revised July 1, 1994).

(iii) *Optional accelerated effective date of RPA '94 rules.* This paragraph (d) is also effective for a distribution with an annuity starting date after December 7, 1994, during a plan year beginning before January 1, 1995, if the employer elects, on or before the annuity starting date, to make the rules of this paragraph (d) effective with respect to the plan as of the optional accelerated effective date described in paragraph (d)(8)(iv) of this section. An employer is treated as making this election by making the plan amendments described in paragraph (d)(8)(iv) of this section.

(iv) *Determination of delayed or accelerated effective date by plan amendment adopting RPA '94 rules.* The optional delayed effective date of paragraph (d)(8)(ii) of this section, or the optional accelerated effective date of paragraph (d)(8)(iii) of this section, whichever is

applicable, is the date plan amendments applying both the applicable mortality table of paragraph (d)(2) of this section and the applicable interest rate of paragraph (d)(3) of this section are adopted or, if later, are made effective.

(9) *Plan years beginning before January 1, 1995*—(i) *Interest rate.* (A) For distributions made in plan years beginning after December 31, 1986, and before January 1, 1995, the following interest rate described in paragraph (d)(9)(i)(A)(*1*) or (*2*) of this section, whichever applies, is substituted for the applicable interest rate for purposes of this section—

(*1*) The rate or rates that would be used by the PBGC for a trusteed single-employer plan to value the participant's (or beneficiary's) vested benefit (PBGC interest rate) if the present value of such benefit does not exceed $25,000; or

(*2*) 120 percent of the PBGC interest rate, as determined in accordance with paragraph (d)(9)(i)(A)(*1*) of this section, if such present value exceeds $25,000. In no event shall the present value determined by use of 120 percent of the PBGC interest rate result in a present value less than $25,000.

(B) The PBGC interest rate may be a series of interest rates for any given date. For example, the PBGC interest rate for immediate annuities for November 1994 is 6%, and the PBGC interest rates for the deferral period for that month are as follows: 5.25% for the first 7 years of the deferral period, 4% for the following 8 years of the deferral period, and 4% for the remainder of the deferral period. For November 1994, 120 percent of the PBGC interest rate is 7.2% (1.2 times 6%) for an immediate annuity, 6.3% (1.2 times 5.25%) for the first 7 years of the deferral period, 4.8% (1.2 times 4%) for the following 8 years of the deferral period, and 4.8% (1.2 times 4%) for the remainder of the deferral period. The PBGC interest rates are the interest rates that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of that benefit upon termination of an insufficient trusteed single employer plan. Except as otherwise provided by the Commissioner, the PBGC interest rates are determined by PBGC regulations. See subpart B of 29 CFR part 4044 for the applicable PBGC rates.

(ii) *Time for determining interest rate.* (A) Except as provided in paragraph (d)(9)(ii)(B) of this section, the PBGC interest rate or rates are determined on either the annuity starting date or the first day of the plan year that contains the annuity starting date. The plan must provide which date is applicable.

(B) The plan may provide for the use of any other time for determining the PBGC interest rate or rates provided that such time is not more than 120 days before the annuity starting date if such time is determined in a consistent manner and is applied uniformly to all participants.

(C) The Commissioner may, in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*), prescribe other times for determining the PBGC interest rate or rates.

(iii) *No applicable mortality table.* In the case of a distribution to which this paragraph (d)(9) applies, the rules of this paragraph (d) are applied without regard to the applicable mortality table described in paragraph (d)(2) of this section.

(10) *Relationship with section 411(d)(6)*—(i) *In general.* A plan amendment that changes the interest rate, the time for determining the interest rate, or the mortality assumptions used for the purposes described in paragraph (d)(1) of this section is subject to section 411(d)(6). But see §1.411(d)–4, Q&A–2(b)(2)(v) (regarding plan amendments relating to involuntary distributions). In addition, a plan amendment that changes the interest rate or the mortality assumptions used for the purposes described in paragraph (d)(1) of this section merely to eliminate use of the interest rate described in paragraph (d)(3) or paragraph (d)(9) of this section, or the applicable mortality table, with respect to a distribution form described in paragraph (d)(6) of this section, for distributions with annuity starting dates occurring after a specified date that is after the amendment is adopted, does not violate the requirements of section 411(d)(6) if the amendment is adopted on or before the

last day of the last plan year ending before January 1, 2000.

(ii) *Section 411(d)(6) relief for change in time for determining interest rate.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, if a plan amendment changes the time for determining the applicable interest rate (including an indirect change as a result of a change in plan year), the amendment will not be treated as reducing accrued benefits in violation of section 411(d)(6) merely on account of this change if the conditions of this paragraph (d)(10)(ii) are satisfied. If the plan amendment is effective on or after the adoption date, any distribution for which the annuity starting date occurs in the one-year period commencing at the time the amendment is effective must be determined using the interest rate provided under the plan determined at either the date for determining the interest rate before the amendment or the date for determining the interest rate after the amendment, whichever results in the larger distribution. If the plan amendment is adopted retroactively (that is, the amendment is effective prior to the adoption date), the plan must use the interest rate determination date resulting in the larger distribution for the period beginning with the effective date and ending one year after the adoption date.

(iii) *Section 411(d)(6) relief for plan amendments pursuant to changes to section 417 made by RPA '94 providing for statutory interest rate determination date.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, except as provided in paragraph (d)(10)(vi)(B) of this section, a participant's accrued benefit is not considered to be reduced in violation of section 411(d)(6) merely because of a plan amendment that changes any interest rate or mortality assumption used to calculate the present value of a participant's benefit under the plan, if the following conditions are satisfied—

(A) The amendment replaces the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as the interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d); and

(B) After the amendment is effective, the present value of a participant's benefit under the plan cannot be less than the amount calculated using the applicable mortality table and the applicable interest rate for the first full calendar month preceding the calendar month that contains the annuity starting date.

(iv) *Section 411(d)(6) relief for plan amendments pursuant to changes to section 417 made by RPA '94 providing for prior determination date or up to two months earlier.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, except as provided in paragraph (d)(10)(vi)(B) of this section, a participant's accrued benefit is not considered to be reduced in violation of section 411(d)(6) merely because of a plan amendment that changes any interest rate or mortality assumption used to calculate the present value of a participant's benefit under the plan, if the following conditions are satisfied—

(A) The amendment replaces the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as the interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d); and

(B) After the amendment is effective, the present value of a participant's benefit under the plan cannot be less than the amount calculated using the applicable mortality table and the applicable interest rate, but only if the applicable interest rate is the annual interest rate on 30-year Treasury securities for the calendar month that contains the date as of which the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) was determined immediately before the amendment, or for one of the two calendar months immediately preceding such month.

(v) *Section 411(d)(6) relief for plan amendments pursuant to changes to section 417 made by RPA '94 providing for other interest rate determination date.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, except as provided in paragraph (d)(10)(vi)(B) of this section, a participant's accrued benefit is not considered to be reduced in violation of section 411(d)(6) merely because of a plan

amendment that changes any interest rate or mortality assumption used to calculate the present value of a participant's benefit under the plan, if the following conditions are satisfied—

(A) The amendment replaces the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as the interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d);

(B) After the amendment is effective, the present value of a participant's benefit under the plan cannot be less than the amount calculated using the applicable mortality table and the applicable interest rate; and

(C) The plan amendment satisfies either the condition of paragraph (d)(10)(ii) of this section (determined using the interest rate provided under the terms of the plan after the effective date of the amendment) or the special early transition interest rate rule of paragraph (d)(10)(vi)(C) of this section.

(vi) *Special rules*—(A) *Provision of temporary additional benefits.* A plan amendment described in paragraph (d)(10)(iii), (iv), or (v) of this section is not considered to reduce a participant's accrued benefit in violation of section 411(d)(6) even if the plan amendment provides for temporary additional benefits to accommodate a more gradual transition from the plan's old interest rate to the new rules.

(B) *Replacement of non-PBGC interest rate.* The section 411(d)(6) relief provided in paragraphs (d)(10)(iii) through (v) of this section does not apply to a plan amendment that replaces an interest rate other than the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as an interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d). Thus, the accrued benefit determined using that interest rate and the associated mortality table is protected under section 411(d)(6). For purposes of this paragraph (d), an interest rate is based on the PBGC interest rate if the interest rate is defined as a specified percentage of the PBGC interest rate, the PBGC interest rate minus a specified number of basis points, or an average of such interest rates over a specified period.

(C) *Special early transition interest rate rule for paragraph (d)(10)(v).* A plan amendment satisfies the special rule of this paragraph (d)(10)(vi)(C) if any distribution for which the annuity starting date occurs in the one-year period commencing at the time the plan amendment is effective is determined using whichever of the following two interest rates results in the larger distribution—

(*1*) The interest rate as provided under the terms of the plan after the effective date of the amendment, but determined at a date that is either one month or two months (as specified in the plan) before the date for determining the interest rate used under the terms of the plan before the amendment; or

(*2*) The interest rate as provided under the terms of the plan after the effective date of the amendment, determined at the date for determining the interest rate after the amendment.

(vii) *Examples.* The provisions of this paragraph (d)(10) are illustrated by the following examples:

Example 1. On December 31, 1994, Plan A provided that all single-sum distributions were to be calculated using the UP–1984 Mortality Table and 100% of the PBGC interest rate for the date of distribution. On January 4, 1995, and effective on February 1, 1995, Plan A was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for the first full calendar month preceding the calendar month that contains the annuity starting date. Pursuant to paragraph (d)(10)(iii) of this section, this amendment of Plan A is not considered to reduce the accrued benefit of any participant in violation of section 411(d)(6).

Example 2. On December 31, 1994, Plan B provided that all single-sum distributions were to be calculated using the UP–1984 Mortality Table and an interest rate equal to the lesser of 100% of the PBGC interest rate for the date of distribution, or 6%. On January 4, 1995, and effective on February 1, 1995, Plan B was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for the second full calendar month preceding the calendar month that contains the annuity starting date. Pursuant to paragraph

(d)(10)(iv) of this section, this amendment of Plan B is not considered to reduce the accrued benefit of any participant in violation of section 411(d)(6) merely because of the replacement of the PBGC interest rate. However, under paragraph (d)(10)(vi)(B) of this section, the section 411(d)(6) relief provided in paragraphs (d)(10)(iii) through (v) of this section does not apply to a plan amendment that replaces an interest rate other than the PBGC interest rate (or a rate based on the PBGC interest rate). Therefore, pursuant to paragraph (d)(10)(vi)(B) of this section, to satisfy the requirements of section 411(d)(6), the plan must provide that the single-sum distribution payable to any participant must be no less than the single-sum distribution calculated using the UP–1984 Mortality Table and an interest rate of 6%, based on the participant's benefits under the plan accrued through January 31, 1995, and based on the participant's age at the annuity starting date.

Example 3. On December 31, 1994, Plan C, a calendar year plan, provided that all single sum distributions were to be calculated using the UP–1984 Mortality Table and an interest rate equal to the PBGC interest rate for January 1 of the plan year. On March 1, 1995, and effective on July 1, 1995, Plan C was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for August of the year before the plan year that contains the annuity starting date. The plan amendment provides that each distribution with an annuity starting date after June 30, 1995, and before July 1, 1996, is calculated using the 30-year Treasury rate for August of the year before the plan year that contains the annuity starting date, or the 30-year Treasury rate for January of the plan year that contains the annuity starting date, whichever produces the larger benefit. Pursuant to paragraph (d)(10)(v) of this section, the amendment of Plan C is not considered to have reduced the accrued benefit of any participant in violation of section 411(d)(6).

Example 4. (a) Employer X maintains Plan D, a calendar year plan. As of December 7, 1994, Plan D provided for single-sum distributions to be calculated using the PBGC interest rate as of the annuity starting date for distributions not greater than $25,000, and 120% of that interest rate (but not an interest rate producing a present value less than $25,000) for distributions over $25,000. Employer X wishes to delay the effective date of the RPA '94 rules for a year, and to provide for an extended transition from the use of the PBGC interest rate to the new applicable interest rate under section 417(e)(3). On December 1, 1995, and effective on January 1, 1996, Employer X amends Plan D to provide that single-sum distributions are determined as the sum of—

(i) The single-sum distribution calculated based on the applicable mortality table and the annual interest rate on 30-year Treasury securities for the first full calendar month preceding the calendar month that contains the annuity starting date; and

(ii) A transition amount.

(b) The amendment provides that the transition amount for distributions in the years 1996–99 is a transition percentage of the excess, if any, of the amount that the single-sum distribution would have been under the plan provisions in effect prior to this amendment over the amount of the single sum described in paragraph (a)(i) of this *Example 4*. The transition percentages are 80% for 1996, decreasing to 60% for 1997, 40% for 1998 and 20% for 1999. The amendment also provides that the transition amount is zero for plan years beginning on or after the year 2000. Pursuant to paragraphs (d)(10)(iii) and (vi)(A) of this section, the amendment of Plan D is not considered to have reduced the accrued benefit of any participant in violation of section 411(d)(6).

Example 5. On December 31, 1994, Plan E, a calendar year plan, provided that all single-sum distributions were to be calculated using the UP–1984 Mortality Table and an interest rate equal to the PBGC interest rate for January 1 of the plan year. On March 1, 1995, and effective on July 1, 1995, Plan E was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for August of the year before the plan year that contains the annuity starting date. The plan amendment provides that each distribution with an annuity starting date after June 30, 1995, and before July 1, 1996, is calculated using the 30-year Treasury rate for August of the year before the plan year that contains the annuity starting date, or the 30-year Treasury rate for November of the plan year preceding the plan year that contains the annuity starting date, whichever produces the larger benefit. Pursuant to paragraphs (d)(10)(v) and (vi)(C) of this section, the amendment of Plan E is not considered to have reduced the accrued benefit of any participant in violation of section 411(d)(6).

(e) *Special rules for annuity contracts*—(1) *General rule.* Any annuity contract purchased by a plan subject to section 401(a)(11) and distributed to or owned by a participant must provide that benefits under the contract are provided in accordance with the applicable consent, present value, and other requirements of sections 401(a)(11) and 417 applicable to the plan.

(2) [Reserved]

(f) *Effective dates*—(1) *Annuity contracts.* (i) Paragraph (e) of this section

does not apply to contracts distributed to or owned by a participant prior to September 17, 1985, unless additional contributions are made under the plan by the employer with respect to such contracts.

(ii) In the case of a contract owned by the employer or distributed to or owned by a participant prior to the first plan year beginning after December 31, 1988, paragraph (e) of this section shall be satisfied if the annuity contracts described therein satisfy the requirements in §§1.401(a)–11T and 1.417(e)–1T. The preceding sentence shall not apply if additional contributions are made under the plan by the employer with respect to such contracts on or after the beginning of the first plan year beginning after December 31, 1988.

(2) *Interest rates.* (i) A plan that uses the PBGC immediate interest rate as required by §1.417(e)–1T(e) for distributions commencing in plan years beginning before January 1, 1987, shall be deemed to satisfy paragraph (d) of this section for such years.

(ii) For a special exception to the requirements of section 411(d)(6) for certain plan amendments that incorporate applicable interest rates, see section 1139(d)(2) of the Tax Reform Act of 1986.

(3) *Other effective dates and transitional rules.* (i) Except as otherwise provided, a plan will be treated as satisfying sections 401(a)(11) and 417 for plan years beginning before the first plan year that the requirements of section 410(b) as amended by TRA 86 apply to such plan, if the plan satisfied the requirements in §§1.401(a)–11T and 1.417(e)–1T.

(ii) See §1.401(a)–20 for other effective dates and transitional rules that apply to plans subject to sections 401(a)(11) and 417.

[T.D. 8219, 53 FR 31854, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988, as amended by T.D. 8591, 60 FR 17219, Apr. 5, 1995; T.D. 8620, 60 FR 49221, Sept. 22, 1995; T.D. 8768, 63 FR 16898, Apr. 7, 1998; T.D. 8796, 63 FR 70011, Dec. 18, 1998; T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8891, 65 FR 44681, 44682, July 19, 2000]

§1.417(e)–1T Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417. (Temporary)

(a) [Reserved]

(b) *Consent, etc. requirements*—(1) *General rule.* [Reserved]

(2) *Consent.* [Reserved]

(c) [Reserved]

(d) For rules regarding the present value of a participant's accrued benefit and related matters, see §1.417(e)–1(d).

[T.D. 8591, 60 FR 17219, Apr. 5, 1995, as amended by T.D. 8620, 60 FR 49221, Sept. 22, 1995; T.D. 8768, 63 FR 16902, Apr. 7, 1998; T.D. 8796, 63 FR 70012, Dec. 18, 1998]

§1.419–1T Treatment of welfare benefit funds. (Temporary)

Q–1: What does section 419 of the Internal Revenue Code provide?

A–1: Section 419 prescribes limitations upon deductions for contributions paid or accrued with respect to a welfare benefit fund. Under section 419 (a) and (b), an employer's contributions to a welfare benefit fund are not deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for production of income) but, if the requirements of section 162 or 212 are otherwise met, are deductible under section 419 for the taxable year of the employer in which paid to the extent of the welfare benefit fund's qualified cost (within the meaning of section 419(c)(1)) for the taxable year of the fund that relates to such taxable year of the employer. Under section 419(g), section 419 and this section shall also apply to the deduction by a taxpayer of contributions with respect to a fund that would be a welfare benefit fund but for the fact that there is no employer-employee relationship between the person providing the services and the person for whom the services are provided. Contributions paid to a welfare benefit fund after section 419 becomes effective with respect to such contributions are deemed to relate, first, to amounts accrued and deducted (but not paid) by the employer with respect to such fund before section 419 becomes effective with respect to such contributions and thus shall not be treated as satisfying the payment requirement of section 419. See paragraph (b) of Q&A–5 for special deduction limits applicable to employer contributions to welfare benefit funds with excess reserves.

Q–2: When do the deduction rules of section 419, as enacted by the Tax Reform Act of 1984, become effective?

A–2: (a) Section 419 generally applies to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date. See Q&A–9 of this regulation for special rules relating to the deduction limit for the first taxable year of a fiscal year employer ending after December 31, 1985.

(b) In the case of a welfare benefit fund which is part of a plan maintained pursuant to one or more collective bargaining agreements (1) between employee representatives and one or more employers, and (2) that are in effect on July 1, 1985 (or ratified on or before such date), sections 419 shall not apply to contributions paid or accrued in taxable years beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension thereof agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act of 1984 (i.e., requirements under sections 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreement. See §1.419A–2T for special rules relating to the application of section 419 to collectively bargained welfare benefit funds.

(c) Notwithstanding paragraphs (a) and (b), section 419 applies to any contribution of a facility to a welfare benefit fund (or other contribution, such as cash, which is used to acquire, construct, or improve such a facility) after June 22, 1984, unless such facility is placed in service by the fund before January 1, 1987, and either (1) is acquired or improved by the fund (or contributed to the fund) pursuant to a binding contract in effect on June 22, 1984, and at all times thereafter, or (2) the construction of which was begun by or for the welfare benefit fund before June 22, 1984. See Q&A–11 of this regulation for special rules relating to the application of section 419 to the contribution of a facility to a welfare benefit fund (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve such a facility) before section 419 generally becomes effective with respect to contributions to the fund.

Q–3. What is a ''welfare benefit fund'' under section 419?

A–3. (a) A ''welfare benefit fund'' is any fund which is part of a plan, or method or arrangement, of an employer and through which the employer provides welfare benefits to employees or their beneficiaries. For purposes of this section, the term ''welfare benefit'' includes any benefit other than a benefit with respect to which the employer's deduction is governed by section 83(h), section 404 (determined without regard to section 404(b)(2)), section 404A, or section 463.

(b) Under section 419(e)(3) (A) and (B), the term ''fund'' includes any organization described in section 501(c) (7), (9), (17) or (20), and any trust, corporation, or other organization not exempt from tax imposed by chapter 1, subtitle A, of the Internal Revenue Code. Thus, a taxable trust or taxable corporation that is maintained for the purpose of providing welfare benefits to an employer's employees is a ''welfare benefit fund.''

(c) Section 419(e)(3)(C) also provides that the term ''fund'' includes, to the extent provided in regulations, any account held for an employer by any person. Pending the issuance of further guidance, only the following accounts, and arrangements that effectively constitute accounts, as described below, are ''funds'' within section 419(e)(3)(C).

A retired lives reserve or a premium stabilization reserve maintained by an insurance company is a ''fund,'' or part of a ''fund,'' if it is maintained for a particular employer and the employer has the right to have any amount in the reserve applied against its future years' benefit costs or insurance premiums. Also, if an employer makes a payment to an insurance company under an ''administrative services only'' arrangement with respect to which the life insurance company maintains a separate account to provide benefits, then the arrangement

would be considered to be a ''fund.'' Finally, an insurance or premium arrangement between an employer and an insurance company is a ''fund'' if, under the arrangement, the employer has a right to a refund, credit, or additional benefits (including upon termination of the arrangement) based on the benefit or claims experience, administrative cost experience, or investment experience attributable to such employer. However, an arrangement with an insurance company is not a ''fund'' under the previous sentence merely because the employer's premium for a renewal year reflects the employer's own experience for an earlier year if the arrangement is both cancellable by the insurance company and cancellable by the employer as of the end of any policy year and, upon cancellation by either of the parties, neither of the parties can receive a refund or additional amounts or benefits and neither of the parties can incur a residual liability beyond the end of the policy year (other than, in the case of the insurer, to provide benefits with respect to claims incurred before cancellation). The determination whether either of the parties can receive a refund or additional amounts or benefits or can incur a residual liability upon cancellation of an arrangement will be made by examining both the contractual rights and obligations of the parties under the arrangement and the actual practice of the insurance company (and other insurance companies) with respect to other employers upon cancellation of similar arrangements. Similarly, a disability income policy does not constitute a ''fund'' under the preceding provisions merely because, under the policy, an employer pays an annual premium so that employees who became disabled in such year may receive benefit payments for the duration of the disability.

Q–4: For purposes of determining the section 419 limit on the employer's deduction for contributions to the fund for a taxable year of the employer, which taxable year of the welfare benefit fund is related to the taxable year of the employer?

A–4: The amount of an employer's deduction for contributions to a welfare benefit fund for a taxable year of the employer is limited to the ''qualified cost'' of the welfare benefit fund for the taxable year of the fund that is related to such taxable year of the employer. The taxable year of the welfare benefit fund that ends with or within the taxable year of the employer is the taxable year of the fund that is related to the taxable year of the employer. Thus, for example, if an employer has a calendar taxable year and it makes contributions to a fund having a taxable year ending June 30, the ''qualified cost'' of the fund for the taxable year of the fund ending on June 30, 1986, applies to limit the employer's deduction for contributions to the fund in the employer's 1986 taxable year. In the case of employer contributions paid directly to an account or arrangement with an insurance company that is treated as a welfare benefit fund for the purposes of section 419, the policy year will be treated as the taxable year of the fund. See Q&A–7 of this regulation for special section 419 rules relating to the coordination of taxable years for the taxable year of the employer in which a welfare benefit fund is established and for the next following taxable year of the employer.

Q–5: What is the ''qualified cost'' of a welfare benefit fund for a taxable year under section 419?

A–5: (a) Under section 419(c), the ''qualified cost'' of a welfare benefit fund for a taxable year of the fund is the sum of: (1) The ''qualified direct cost'' of such fund for such taxable year of the fund, and (2) the amount that may be added to the qualified asset account for such taxable year of the fund to the extent that such addition does not result in a total amount of such account as of the end of such taxable year of the fund that exceeds the applicable account limit under section 419A(c). However, in calculating the qualified cost of a welfare benefit fund for a taxable year of the fund, this sum is reduced by the fund's ''after-tax income'' (as defined in section 419(c)(4)) for such taxable year of the fund. Also, the qualified cost of a welfare benefit fund is reduced further under the provisions of paragraph (b) of this Q&A.

(b)(1) Pursuant to section 419A(i), notwithstanding section 419 and § 1.419–1T, contributions to a welfare benefit

fund during any taxable year of the employer beginning after December 31, 1985, shall not be deductible for such taxable year to the extent that such contributions result in the total amount in the fund as of the end of the last taxable year of the fund ending with or within such taxable year of the employer exceeding the account limit applicable to such taxable year of the fund (as adjusted under section 419A(f)(7)). Solely for purposes of this subparagraph, (i) contributions paid to a welfare benefit fund during the taxable year of the employer but after the end of the last taxable year of the fund that relates to such taxable year of the employer, and (ii) contributions accrued with respect to a welfare benefit fund during the taxable year of the employer or during any prior taxable year of the employer (but not actually paid to such fund on or before the end of a taxable year of the employer) and deducted by the employer for such or any prior taxable year of the employer, shall be treated as an amount in the fund as of the end of the last taxable year of the fund that relates to the taxable year of the employer. Contributions that are not deductible under this subparagraph are in excess of the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to the taxable year of the employer and thus are treated as contributed to the fund on the first day of the employer's next taxable year.

(2) Paragraph (b)(1) of this section shall not apply to contributions with respect to a collectively bargained welfare benefit fund within the meaning of § 1.419A–2T. In addition, paragraph (b)(1) of this section shall not apply to any taxable year of an employer beginning after the end of the earlier of the following taxable years: (i) the first taxable year of the employer beginning after December 31, 1985, for which the employer's deduction limit under section 419 (after the application of paragraph (b)(1) of this section) is at least equal to the qualified direct cost of the fund for the taxable year (or years) of the fund that relates to such first taxable year of the employer, or (ii) the first taxable year of the employer beginning after December 31, 1985, with or within which ends the first taxable year of the fund with respect to which the total amount in the fund as of the end of such taxable year of the fund does not exceed the account limit for such taxable year of the fund (as adjusted under section 419A(f)(7)).

(3) For example, assume an employer with a taxable year ending June 30 and a welfare benefit fund with a taxable year ending January 31. During its taxable year ending June 30, 1987, and on or before January 31, 1987, the employer contributes $250,000 to the fund, and during the remaining portion of its taxable year ending June 30, 1987, the employer contributes $200,000. The qualified direct cost of the fund for its taxable year ending January 31, 1987, is $500,000, the account limit applicable to such taxable year (after the adjustment under section 419A(f)(7)) is $750,000, and the total amount in the fund as of January 31, 1987, is $800,000. Before the application of this paragraph, the employer may deduct the entire $450,000 contribution for its taxable year ending June 30, 1987. However, under this paragraph, the excess of (i) the sum of the total amount in the fund as of January 31, 1987 ($800,000), and employer contributions to the fund after January 31, 1987, and on or before June 30, 1987 ($200,000), over (ii) the account limit applicable to the fund for its taxable year ending January 31, 1987 ($750,000), is $250,000. Thus, under this paragraph, only $200,000 of the $450,000 contribution the employer made during its taxable year ending June 30, 1987, is deductible for such taxable year. If the excess were $450,000 or greater, no portion of the $450,000 contribution would be deductible by the employer for its taxable year ending June 30, 1987. Such nondeductible contributions are in excess of the fund's qualified cost for the taxable year related to the employer's taxable year and thus are deemed to be contributed on the first day of the employer's next taxable year.

(c) See Q&A–7 of this regulation for special rules relating to the calculation of the qualified cost of a welfare benefit fund for an Initial Fund Year and an Overlap Fund Year (as defined

in Q&A–7). See Q&A–11 of this regulation for special rules relating to the application of section 419 to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve a facility) before section 419 generally becomes effective with respect to contributions to the fund. See §1.419A–2T for special rules relating to certain collectively bargained welfare benefit funds.

Q–6: What is the ''qualified direct cost'' of a welfare benefit fund under section 419(c)(3)?

A–6: (a) Under section 419(c)(3), the ''qualified direct cost'' of a welfare benefit fund for any taxable year of the fund is the aggregate amount which would have been allowable as a deduction to the employer for benefits provided by such fund during such year (including insurance coverage for such year) if (1) such benefits were provided directly by the employer and (2) the employer used the cash receipts and disbursements method of accounting and had the same taxable year as the fund. In this regard, a benefit is treated as provided when such benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for a provision of chapter 1, subtitle A, of the Internal Revenue Code excluding it from gross income). Thus, for example, if a calendar year welfare benefit fund pays an insurance company in July 1986 the full premium for coverage of its current employees under a term health insurance policy for the twelve month period ending June 30, 1987, the insurance coverage will be treated as provided by the fund over such twelve month period. Accordingly, only the portion of the premium for coverage during 1986 will be treated as a ''qualified direct cost'' of the fund for 1986; the remaining portion of the premium will be treated as a ''qualified direct cost'' of the fund for 1987. The ''qualified direct cost'' for a taxable year of the fund includes the administrative expenses incurred by the welfare benefit fund in delivering the benefits for such year.

(b) If, in a taxable year of a welfare benefit fund, the fund holds an asset with a useful life extending substantially beyond the end of the taxable year (e.g., buildings, vehicles, tangible assets, and licenses) and, for such taxable year of the fund, the asset is used in the provision of welfare benefits to employees, the ''qualified direct cost'' of the fund for such taxable year of the fund includes the amount that would have been allowable to the employer as a deduction under the applicable Code provisions (e.g., sections 168 and 179) with respect to the portion of the asset used in the provision of welfare benefits for such year if the employer had acquired and placed in service the asset at the same time the fund received and placed in service the asset, and the employer had the same taxable year as the fund. This rule applies regardless of whether the fund received the asset through a contribution of the asset by the employer or through an acquisition or the construction by the fund of the asset. For example, assume that in 1986 a calendar year employer contributes recovery property under section 168(c) to a welfare benefit fund with a calendar taxable year to be used in the provision of welfare benefits. The employer will be treated as having sold the property in such year and thus will recognize gain to the extent that the fair market value of the property exceeds the employer's adjusted basis in the property. In this regard, see section 1239(d). Also, the employer will be treated as having made a contribution to the fund in such year equal to the fair market value of the property. Finally, the qualified direct cost of the welfare benefit fund for 1986 will include the amount that the employer could have deducted in 1986 with respect to the portion of the property used in the provision of welfare benefits if the employer had acquired the property in 1986 and had placed the property in service when the fund actually placed the property in service. Similarly, for example, assume that in 1986 a welfare bendfit fund purchases and places in service a facility to be used in the provision of welfare benefits. The qualified direct cost of the fund for 1986 will include the amount that the employer could have deducted with respect to such facility if the employer had purchased and placed in service the facility at the same time

that the fund purchased and placed in service the facility.

(c) The qualified direct cost of a welfare benefit fund does not include expenditures by the fund that would not have been deductible if they had been made directly by the employer. For example, a fund's purchase of land in a year for an employee recreational facility will not be treated as a qualified direct cost because, if made directly by the employer, the purchase would not have been deductible under section 263. See also sections 264 and 274.

(d) Notwithstanding the preceding paragraphs, the qualified direct cost of a welfare benefit fund with respect to that portion of a child care facility used in the provision of welfare benefits for a year will include the amount that would have been allowable to the employer as a deduction for the year under a straight-line depreciation schedule for a period of 60 months beginning with the month in which the facility is placed in service under rules similar to those provided for section 188 property under §1.188–1(a). For purposes of this section, a ''child care facility'' is tangible property of a character subject to depreciation that is located in the United States and specifically used as an integral part of a ''qualified child care center facility'' within the meaning of §1.188–1(d)(4).

(e) See Q&A–7 of this regulation for special section 419 rules relating to the calculation of the qualified direct cost of a welfare benefit fund for an Initial Fund Year and an Overlap Fund Year (as defined in Q&A–7). See Q&A–11 of this regulation for special rules relating to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve a facility) before section 419 generally becomes effective with respect to contributions to the fund.

Q–7: What special rules apply for purposes of determining the section 419 limit on the employer's deduction for contributions to a welfare benefit fund for the taxable year of the employer in which the fund is established and for the next following taxable year of the employer?

A–7: (a) If the taxable year of a welfare benefit fund is the same as the taxable year of the employer, there are no special rules that apply for purposes of determining the section 419 limit on an employer's deduction for contributions to the fund for either the taxable year of the employer in which the fund is established or the next following taxable year of the employer. However, if the taxable year of a welfare benefit fund is different from the taxable year of the employer, the general section 419 rules are modified by the special rules set forth below for purposes of determining the section 419 deduction limit for the taxable year of the employer in which a fund is established and for the next following taxable year of the employer.

(b) If a welfare benefit fund is established after December 31, 1985, during a taxable year of an employer and either (i) the first taxable year of the fund ends after the close of such taxable year of the employer, or (ii) the first taxable year of the fund is six months or less and ends before the close of such taxable year of the employer and the second taxable year of the fund begins before and ends after the close of such taxable year of the employer, the taxable year of the fund that contains the closing day of such taxable year of the employer will be treated as an ''Overlap Fund Year.'' For purposes of determining the limit on the employer's deduction for contributions to a welfare benefit fund for the taxable year of the employer in which the fund was established, the period between the beginning of the fund's Overlap Fund Year and the end of the employer's taxable year in which the Overlap Fund Year began will be treated as a taxable year of the fund (''Initial Fund Year'').

(c) The qualified cost of a welfare benefit fund for its Initial Fund Year will be equal to the qualified direct cost of the fund for such Initial Fund Year. The qualified cost of a fund for its Overlap Fund Year will be determined under the general rules of Q&A–5 of this regulation and section 419(c), with the exception that such qualfied cost will be reduced by the employer contributions made during the Initial Fund Year and deductible by the employer for the taxable year of the employer in which the Overlap Fund Year of the fund begins.

(d) Assume that an employer with a calendar taxable year establishes on July 1, 1986, a welfare benefit fund with a taxable year ending on June 30. The fund's first taxable year from July 1, 1986, to June 30, 1987, is an Overlap Fund Year. The employer contributes $1,000 to the fund during its taxable year ending December 31, 1986 (i.e., during the period between July 1, 1986, and December 31, 1986, which is also the Initial Fund Year) and another $1,500 to the fund during its taxable year ending December 31, 1987. Assume further that the qualified direct cost of the fund for the Initial Fund Year is $900 and that the qualified cost for the Overlap Fund Year is $2,500 (prior to the reduction required by paragraph (c) of this Q&A). Under the special rules of paragraphs (b) and (c), the employer may deduct $900 for its taxable year ending on December 31, 1986, and $1,600 for its taxable year ending on December 31, 1987. If the qualified direct cost of the fund for the Initial Fund Year had been $1,050 and the qualified cost for the Overlap Fund Year had been $2,500 (prior to the reduction required by paragraph (c) of this Q&A), the employer's deduction for its taxable year ending December 31, 1986, would have been $1,000 and its deduction for its taxable year ending December 31, 1987, would have been $1,500.

(e) Assume that an employer with a calendar taxable year establishes on March 1, 1986, a welfare benefit fund with a taxable year ending June 30. Thus, the fund has a short first taxable year ending June 30, 1986, an Overlap Fund Year from July 1, 1986, until June 30, 1987, and an ongoing June 30 taxable year. The employer contributes $1,750 to the fund during the employer's taxable year ending December 31, 1986—$750 during the short first taxable year of the fund and $1,000 during the Initial Fund Year (i.e., the period between July 1, 1986, and December 31, 1986)—and $1,500 to the fund during its taxable year ending December 31, 1987. Assume that the qualified cost of the fund for the short first taxable year of the fund is $800, the qualified direct cost for the Initial Fund Year is $900, and the qualified cost for the Overlap Fund Year is $2,500 (prior to the reduction required by paragraph (c) of this Q&A). Under the special rules of paragraphs (b) and (c), the employer may deduct $1,700 for its taxable year ending December 31, 1986, and $1,550 for its taxable year ending December 31, 1987.

Q–8: How does section 419 treat an employer's contribution with respect to a welfare benefit fund in excess of the applicable deduction limit for a taxable year of the employer?

A–8: (a) If an employer makes contributions to a welfare benefit fund in a taxable year of the employer and such contributions (when combined with prior contributions that are deemed under the rule of this Q&A and section 419(d) to have been made in such taxable year) exceed the section 419 deduction limit for such taxable year of the employer, the excess amounts are deemed to be contributed to the fund on the first day of the next taxable year of the employer. Such deemed contributions are combined with amounts actually contributed by the employer to the fund during the next taxable year and may be deductible for such year, subject to the otherwise applicable section 419 deduction limit for such year.

(b) Contributions to a welfare benefit fund on or before December 31, 1985, that were not deductible by the employer for any taxable year of the employer ending on or before December 31, 1985, or for the first taxable year of the employer ending after December 31, 1985, as pre-1986 contributions (see Q&A–9 of this regulation) are deemed to be contributed to the fund on January 1, 1986, However, see Q&A–11 of this regulation for special rules relating to the contribution to a welfare benefit fund of amounts (such as cash) used to acquire, construct, or improve a facility before section 419 generally becomes effective with respect to contributions to the fund. Generally, such contributions (to the extent that they were made after June 22, 1984 and on or before December 31, 1985) are treated as nondeductible pre-1986 contributions and are deemed to be contributed in the form of a facility at the same time as when the facility is placed in service by the fund.

Q–9: How does an employer with a fiscal taxable year calculate its deduction limit for contributions with respect to

a welfare benefit fund for the first taxable year of the employer ending after December 31, 1985?

A–9: (a) If the first taxable year of an employer ending after December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this section, the first taxable year of an employer beginning after termination of the last of the collective bargaining agreements pursuant to which the fund is maintained) is a fiscal year, the employer's deduction for such taxable year for contributions to a welfare benefit fund that is not a collectively bargained welfare benefit fund under § 1.419A–2T is limited to the greater of the following two amounts: (1) The contributions paid to the fund during such first taxable year up to the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to such taxable year of the employer, and (2) the contributions paid to the fund during the 1985 portion of such first taxable year of the employer (''the pre-1986 contributions'') to the extent that such pre-1986 contributions are deductible under the rules governing the deduction of such contributions before section 419 generally becomes effective (including the rules set forth in Q&A–10 of this regulation, modified for purposes of this Q&A–9 by substituting ''December 31, 1986'' for ''December 31, 1985'' in paragraph (c)). See Q&A–11 of this regulation for special rules relating to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve such a facility) before section 419 generally becomes effective with respect to contributions to such fund.

(b) For example, assume that an employer with a taxable year ending June 30, contributes to a welfare benefit fund with a taxable year ending January 31. This employer contributes $1,000 to the fund between July 1, 1985, and December 31, 1985, and an additional $500 to the fund between January 1, 1986, and June 30, 1986. Assume further that the qualified direct cost of the fund for the taxable year of the fund ending January 31, 1986, is $500 and that the qualified cost for such taxable year is $800. Under the deduction rule set forth above, the employer's deduction for its taxable year ending June 30, 1986, is the greater of two amounts: (1) The contributions made during such full taxable year ($1,500) up to the qualifed cost of the fund with respect to such taxable year ($800), and (2) the pre-1986 contributions ($1,000) to the extent that such pre-1986 contributions are deductible under the pre-section 419 rules. In determining the extent to which the pre-1986 contributions are deductible under the pre-section 419 rules, the rules contained in Q&A–10 apply as though December 31, 1985, in paragraph (c) were December 31, 1986. Assuming that only $875 is deductible under the pre-section 419 rules, because $875 is greater than $800, this employer may deduct $875 for its first taxable year ending after December 31, 1985. This full $875 deduction for 1985 is deemed to consist entirely of pre-1986 contributions.

Q–10: How do the rules of sections 263, 446(b), 461(a), and 461(h) apply in determining whether contributions with respect to a welfare benefit fund are deductible for a taxable year?

A–10: (a) Both before and after the effective date of section 419 (see Q&A–2 of this regulation), an employer is allowed a deduction for taxable year for contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in Q&A–3 of this regulation and section 419(e)) only to the extent that such contributions satisfy the requirements of section 162 or 212. These requirements must be satisfied after the effective date of section 419 because 419 requires that (among other requirements) contributions to a welfare benefit fund satisfy the requirements of section 162 or 212.

(b) Except as provided in paragraphs (c) and (d), in determinig the extent to which contributions paid or accrued with respect to welfare benefit fund satisfy the requirements of section 162 or 212 for a taxable year (both before and after section 419 generally becomes effective with respect to such contributions), the rules of sections 263, 446(b), 461(a) (including the rules that relate to the creation of an asset with a useful life extending substantially beyond the close of the taxable year), and 461(h) (to the extent that such section

is effective with respect to such contributions) are are generally applicable.

(c) Notwithstanding paragraph (b), under the authority of section 7805(b), the rules of sections 263, 446(b), and 461(a) shall not be applied in determining the extent to which an employer's contribution with respect to a welfare benefit fund is deductible under section 162 or 212 with respect to any taxable year of the employer ending on or before December 31, 1985, to the extent that, for such taxable year, (1) the contribution was made pursuant to a bona fide collective bargaining agreement requiring fixed and determinable contributions to a collectively bargained welfare benefit fund (as defined in §1.419A–2T), or (2) the contribution was not in excess of the amount deductible under the principles of Revenue Rulings 69–382, 1969–2 C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40, modified as appropriate for benefits for active employees.

(d) Notwithstanding paragraph (b), in determining the extent to which contributions paid or accrued with respect to a welfare benefit fund are deductible under section 419, the rules of sections 263, 446(b), and 461(a) will be treated as having been satisfied to the extent that such contributions satisfy the otherwise applicable rules of section 419. Thus, for example, contributions to a welfare benefit fund will not fail to be deductible under section 419 merely because they create an asset with a useful life extending substantially beyoud the close of the taxable year if such contributions satisfy the otherwise applicable requirements of section 419.

(e) In determining the extent to which contributions with respect to a welfare benefit fund satisfy the requirements of section 461(h) for any taxable year for which section 461(h) is effective, pursuant to the authority under section 461(h)(2), economic performance occurs as contributions to the welfare benefit fund are made. Solely for purposes of section 461(h), in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986, contributions made to the welfare benefit fund after the end of such taxable year and on or before March 21, 1986 shall be deemed to have been made on the last day of such taxable year.

Q–11: What special section 419 rules apply to the payment or accrual with respect to a welfare benefit fund of a facility (and the payment or accrual of other amounts, such as cash, used to acquire, construct, or improve such a facility)?

A–11: (a)(1) In the case of an employer's payment or accrual with respect to a welfare benefit fund after June 22, 1984, and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this regulation, before section 419 generally becomes effective with respect to contributions to such fund), of a facility, the rules of section 419, §1.419–1T, and §1.419A–2T generally apply to determine the extent to which such contribution is deductible by the employer for its taxable year of contribution. For this purpose, however, the facility is to be treated as the only contribution made to the fund and the qualified cost of the fund for the taxable year of the fund in which the facility was contributed is to be equal to the qualified direct cost directly attributable to the facility (as determined under Q&A–6 of this regulation). Also, for this purpose, the welfare benefit fund to which the facility was contributed may not be aggregated with any other fund. For purposes of this Q&A, ''facility'' means any tangible asset with a useful life extending substantially beyond the end of the taxable year (e.g., vehicles, buildings) and any intangible asset (e.g., licenses) related to a tangible asset, whether or not such asset is used in the provision of welfare benefits. See, however, paragraph (c) of Q&A–2 of this regulation for a binding contract exception.

(2) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and that, during 1985, the employer contributes to the fund $200,000 in cash and a facility with a fair market value of $100,000. Such facility is used in the provision of welfare benefits under the fund. The employer is treated as having sold the facility in such year and thus will recognize gain to the extent that the fair market value of the facility exceeds the employer's adjusted basis in the facility. In this regard, see section

1239(d). The extent to which the facility contribution is deductible by the employer for its 1985 taxable year is determined as though it were the only contribution made by the employer to the fund during such year and the qualified cost of the fund for the taxable year of the fund in which the contribution was made (i.e., the 1985 taxable year) were equal to the amount that would have been allowable to the employer as a deduction for such year under the applicable Code provisions with respect to the portion of the facility used in the provision of welfare benefits for such year if the employer had placed in service the facility at the time the fund placed in service the facility and if the employer had the same taxable year as the fund. If, under these assumptions, the employer would have been allowed a $10,000 deduction with respect to the facility for the 1985 taxable year, the fund's qualified cost for its 1985 taxable year would be only $10,000. Thus, only $10,000 of the $100,000 facility contribution would be deductible by the employer for its 1985 taxable year (i.e., the taxable year of the employer with or within which the applicable taxable year of the fund ends). However, in determining the extent to which the $200,000 in cash is deductible by the employer for its 1985 taxable year, the $100,000 facility is not to be disregarded. Thus, if under the applicable pre-section 419 rules the employer is allowed for 1985 a total deduction of only $175,000, the employer would be permitted a deduction for 1985 of $175,000 ($10,000 with respect to the facility and $165,000 of the cash contribution). The nondeductible portion of the cash contribution is to be treated as contributed to the fund on the first day of the next taxable year of the employer. If under the applicable pre-section 419 rules the employer were allowed a total deduction of $300,000 for 1985, the employer would be permitted a deduction for 1985 of only $210,000 ($10,000 with respect to the facility and the full $200,000 cash contribution).

(3) For example, assume that an employer has a June 30 taxable year and maintains a welfare benefit fund with a taxable year ending January 31. During the 1985 portion of its taxable year ending June 30, 1986, the employer contributes $50,000 in cash and a facility with a fair market value of $100,000; and during the 1986 portion of such taxable year, the employer contributes another $75,000 in cash to the fund. The facility is used in the provision of welfare benefits under the fund. Under the rules of Q&A–9 of this regulation, the employer's deduction for its June 30, 1986, taxable year is limited to the greater of the following two amounts: (i) The contributions paid to the fund during such taxable year ($225,000) up to the qualified cost of the fund for the taxable year of the fund ending January 31, 1986, and (ii) the contributions paid to the fund during the 1985 portion of the employer's taxable year ending June 30, 1986 (''the pre-1986 contributions'') ($150,000) to the extent that such pre-1986 contributions are deductible under the rules governing the deduction of such contributions before section 419 is generally effective with respect to the fund. For purposes of this rule, the contribution of the facility on or before December 31, 1985, is to be treated as a pre-1986 contribution and the rules of section 419 and this Q&A are to be treated as rules governing the deduction of such contribution before section 419 generally becomes effective with respect to the fund. Thus, in determining the extent to which the facility is deductible as a pre-1986 contribution under the rules before section 419 generally becomes effective, the facility is treated as the only contribution to the welfare benefit fund and the qualified cost of such fund for the taxable year of the fund in which the facility was contributed is the amount that would have been allowable to the employer as a deduction with respect to the portion of the facility used in the provision of welfare benefits if the employer had placed in service the facility at the same time that the fund placed in service the facility and the employer's taxable year ended on January 31, 1986.

(b)(1) The preceding rules shall also apply for purposes of determining when and the extent to which an employer may deduct contributions or other items and amounts after June 22, 1984 and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this regulation, before section 419 generally becomes effective

with respect to contributions to the fund) that are not facilities (e.g., cash contributions) to a welfare benefit fund that are used by the fund to acquire, construct, or improve a facility. The most recent non-facility contributions made to a welfare benefit fund before the facility in question is placed in service by the fund (up to the fair market value of the facility at such time) are to be treated as used by the fund for the acquisition, construction, or improvement (as the case may be) of such facility. To the extent that contributions before such a facility is placed in service are not at least equal to the value of the facility at such time, contributions after such date (up to the value of the facility at the time it is placed in service) are treated as used for acquisition, construction, or improvement of the facility. Such non-facility contributions, to the extent that they were made after June 22, 1984, and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this regulation, before section 419 generally becomes effective with respect to contributions to the fund), are not deductible by the employer as non-facility contributions for any year. Instead, the employer is permitted a deduction with respect to such contributions only under the rules of this Q&A as though the employer had contributed a facility to the fund at the same time that the fund placed in service the facility in question and, at such time, the facility had a fair market value equal to the total of such non-facility contributions.

(2) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and during 1985 the fund acquired and placed in service a facility with a fair market value of $100,000 to be used in the provision of welfare benefits. Further, during July 1984 the employer contributed $150,000 in cash to the fund and, during the portion of 1985, before the facility was placed in service by the fund, the employer contributed another $75,000 in cash to the fund; during the remaining portion of 1985, the employer contributed $125,000 in cash. The facility is used in the provision of welfare benefits under the fund. Because $25,000 of the employer's 1984 contribution is treated under this rule as used for the acquisition of a facility, such $25,000 is not deductible by the employer for 1984. For purposes of determining the employer's deduction for 1985, the employer will be treated as having contributed $125,000 in cash and a facility with a fair market value of $100,000. The employer's deduction for its 1985 taxable year will be determined under the rules relating to the contribution of a facility after June 22, 1984, and on or before December 31, 1985.

(3) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and during 1986 the fund placed in service a facility with a fair market value of $100,000 to be used in the provision of welfare benefits. During 1985, the employer contributed $125,000 in cash to the fund. During the portion of 1986 before the facility was placed in service, the employer contributed $60,000 in cash, and during the remaining portion of 1986, the employer contributed another $75,000 in cash. The facility is used in the provision of welfare benefits under the fund. Because $40,000 of its 1985 cash contribution is treated under this rule as used for the acquisition of the facility, such $40,000 is not deductible by the employer for 1985. For purposes of determining the employer's deduction for 1986, the employer will be treated as though it had contributed a $40,000 facility to the fund at the time the fund placed the facility in service.

(c) For purposes of calculating the ''existing excess reserve amount'' under Q&A–1 of §1.419A–1T and the ''existing reserves for post-retirement medical or life insurance benefits'' under Q&A–4 of §1.512(a)–5T (but not the exempt function income under Q&A–3 of §1.512(a)–5T), the amount set aside as of any applicable date is to be reduced to the extent that contributions originally included in such amount are subsequently treated under this Q&A as used for the acquisition, construction, or improvement of an asset excluded from the calculation of the total amount set aside under paragraph (b) of §1.512(a)–5T (or would be so treated under this Q&A if it applied to such asset). The reduction required

under this paragraph applies for purposes of calculating the ''existing excess reserve amount'' and the ''existing reserves for post-retirement medical or life insurance benefits'' for all taxable years of the welfare benefit fund.

[T.D. 8073, 51 FR 4323, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986; 51 FR 11303, Apr. 2, 1986]

§ 1.419A–1T Qualified asset account limitation of additions to account. (Temporary)

Q–1: What does the transition rule under section 419A(f)(7) provide?

A–1: Section 419A(f)(7) provides that, in the case of a welfare benefit fund that was in existence on July 18, 1984, the account limit (as determined under section 419A(c)) for each of the first four taxable years of the fund that relate to taxable years of the employer ending after December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of § 1.419–1T, taxable years of the employer beginning after the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained) shall be increased by the following percentages of the ''existing excess reserve amount'':

	Percent
First taxable year	80
Second taxable year	60
Third taxable year	40
Fourth taxable year	20

For purposes of this section, the ''existing excess reserve amount'' for any taxable year of a fund is the excess of (a) the assets actually set aside for purposes described in section 419A(a) at the close of the first taxable year of the fund ending after July 18, 1984 (calculated in the manner set forth in Q&A–3 of § 1.512(a)–3T, and adjusted under paragraph (c) of Q&A–11 of § 1.419–1T), reduced by employer contributions to the fund before the close of such first taxable year to the extent that such contributions are not deductible for the taxable year of the employer with or within which such taxable year of the fund ends and for any prior taxable year of the employer, over (b) the account limit which would have applied to the taxable year of the fund for which the excess is being computed (without regard to this transition rule). A welfare benefit fund is treated as in existence on July 18, 1984, for purposes of this transition rule only if amounts were actually set aside in such fund on such date to provide welfare benefits enumerated under section 419A.

[T.D. 8073, 51 FR 4329, Feb. 4, 1986, as amended at 51 FR 11303, Apr. 2, 1986]

§ 1.419A–2T Qualified asset account limitation for collectively bargained funds. (Temporary)

Q–1: What account limits apply to welfare benefit funds that are maintained pursuant to a collective bargaining agreement?

A–1: Contributions to a welfare benefit fund maintained pursuant to one or more collective bargaining agreements and the reserves of such a fund generally are subject to the rules of sections 419, 419A, and 512. However, neither contributions to nor reserves of such a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b), 419A(b), or 512(a)(3)(E) until the earlier of: (i) The date on which the last of the collective bargaining agreements relating to the fund in effect on, or ratified on or before, the date of issuance of final regulations concerning such limits for collectively bargained welfare benefit funds terminates (determined without regard to any extension thereof agreed to after the date of issuance of such final regulations), or (ii) the date 3 years after the issuance of such final regulations.

Q–2: What is a welfare benefit fund maintained pursuant to a collective bargaining agreement for purposes of Q&A–1?

A–2: (1) For purposes of Q&A–1, a collectively bargained welfare benefit fund is a welfare benefit fund that is maintained pursuant to an agreement which the Secretary of Labor determines to be a collective bargaining agreement and which meets the requirements of the Secretary of the Treasury as set forth in paragraph 2 below.

(2) Notwithstanding a determination by the Secretary of Labor that an agreement is a collective bargaining agreement, a welfare benefit fund is

considered to be maintained pursuant to a collective bargaining agreement only if the benefits provided through the fund were the subject of arms-length negotiations between employee representatives and one or more employers, and if such agreement between employee representatives and one or more employers satisfies section 7701(a)(46) of the Code. Moreover, the circumstances surrounding a collective bargaining agreement must evidence good faith bargaining between adverse parties over the welfare benefits to be provided through the fund. Finally, a welfare benefit fund is not considered to be maintained pursuant to a collective bargaining agreement unless at least 50 percent of the employees eligible to receive benefits under the fund are covered by the collective bargaining agreement.

(3) In the case of a collectively bargained welfare benefit fund, only the portion of the fund (as determined under allocation rules to be provided by the Commissioner) attributable to employees covered by a collective bargaining agreement, and from which benefits for such employees are provided, is considered to be maintained pursuant to a collective bargaining agreement.

(4) Notwithstanding the preceding paragraphs and pending the issuance of regulations setting account limits for collectively bargained welfare benefit funds, a welfare benefit fund will not be treated as a collectively bargained welfare benefit fund for purposes of Q&A–1 if and when, after July 1, 1985, the number of employees who are not covered by a collective bargaining agreement and are eligible to receive benefits under the fund increases by reason of an amendment, merger, or other action of the employer or the fund. In addition, pending the issuance of such regulations, for purposes of applying the 50 percent test of paragraph (2) to a welfare benefit fund that is not in existence on July 1, 1985, ''90 percent'' shall be substituted for ''50 percent''.

[T.D. 8034, 50 FR 27428, July 3, 1985]

§ 1.420–1 Significant reduction in retiree health coverage during the cost maintenance period.

(a) In *general*. Notwithstanding section 420(c)(3)(A), the minimum cost requirements of section 420(c)(3) are not met if the employer significantly reduces retiree health coverage during the cost maintenance period.

(b) *Significant reduction*—(1) *In general*. An employer significantly reduces retiree health coverage during the cost maintenance period if, for any taxable year beginning on or after January 1, 2002, that is included in the cost maintenance period, either —

(i) The employer-initiated reduction percentage for that taxable year exceeds 10 percent; or

(ii) The sum of the employer-initiated reduction percentages for that taxable year and all prior taxable years during the cost maintenance period exceeds 20 percent.

(2) *Employer-initiated reduction percentage*. The employer-initiated reduction percentage for any taxable year is the fraction B/A, expressed as a percentage, where:

A = The total number of individuals (retired employees plus their spouses plus their dependents) receiving coverage for applicable health benefits as of the day before the first day of the taxable year.

B = The total number of individuals included in A whose coverage for applicable health benefits ended during the taxable year by reason of employer action.

(3) *Special rules for taxable years beginning before January 1, 2002*. The following rules apply for purposes of computing the amount in paragraph (b)(1)(ii) of this section if any portion of the cost maintenance period precedes the first day of the first taxable year beginning on or after January 1, 2002—

(i) *Aggregation of taxable years*. The portion of the cost maintenance period that precedes the first day of the first taxable year beginning on or after January 1, 2002 (the initial period) is treated as a single taxable year and the employer-initiated reduction percentage for the initial period is computed as set forth in paragraph (b)(2) of this section,

except that the words ''initial period'' apply instead of ''taxable year.''

(ii) *Loss of coverage.* If coverage for applicable health benefits for an individual ends by reason of employer action at any time during the initial period, an employer may treat that coverage as not having ended if the employer restores coverage for applicable health benefits to that individual by the end of the initial period.

(4) *Employer action*—(i) *General rule.* For purposes of paragraph (b)(2) of this section, an individual's coverage for applicable health benefits ends during a taxable year by reason of employer action, if on any day within the taxable year, the individual's eligibility for applicable health benefits ends as a result of a plan amendment or any other action of the employer (e.g., the sale of all or part of the employer's business) that, in conjunction with the plan terms, has the effect of ending the individual's eligibility. An employer action is taken into account for this purpose regardless of when the employer action actually occurs (e.g., the date the plan amendment is executed), except that employer actions occurring before the later of December 18, 1999, and the date that is 5 years before the start of the cost maintenance period are disregarded.

(ii) *Special rule.* Notwithstanding paragraph (b)(4)(i) of this section, coverage for an individual will not be treated as having ended by reason of employer action merely because such coverage ends under the terms of the plan if those terms were adopted contemporaneously with the provision under which the individual became eligible for retiree health coverage. This paragraph (b)(4)(ii) does not apply with respect to plan terms adopted contemporaneously with a plan amendment that restores coverage for applicable health benefits before the end of the initial period in accordance with paragraph (b)(3)(ii) of this section.

(iii) *Sale transactions.* If a purchaser provides coverage for retiree health benefits to one or more individuals whose coverage ends by reason of a sale of all or part of the employer's business, the employer may treat the coverage of those individuals as not having ended by reason of employer action. In such a case, for the remainder of the year of the sale and future taxable years of the cost maintenance period —

(A) For purposes of computing the applicable employer cost under section 420(c)(3), those individuals are treated as individuals to whom coverage for applicable health benefits was provided (for as long as the purchaser provides retiree health coverage to them), and any amounts expended by the purchaser of the business to provide for health benefits for those individuals are treated as paid by the employer;

(B) For purposes of determining whether a subsequent termination of coverage is by reason of employer action under this paragraph (b)(4), the purchaser is treated as the employer. However, the special rule in paragraph (b)(4)(ii) of this section applies only to the extent that any terms of the plan maintained by the purchaser that have the effect of ending retiree health coverage for an individual are the same as terms of the plan maintained by the employer that were adopted contemporaneously with the provision under which the individual became eligible for retiree health coverage under the plan maintained by the employer.

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Applicable health benefits.* Applicable health benefits means applicable health benefits as defined in section 420(e)(1)(C).

(2) *Cost maintenance period.* Cost maintenance period means the cost maintenance period as defined in section 420(c)(3)(D).

(3) *Sale.* A sale of all or part of an employer's business means a sale or other transfer in connection with which the employees of a trade or business of the employer become employees of another person. In the case of such a transfer, the term *purchaser* means a transferee of the trade or business.

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) Employer W maintains a defined benefit pension plan that includes a 401(h) account and permits qualified transfers that satisfy section 420. The number of individuals receiving coverage for applicable health benefits as of the day before the first

day of Year 1 is 100. In Year 1, Employer W makes a qualified transfer under section 420. There is no change in the number of individuals receiving health benefits during Year 1. As of the last day of Year 2, applicable health benefits are provided to 99 individuals, because 2 individuals became eligible for coverage due to retirement and 3 individuals died in Year 2. During Year 3, Employer W amends its health plan to eliminate coverage for 5 individuals, 1 new retiree becomes eligible for coverage and an additional 3 individuals are no longer covered due to their own decision to drop coverage. Thus, as of the last day of Year 3, applicable health benefits are provided to 92 individuals. During Year 4, Employer W amends its health plan to eliminate coverage under its health plan for 8 more individuals, so that as of the last day of Year 4, applicable health benefits are provided to 84 individuals. During Year 5, Employer W amends its health plan to eliminate coverage for 8 more individuals.

(ii) There is no significant reduction in retiree health coverage in either Year 1 or Year 2, because there is no reduction in health coverage as a result of employer action in those years.

(iii) There is no significant reduction in Year 3. The number of individuals whose health coverage ended during Year 3 by reason of employer action (amendment of the plan) is 5. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 2 is 99, the employer-initiated reduction percentage for Year 3 is 5.05 percent (5/99), which is less than the 10 percent annual limit.

(iv) There is no significant reduction in Year 4. The number of individuals whose health coverage ended during Year 4 by reason of employer action is 8. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 3 is 92, the employer-initiated reduction percentage for Year 4 is 8.70 percent (8/92), which is less than the 10 percent annual limit. The sum of the employer-initiated reduction percentages for Year 3 and Year 4 is 13.75 percent, which is less than the 20 percent cumulative limit.

(v) In Year 5, there is a significant reduction under paragraph (b)(1)(ii) of this section. The number of individuals whose health coverage ended during Year 5 by reason of employer action (amendment of the plan) is 8. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 4 is 84, the employer-initiated reduction percentage for Year 5 is 9.52 percent (8/84), which is less than the 10 percent annual limit. However, the sum of the employer-initiated reduction percentages for Year 3, Year 4, and Year 5 is 5.05 percent + 8.70 percent + 9.52 percent = 23.27 percent, which exceeds the 20 percent cumulative limit.

Example 2. (i) Employer X, a calendar year taxpayer, maintains a defined benefit pension plan that includes a 401(h) account and permits qualified transfers that satisfy section 420. X also provides lifetime health benefits to employees who retire from Division A as a result of a plant shutdown, no health benefits to employees who retire from Division B, and lifetime health benefits to all employees who retire from Division C. In 2000, X amends its health plan to provide coverage for employees who retire from Division B as a result of a plant shutdown, but only for the 2-year period coinciding with their severance pay. Also in 2000, X amends the health plan to provide that employees who retire from Division A as a result of a plant shutdown receive health coverage only for the 2-year period coinciding with their severance pay. A plant shutdown that affects Division A and Division B employees occurs in 2000. The number of individuals receiving coverage for applicable health benefits as of the last day of 2001 is 200. In 2002, Employer X makes a qualified transfer under section 420. As of the last day of 2002, applicable health benefits are provided to 170 individuals, because the 2-year period of benefits ends for 10 employees who retired from Division A and 20 employees who retired from Division B as a result of the plant shutdown that occurred in 2000.

(ii) There is no significant reduction in retiree health coverage in 2002. Coverage for the 10 retirees from Division A who lose coverage as a result of the end of the 2-year period is treated as having ended by reason of employer action, because coverage for those Division A retirees ended by reason of a plan amendment made after December 17, 1999. However, the terms of the health plan that limit coverage for employees who retired from Division B as a result of the 2000 plant shutdown (to the 2-year period) were adopted contemporaneously with the provision under which those employees became eligible for retiree coverage under the health plan. Accordingly, under the rule provided in paragraph (b)(4)(ii) of this section, coverage for those 20 retirees from Division B is not treated as having ended by reason of employer action. Thus, the number of individuals whose health benefits ended by reason of employer action in 2002 is 10. Since the number of individuals receiving coverage for applicable health benefits as of the last day of 2001 is 200, the employer-initiated reduction percentage for 2002 is 5 percent (10/200), which is less than the 10 percent annual limit.

(e) *Regulatory effective date.* This section is applicable to transfers of excess pension assets occurring on or after December 18, 1999.

[T.D. 8948, 66 FR 32900, June 19, 2001]

CERTAIN STOCK OPTIONS

§ 1.421–1 Effective dates and meaning and use of certain terms.

(a) *Option.* (1) For the purpose of section 421, the term ''option'' includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at $85 per share during 1955, or at $75 per share during 1956, or at $65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at $85 per share during 1955, an alternative option for the purchase of 1,000 shares at $75 per share during 1956, and a third alternative option for the purchase of 1,000 shares at $65 per share during 1957.

(b) *Time and date of granting of option.* (1) For the purpose of section 421, the words ''the date of the granting of the option'' and ''the time such option is granted'', and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 421(d)(5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its parent or subsidiary corporation, such option is not granted prior to the

date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) *Stock.* For the purpose of section 421, the term ''stock'' means capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term ''stock'' as used in section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price.* (1) For the purpose of section 421, the term ''option price'' or ''price paid under the option'' means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2) (i) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(A) The option price must be fixed or determinable at the time the option is granted; or

(B) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option price must be determinable under a variable price option as defined in subdivision (ii) of this subparagraph.

An option which does not meet the requirements of either (A) or (B) of this subdivision when granted will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see paragraph (c)(2) of § 1.421–4.

(ii)(A) The term ''variable price option'' means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Except as provided in (*b*) of this subdivision, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than $85, nor more than $110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than $95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed $100,000, the option price shall be $15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed $100,000, the option price shall be $20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a)(1) of § 1.421–2.

(B) In the case of an option granted after September 30, 1958, the term ''variable price option'' does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is

exercised. Whether an option meets the requirement of this subdivision shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial. Thus, an option, granted after September 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this subdivision, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 421(d)(1)(A). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than $85, will not qualify under this subdivision since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement of this subdivision is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(e) *Exercise*. For the purpose of section 421, the term ''exercise'', when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(f) *Transfer*. For the purpose of section 421, the term ''transfer'', when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(g) *Effective dates*. Sections 1.421–1 through 1.421–5 are applicable only to options granted after February 26, 1945, and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of

1954, before the amendments made by section 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421–6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421–7 and 1.421–8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended.

[T.D. 6500, 25 FR 11692, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 410, Jan. 19, 1961, T.D. 6887, 31 FR 8786, June 24, 1966]

§ 1.421–2 Restricted stock option.

(a) *In general.* (1) A ''restricted stock option'' is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For the purpose of applying the rule of subdivision (i) of this subparagraph if the option price is determined by a formula described in paragraph (d)(2)(ii) of § 1.421–1, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1959, an option is granted providing that the option price shall be $10 under the average fair market value of the stock during the month in which the option is exercised or the average fair market value of the stock during the preceding month, whichever is lower, and if on June 15, 1959, the value of the stock subject to the option is $100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average fair market value of the stock during the months of May and June 1959. If such lower average fair market value is $95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of its parent or subsidiary corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations; and

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option; and

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of five years from the date on which such option was granted, or such option is exercised before August 17, 1955.

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-

employee relationship exists, see section 3401(c) and the regulations thereunder. An option granted before employment or after termination of employment is not a restricted stock option. As to the granting of an option conditioned upon employment, see paragraph (b)(2) of § 1.421–1. The option must be granted for a reason connected with the individual's employment by the corporation or by its parent or subsidiary corporation.

(4) An option may qualify as a restricted stock option only if, under the terms of the option, it is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a restricted stock option. However, in case the option contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a restricted stock option.

(5) Any reasonable valuation methods may be used for the purpose of determining whether at the time the option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option. Such methods include the valuation methods described in § 20.2031–2 of this chapter (Estate Tax Regulations).

(b) *Ownership of 10 percent of stock.* In determining the amount of stock owned by an individual, for the purpose of applying the 10 percent test of section 421(d)(1)(C), stock of the employer corporation or of its parent or subsidiary owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

[T.D. 6500, 25 FR 11693, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

§ 1.421–3 Exercise of restricted stock option.

(a) The special rules of income tax treatment provided in section 421(a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or parent or subsidiary thereof), or of a corporation (or parent or subsidiary thereof) which issued or assumed the option under section 421(g) (see paragraph (d) of § 1.421–4), or was an employee of any such corporations within three months before the date the option is exercised.

(b)(1) Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is at the time the option is exercised a parent or subsidiary of such corporation, unless the old option has been assumed or a new option has been issued in its place under section 421(g). See paragraph (d) of § 1.421–4. In case of such an assumption of the old option or such issuance of a new option, the individual exercising the option must, at the time he exercises the option, be a bona fide employee of the corporation so assuming or issuing the option, or a parent or subsidiary of such corporation. Section 421 is also applicable if the individual exercising the option was a bona fide employee of any of such corporations within three months before the exercise of the option. For purposes of determining whether an individual meets the requirement of this subparagraph, the term ''employer corporation'', as used in section 421(d) (2) and (3), shall be read as ''grantor corporation'' or

''corporation issuing or assuming a stock option in a transaction to which section 421(g) is applicable'', as the case may be. Therefore, for purposes of the employment requirement, the determination of whether a corporation is a parent corporation or a subsidiary corporation is based upon whether the corporation is a parent or subsidiary of the corporation granting an option or of a corporation which issued or assumed an option under section 421(g).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1954, X Corporation granted a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1955, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises this restricted stock option on June 1, 1955, section 421 is not applicable to such exercise, because on June 1, 1955, A is not employed by the corporation which granted the option or by a parent or subsidiary of such corporation. Nor was he employed by any of such corporations within three months before June 1, 1955.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 421(g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421(g).

Example (3). Assume that P Corporation which owns all of the stock of S Corporation grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

(c)(1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 1.421–4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S–1. On January 1, 1955, S sells a portion of the S–1 stock which it owns to an unrelated corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has exercised a restricted stock option.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S–1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of § 1.421–5.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

§ 1.421–4 Modification, extension, or renewal.

(a) *In general.* Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954.

(b) *Effect of a modification, extension, or renewal.* (1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421(d)(1)(A)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(3)(i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1954, a restricted stock option was granted to purchase before July 1, 1955, a share of stock for $85. The fair market value of such stock on June 1, 1954, was $100. On June 15, 1955, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1956, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1955, is as follows:

1954	
June	$100
July	90
August	80
September	70
October	80
November	80
December	90
1955	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1955, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (2) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(c) *Definition of modification, extension, or renewal.* (1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (b) of § 1.421–1. For the purpose of section 421, the term ''modification'' means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or

which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(2) Any change in the terms of an option for the purpose of qualifying the option as a restricted stock option grants additional benefits and, therefore, is a modification. For example, if an option was granted to purchase for $80 a share of stock, the fair market value of which was $100 at such time, and if later the option price is increased to $85 in order to meet the requirement of section 421(d)(1)(A), such change is a modification of the option, although the price is increased. Accordingly, the option, despite the change, is not a restricted stock option if the fair market value of the share is more than $100 when the price is increased. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution, such change is not a modification, provided the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted.

(3) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(d) *Assumption or substitution of restricted stock options in connection with certain corporate transactions.* (1) Where, by reason of a corporate transaction, as defined in this paragraph, an employer corporation, or its parent or subsidiary corporation, assumes an existing option, or issues a new option in place of the old option, such assumption or issuance is not a modification, if—

(i) The excess of the aggregate fair market value of the stock subject to the option immediately after such assumption or issuance over the aggregate option price is not more than the excess of the aggregate fair market value of the stock subject to the option immediately before such assumption or issuance over the aggregate option price, and

(ii) Such assumption of the old option, or issuance of the new option, does not give the optionee additional benefits under the option.

For the purpose of this paragraph, the term ''corporate transaction'' means a corporate merger, consolidation, purchase or acquisition of property or stock, separation, reorganization, or liquidation. Thus, for this purpose, a ''corporate transaction'' includes a taxable transaction (such as, a purchase of stock or property for cash) and any corporate reorganization (whether or not it comes within the definition of such term in section 368) and any corporate liquidation (whether or not section 332 is applicable).

(2)(i) Section 421(g) provides rules under which a new employer, or parent or subsidiary of a new employer, may by reason of a corporate transaction assume a restricted stock option granted by the former employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. For example, section 421(g) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume restricted stock options which had been

granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a restricted stock option to purchase its stock in place of the restricted stock option which they had to purchase stock of X Corporation.

(ii) Section 421(g) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a restricted stock option granted by the employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 421(g) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a restricted stock option to buy stock of X Corporation in place of the restricted stock option which they have to purchase the stock of Y Corporation.

(iii) Section 421(g) applies only when the assumption or substitution occurs by reason of a corporate -transaction as defined in this paragraph. Thus, section 421(g) may apply where as a result of a corporate transaction a restricted stock option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 421(g) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 421(g).

(3) For section 421(g) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 421(g) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 421(g) cannot be applied to revive a restricted stock option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 421(g). For section 421(g) to apply, the assumed or substituted option must qualify as a restricted stock option.

(4) Section 421(g) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Thus, section 421(g) would not apply if the old option had just two years to run but the new option has more than two years to run.

(5) For the purpose of applying section 421(g), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 421(g), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 421(g) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 421(g) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the restricted stock option which employee E has entitling him to purchase 100

shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $42.50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $21.25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $21.25 a share in substitution for his right to purchase 50 of the shares covered by the old option.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 421(g), the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(e) *Effect on qualification.* A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or any option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(f) *Examples.* The rule stated in section 421(e) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under section 421(e), the X Corporation is deemed to have granted an option to the employee on February 1, 1955. Unless the value of the stock has substantially declined making paragraph (b)(3) of this section applicable, such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee after February 1, 1955, is not the exercise of a restricted stock option.

Example (2). On June 1, 1954, the X Corporation grants to an employee a restricted stock option to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1955, and on or before June 1, 1956. On June 1, 1954, the fair market value of X Corporation's stock is $100 per share. On February 1, 1955, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1955, and on or before June 1, 1956. On February 1, 1955, the fair market value of X Corporation stock

is $110 per share. Under section 421(e), X Corporation is deemed to have granted an option to the employee on February 1, 1955, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee is not the exercise of a restricted stock option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1955, before the date of the modification of the option. Any exercise of the option after February 1, 1955, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1955, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

Example (4). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted stock option) with respect to 100 shares having been granted on June 1, 1954, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1955. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960]

§ 1.421–5 Operation of section 421.

(a) *Rules applicable to all restricted stock options*—(1) *In general.* If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date of the granting of the option nor within 1 year (6 months for taxable years before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him, then, under section 421(a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation, or to a corporation which assumed or issued the option under section 421(g), with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by any of such corporations for the share so transferred.

For the purpose of subdivisions (i), (ii), and (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(2) *Holding period.* The special rules provided in section 421(a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 421 is not made inapplicable by a transfer within the 2-year or 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by

reason of the death of such individual, see paragraph (d) of this section.

(3) *Disposition of stock*. (i) For the purpose of section 421, the term ''disposition'' includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(a) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(b) An exchange which occurs in a taxable year of the optionee beginning after December 31, 1953, and ending after August 16, 1954, and to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939; or

(c) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership is a disposition of such share, except to the extent that the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) *Examples*. The rules of section 421(a) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at $95 per share. On that date, the fair market value of X Corporation stock is $100 per share. On June 1, 1955, while employed by X Corporation, E exercises the option in full and pays X Corporation $9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1956, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1955, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is $9,500.

Example (2). Assume, in example (1), that on August 1, 1956, two years and two months after the granting of the option and one year and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,500 ($13,000 minus E's basis of $9,500), which is treated as long-term capital gain.

Example (3). Assume, in example (2), that on August 1, 1956, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $9,500 becomes the donee's basis for determining gain or loss.

Example (4). Assume, in example (1), that on May 1, 1956, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted. See paragraph (e) of this section for the effect of a disqualifying disposition.

Example (5). Assume, in example (1), that E dies on September 1, 1955, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1955, of the restricted stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

(b) *Additional rules applicable where the option price is between 85 percent and 95 percent of the value of the stock*—(1) *In*

general. (i) If all the conditions necessary for the application of section 421(a) exist, section 421(b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If the option qualified under section 421(d)(1)(A)(i) (see paragraph (d)(2)(i)*(a)* of §1.421–1), such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, if the option qualified under section 421(d)(1)(A)(ii) (see paragraph (d)(2)(i)*(b)* of §1.421–1), such amount shall be whichever of the following amounts is lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 421(b).

(ii) The application of the special rules provided in section 421(b) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 421(b), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) *Basis*. If the special rules provided in section 421(b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). However, in the case of a share of stock acquired by the exercise of a restricted stock option after the death of the employee to whom the option was granted, the basis of such share shall be determined in accordance with the rules of paragraph (d)(4) of this section. If the special rules provided in section 421(b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 421(b). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples*. The operation of section 421(b) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted

stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1955, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1957, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of $15 is includible in E's gross income for 1957, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) The X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1958, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in E's gross income for 1958. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume, in example (1), that the option provides that the option price shall be 90 percent of the fair market value of a share of the stock on the day the option is exercised. On June 1, 1955, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of stock. Compensation in the amount of $10 is includible in E's gross income for 1957, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10 the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume, in example (1), that instead of selling the share on January 1, 1957, E makes a gift of the share on that day. In such case, $15 is includible as compensation in E's gross income for 1957. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume, in example (2), that instead of selling the share on January 1, 1958, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1958. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume, in example (1), that after acquiring the share of stock on June 1, 1955, E dies on August 1, 1956, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume, in example (6), that E dies on August 1, 1955, at which time the share has a fair market value of $150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1956, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1956, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except that the share of stock

was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1956, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume, in example (9), that E's wife predeceased him on July 1, 1956. Section 421(b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1956, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1956 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) *Acquisition of other stock.* (1) Section 421(c) provides that the special rules stated in section 421 (a) and (b), if applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which is applicable section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939. Stock so acquired shall, for the purpose of section 421, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 421(c) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036). Section 421(c) is applicable only with respect to such acquisitions which occur in any taxable year of the shareholder which begins after December 31, 1953, and ends after August 16, 1954. As to acquisitions occurring in earlier taxable years, see section 130A(c) of the Internal Revenue Code of 1939.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a restricted stock option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock within two years after the option was granted, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of within two years after the option was granted, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the old stock pursuant to the exercise of the option, section 421 is applicable.

(d) *Exercise after death.* (1) If a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, and if such exercise occurs in a taxable year of the estate or of such person beginning after December 31, 1953, and ending after August 16, 1954, section 421 applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421 become inapplicable if such executor, administrator, or person disposes of the stock so acquired within two years after the granting of such option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the stock pursuant to the exercise of such option. This exception as to the applicability of section 421 does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421 to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of § 1.421–4, relating to the modification, extension, or renewal of the option. Section 421 is applicable even

though such executor, administrator, or person is not employed by the corporation granting the option, or a parent or subsidiary thereof, either when the option is exercised or at any time. However, section 421 is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the requirements of paragraph (b) of § 1.421–3, relating to the employment of such individual, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421 is not applicable to the exercise. For example, if the option is sold by the estate, section 421 does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421 is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 421(b) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 421(b) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If under section 421(b) an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the restricted stock option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the restricted stock option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 421(b) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 421(b). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)–1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1953, E was granted a restricted stock option to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 a share. E died on February 1, 1954, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at $30. On March 1, 1955, the estate exercised the option, and on March 15, 1955, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1955, the estate is required by section 421(b) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(d)(6)(B), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the restricted stock option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the restricted stock option in the estate of E is $10. Since $15, the amount includible in gross income by reason of section 421(b), is less than the value for estate tax purposes of the option, only 15/30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15/30 of $10, or $5. No deduction under section 421(d)(6)(B) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). The basis of the share shall not be increased by reason of the inclusion

of the value of the restricted stock option in the estate for estate tax purposes.

(ii)*(A)* In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a restricted stock option to acquire 10 shares of stock has a basis of $100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10 of $100, or $10. The option acquires a basis, determined under section 1014(a), only if it is exercised in accordance with section 421. Therefore, to the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by *(B)* and *(C)* of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 421(b).

(B) If the amount which would have been includible in gross income under section 421(b) had the employee exercised the option and held the share at the time of his death exceeds the amount which is includible in gross income under section 421(b), the basis of the share, determined under *(A)* of this subdivision, shall be reduced by such excess. For example, if $15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only $10 is includible under section 421(b), the basis of the share, determined under *(A)* of this subdivision, would be reduced by $5. For purposes of determining the amount which would have been includible in gross income under section 421(b) if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(C) If the amount includible in gross income under section 421(b) exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under *(A)* of this subdivision, shall be increased by such excess. Thus, if $15 is includible in gross income under section 421(b), and the basis of the option with respect to the share is $10, the basis of the share, determined under *(A)* of this subdivision, will be increased by $5.

(iii) If a restricted stock option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date was $100 per share. On June 1, 1955, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1956, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $90. The estate is required by section 421(b) to include $5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is $90 (the $85 paid for the stock plus the $5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1956, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation stock for $85. The fair market value of X Corporation stock on such date was $100 per share. On June 1, 1957, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1958, the estate of E exercised the option and sold the share of X Corporation stock at a time when

the fair market value of the share was $120. The basis of the share is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since $15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(B)* of this subparagraph does not apply. Moreover, since the $15 includible in the gross income of the estate does not exceed the basis of the option ($35), subdivision (ii)*(C)* of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time if its sale was $90. The basis of the share, determined under subdivision (ii)*(A)* of this subparagraph, is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $90, the estate is required to include $5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of this death, $15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by $10 the amount which the estate is required to include in its gross income, subdivision (ii)*(B)* of this subparagraph applies, and the basis of the share ($120), determined under subdivision (ii)*(A)* of this subparagraph is reduced by $10. Accordingly, the basis is $110, and a capital loss of $20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was $5, and that the fair market value of X Corporation stock on the date the employee died did not exceed $100. The basis of the share, determined under subdivision (ii)*(A)* of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since such amount exceeds by $10 the basis of the option, subdivision (ii)*(C)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(A)* of this subparagraph, is increased by $10. Accordingly, the basis is $100 and a capital gain of $20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1957, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1958, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was $5. On August 1, 1958, the estate of E exercised the option and sold the share when its fair market value was $92. The basis of the share, determined under subdivision (ii)*(A)* of this subparagraph, is $90 (the $85) paid for the stock plus the $5 basis of the option). When the share is sold for $92, the estate is required to include $7 in its gross income as compensation. Since $13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(B)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(A)* of this subparagraph, is reduced by $6 to $84. Furthermore, since the $7 that the estate is required to include in its gross income when the share is sold for $92 exceeds by $2 the basis of the option, subdivision (ii)*(C)* of this subparagraph applies, and the basis of the share ($84), determined under subdivision (ii)*(A)* and (ii)*(B)* of this subparagraph, is increased by $2. Accordingly, the basis is $86 and a capital gain of $6 is realized on the disposition of the share.

(e) *Disqualifying disposition.* The disposition of a share of stock, acquired by the exercise of a restricted stock option, within two years after the granting of the option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the share pursuant to such exercise makes section 421 inapplicable to such transfer of the share. If such disqualifying disposition occurs in a taxable year of the individual which begins after December 31, 1953, and ends after August 16, 1954, the income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, if such disposition occurs in a taxable year of the employer which begins after December 31, 1953, and ends after August 16, 1954, the deduction attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which occurs the disposition. However, if the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determinded as if the employee had

been paid compensation at the time provided in paragraph (d) of § 1.421–6.

[T.D. 6500, 25 FR 11696, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.421–6 Options to which section 421 does not apply.

(a) *Scope of section.* (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a qualified or restricted stock option at the time it is granted or an option granted under an employee stock purchase plan, or when an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of the parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property. In addition, § 1.61–15 makes the rules of this section applicable in determining the time when certain other options result in the realization of income and the amount of such income.

(2) This section is applicable to options granted on or after February 26, 1945, and before July 1, 1969 (and thereafter, to the extent that § 1.83–8(b) applies). For rules relating to options granted after June 30, 1969, see § 1.83–7. This section, however, is not applicable to—

(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred subject to a restriction which has a significant effect on its value, or

(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if, under the terms of the contract granting such option, the property to be transferred upon the exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction. However, if an option granted before September 25, 1959, and on or after February 26, 1945, is sold or otherwise disposed of before exercise, the provisions of this section shall be fully applicable to such disposition.

(3) If an option to which this section applies has a readily ascertainable fair market value when granted, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option, irrespective of whether such value was included in income for the taxable year in which the option was granted, and any deduction which is allowable as a result of the granting of such option is allowable only for the taxable year in which the option is granted. Thus, if an option having a readily ascertainable fair market value to which this section applies was granted in a taxable year for which an assessment of deficiency was barred at the time of the adoption of paragraph (c) of this section as a Treasury decision, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option. However, if there is a determination to which the rules of sections 1311–1314 apply, there may be an adjustment for the taxable year in which the option was granted.

(b) *Meaning and use of certain terms.* (1) For the purpose of this section, the term ''option'' includes the right or privilege of a person to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such person being under no obligation to purchase.

(2) As used in this section, the terms ''employee'', ''employment'', and ''employer'' have reference to the legal and

bona fide relationship of employer and employee. For rules applicable to the determination whether the employer employee relationship exists, see section 3401(c) and the regulations thereunder.

(3) For purposes of applying the rules of this section to the options which are made subject to such rules by § 1.61–15—

(i) The term ''employee'' includes the person who provided the consideration resulting in the grant of the option, the term ''employer'' includes the person to whom, or for whom, such consideration was provided, and the term ''employment'' includes the providing of such consideration;

(ii) Where a stock option is granted to an underwriter prior to a public offering and such grant is expressly or impliedly conditional upon the successful completion of the underwriting, the date on which the option shall be considered ''granted'' shall be the date of the successful completion of the underwriting.

(c) *Options with a readily ascertainable fair market value.* (1) If there is granted an option to which this section applies and which has a readily ascertainable fair market value (determined in accordance with subparagraphs (2) and (3) of this paragraph) at the time the option is granted, the employee in connection with whose employment such option is granted realizes compensation at such time in an amount equal to the excess, if any, of such fair market value over any amount paid for the option. If an option to which this section applies does not have a readily ascertainable fair market value at the time the option is granted, the time when the compensation is realized and the amount of such compensation shall be determined under paragraph (d) of this section.

(2) Although options may have a value at the time they are granted, that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031–2 of this chapter (the Estate Tax Regulations).

(3)(i) When an option is not actively traded on an established market, the fair market value of the option is not readily ascertainable unless the fair market value of the option can be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(a) The option is freely transferable by the optionee;

(b) The option is exercisable immediately in full by the optionee;

(c) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option or such property; and

(d) The fair market value of the option privilege is readily ascertainable in accordance with subdivision (ii) of this subparagraph.

(ii) The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option, for example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise period), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a

particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(*a*) Whether the value of the property subject to the option can be ascertained; and

(*b*) The probability of any ascertainable value of such property increasing or decreasing; and (*c*) The length of the period during which the option can be exercised.

(d) *Options without a readily ascertainable fair market value.* If there is granted an option to which this section applies, and if the option does not have a readily ascertainable fair market value at the time it is granted, the employee in connection with whose employment the option is granted is considered to realize compensation includible in gross income under section 61 at the time and in the amount determined in accordance with the following rules of this paragraph:

(1) Except as provided in subparagraph (2) of this paragraph, if the option is exercised by the person to whom it was granted, the employee realizes compensation at the time an unconditional right to receive the property subject to the option is acquired by such person, and the amount of such compensation is the difference between the amount payable for the property and the fair market value of the property at the time an unconditional right to receive the property is acquired. An individual has an unconditional right to receive the property subject to the option when his right to receive such property is not subject to any conditions, other than conditions that may be performed by him at any time. Thus, if an individual who has exercised an option has a right to make payment for the property at any time and to receive the property immediately after making such payment, such individual realizes compensation at the time he exercises the option. However, if an individual who has exercised an opinion is prevented by the terms of the option contract from making payment immediately of from receiving an immediate transfer of the property after making payment, such individual does not realize compensation at the time he exercises the option. Such individual will not realize compensation until he does acquire the right to make payment immediately and to receive an immediate transfer of the property. For purposes of this paragraph, an unconditional right to receive the property subject to the option shall not be considered to have been acquired before the date on which the option is exercised.

(2)(i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—

(a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includible in gross income at the time of such sale or exchange, but the amount includible in gross income under this

subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includible in gross income as a result of the sale or exchange not at arm's length.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). On November 1, 1959, X Corporation grants to E, an employee, an option to purchase 100 shares of X Corporation stock at $10 per share. Under the terms of the option, E will be subject to a binding commitment to resell the stock to X Corporation at the price he paid for it in the event that his employment terminates within 2 years after he acquires the stock, for any reason except his death. Evidence of this commitment will be stamped on the face of E's stock certificate. E exercises the option and acquires the stock at a time when the stock, determined without regard to the restriction, has a fair market value of $18 per share. Two years after he acquires the stock, at which time the stock has a fair market value of $30 per share, E is still employed by X Corporation. E realizes compensation upon the expiration of the 2-year restriction and the amount of the compensation is $800. The $800 represents the difference between the amount paid for the stock ($1,000) and the fair market value of the stock (determined without regard to the restriction) at the time of its acquisition ($1,800), since such value is less than the fair market value of the stock at the time the restriction lapsed ($3,000).

Example (2). Assume, in example (1), that E dies one year after he acquires the stock, at which time the stock has a fair market value of $25 per share. Since the restriction lapses upon E's death, he realizes compensation of $800 ($1,800 less $1,000) and this amount is includible in E's gross income for the taxable year closing with his death.

Example (3). Assume that, pursuant to the exercise of an option not having a readily ascertainable fair market value to which this section applies, an employee acquires stock subject to the sole condition that, if he desires to dispose of such stock during the period of his employment, he is obligated to offer to sell the stock to his employer at its fair market value at the time of such sale. Since this condition is not a restriction which has a significant effect on value, the employee realizes compensation upon acquisition of the stock.

Example (4). Assume, in example (3), that the employee is obligated to offer to sell the stock to his employer at its book value rather than at its fair market value. Since this condition amounts to a restriction which has a significant effect on value, the employee does not realize compensation upon acquisition of the stock, but he does realize such compensation upon the lapse of the restriction, such as, for example, his death or the termination of his employment.

(3) If the option is not exercised by the person to whom it was granted, but is transferred in an arm's length transaction, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting.

(4) If the option is not exercised by the person to whom it was granted, but is transferred in a transaction which is not at arm's length, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting. Moreover, the employee realizes additional compensation at the time and in the amount determined under subparagraph (1), (2), or (3) of this paragraph, except that the amount of compensation determined under subparagraph (1), (2), or (3) of this paragraph shall be reduced by any amount previously includible in gross income as a result of such transfer of the option. For example, if in 1960 an employee is granted an option not having a readily ascertainable fair market value to buy a share of stock for $50 at a time when the stock has a fair market value of $100, and later in 1960 the employee transfers, in a transaction not at arm's length, the option to his wife for $10, the employee realizes compensation of $10 in 1960. If in 1961 the wife exercises the option at a time when the stock has a fair market value of $120, the employee realizes additional compensation in 1961 in the amount of $60 (the $70 bargain spread less the $10 taxed as compensation in 1960). For the purpose of this subparagraph if a person other than the employee dies holding an unexercised option at a time when the employee is still living, the transfer which results by reason of the death of such person is a transfer in a transaction which is not at arm's length.

(5) If there is granted an option to which this section applies, and the employee dies before realizing the compensation in accordance with the rules of this paragraph, income having the character of compensation is realized at the time and in the amount determined under this paragraph by the person who transfers or exercises the option, or the person who receives the property subject to a restriction which has a significant effect on its value. For example, this subparagraph is applicable:

(i) When an option not having a readily ascertainable fair market value is granted to an employee, and he dies before transferring or exercising the option,

(ii) When an option not having a readily ascertainable fair market value is granted to the employee, and he dies after the transfer of the option in a transaction which is not at arm's length, but before the option is exercised, or

(iii) When an option not having a readily ascertainable fair market value is granted to another person, and the employee dies before realizing all of the compensation which would result from any transfer or exercise of the option. If the option is one which was granted to the employee and he dies before transferring or exercising the option, the option shall be considered a right to receive income in respect of a decedent to which the rules of section 691 apply. In any such case, if the option is transferred, section 691 provides that the amount received for such transfer or the fair market value of the property transferred at the time of transfer, whichever is greater, is income realized at the time of such transfer. Moreover, if a transfer is subject to this rule, it will be treated as a transfer in an arm's length transaction for the purpose of this paragraph.

(6) If an option to which this section applies is exercised in part and transferred in part, the rules of this paragraph shall be applied as if there were two options—one exercised and one transferred.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section 421(b) and paragraph (b) of § 1.421–8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421–5) and, in the case of a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, the amount of such compensation shall be subject to the limitation provided by section 422(c)(4) and paragraph (b) of § 1.422–1.

(e) *Basis.* (1) If an option to which this section applies is exercised by the person to whom it was granted, such person's basis for the property so acquired shall be increased by any amount that is includible in the gross income of the employee under paragraph (d) of this section. If such person transfers such property to a person whose basis is the same as the transferor's basis, such transferee's basis shall also reflect the adjustment made by this paragraph. However, if such property is transferred by either of such persons at death so that its basis is determined under section 1014, the basis so determined shall not be increased by reason of this paragraph.

(2) If an option to which this section applies is transferred in a transaction which is not at arm's length, the transferee who exercises the option shall increase his basis for the property so acquired by any amount that is includible in the gross income of the employee at the time such transferee acquires the property.

(3) If an option to which this section applies is transferred in a transaction which is at arm's length, the basis of the property acquired by an exercise of the option shall not be increased by reason of any amount that is includible in this gross income of the employee under this section.

(4) If an option to which this section applies has a readily ascertainable fair market value at the time it is granted, the basis of such option includes any amount includible in gross income of

the employee under paragraph (c) of this section.

(f) *Deductions.* If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) or (d) of this section to have realized compensation. The deductibility of the amount considered so paid is determined under section 162 or other provision of the Code which is applicable to such a payment. Whether such amount may be deducted in the taxable year considered so paid, or whether such amount is a capital expenditure which is not deductible or which may be amortized, depends upon the nature of the transaction involved and the facts and circumstances of each case. If this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the employer's taxable year for which such compensation is deductible is determined under section 421(b) and paragraph (b) of § 1.421–8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421–5).

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6540, 26 FR 512, Jan. 20, 1961, as amended by T.D. 6696, 28 FR 13451, Dec. 12, 1963; T.D. 6887, 31 FR 8787, June 24, 1966; T.D. 7554, 43 FR 31926, July 24, 1978]

§ 1.421–7 Meaning and use of certain terms.

(a) *Option.* (1) For purposes of sections 421 through 425, the term ''option'' includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. See section 423.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1964, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1965, another 1,000 shares on or after June 1, 1966, and a further 1,000 shares on or after June 1, 1967, all shares to be purchased before June 1, 1968, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1964, of three options, each for the purchase of 1,000 shares. However, if a corporation grants to an employee on January 1, 1965, the right to purchase 1,000 shares of its stock at $65 per share during 1965, or at $75 per share during 1966, or at $85 per share during 1967, such an arrangement will be construed as the grant to the employee on January 1, 1965, of but one option for the purchase of 1,000 shares, which ceases to be outstanding when fully exercised at the price in effect at the time of exercise.

(b) *Statutory options.* (1) The term ''statutory option'', used for purposes of convenience hereinafter in this section and in §§ 1.421–8 through 1.425–1, means a qualified stock option, as defined by section 422(b) and § 1.422–2; an option granted under an employee stock purchase plan, as defined by section 423(b) and § 1.423–2; and a restricted stock option, as defined in section 424(b) and § 1.424–2.

(2) An option may qualify as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime

of such individual, only by him. See sections 422(b)(6), 423(b)(9), and 424(b)(2). Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, in case the option or the plan under which the option was granted contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option.

(3)(i) The determination of whether an option is a statutory option is made as of the date such option is granted. An option which is a statutory option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a statutory option when granted does not become such an option by reason of subsequent events. See, however, paragraph (e) of §1.425–1, relating to modification, extension, or renewal of an option. For rules concerning options that are not statutory options, see §1.83–7.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1964, P grants to an employee of P a statutory option to purchase a share of stock of S–1. On January 1, 1965, S sells a portion of the S–1 stock which it owns to an unrelated corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. Section 421 applies to such exercise.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1964, S–1 is not a subsidiary of either S or P. Such option is not a statutory option on June 1, 1964. On January 1, 1965, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a statutory option.

(c) *Time and date of granting option.* (1) For purposes of sections 421 through 425, the words ''the date of the granting of the option'' and ''the time such option is granted'', and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. However, under section 425(i), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of, or registration with, some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of a related corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not

operate to make ineffective the granting of the option. For example, on June 1, 1964, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation's stock, exercisable by X on or after June 1, 1965, provided he is employed by the corporation on June 1, 1965, and provided that A's profits during the fiscal year preceding the year of exercise exceed $200,000. Such an option is granted to X on June 1, 1964, and will be treated as outstanding as of such date.

(d) *Stock and voting stock.* For purposes of sections 421 through 425, the term ''stock'' means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term ''stock'' as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock. For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders or whether the limitations pertaining to voting power contained in sections 422(b)(7), 423(b)(3) and 424(b)(3) and the regulations thereunder have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Moreover, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan is to be adopted, it is voting stock for the purpose of ascertaining whether the plan has been approved by the shareholders.

(e) *Option price.* (1) For purposes of sections 421 through 425, the term ''option price'' or ''price paid under the option'' means the consideration in money or other property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term ''option price'' does not include amounts paid as interest under a deferred payment arrangement or treated as unstated interest under section 483 and the regulations thereunder. Thus, for example, section 483 is applicable in determining whether the pricing requirements of section 422(b)(4), 423(b)(6), 424(b)(1), or 424(c) are met and is applicable in determining the basis of any stock acquired pursuant to the exercise of a statutory option. However, with respect to statutory options granted prior to January 1, 1965, the determination of whether the applicable pricing requirements are met shall be made without regard to section 483, but section 483 shall be taken into consideration in determining basis for purposes of determining gain or loss.

(2) In the case of a statutory option, any reasonable valuation method may be used for the purpose of determining whether at the time the option is granted the option price satisfies the pricing requirements of section 442(b)(4) (relating to qualified stock options), section 423(b)(6) (relating to employee stock purchase plans), or section 424(b)(1) (relating to restricted stock options), whichever is applicable, with respect to the stock subject to the option. Such methods include the valuation methods described in § 20.2031–2 of this chapter (Estate Tax Regulations).

(f) *Exercise.* For purposes of sections 421 through 425, the term ''exercise'', when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(g) *Transfer.* For purposes of sections 421 through 425, the term ''transfer'', when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a statutory option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership.

Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(h) *Employment relationship.* (1) Section 421 is applicable to the exercise of a statutory option only if at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation, unless the option has been assumed or a new option has been issued in its place under section 425(a). In case of such an assumption or issuance, the optionee must, at the time of such assumption or issuance, be an employee of the corporation so assuming or issuing the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the assumption or issuance under section 425(a)) will be made in accordance with the rules contained in section 3401(c) and the regulations thereunder. As to the granting of an option conditioned upon employment, see paragraph (c)(2) of this section. A statutory option must be granted for a reason connected with the individual's employment by the corporation or by its related corporation.

(2) In order to qualify for the special tax treatment of section 421, in addition to meeting the requirements of subparagraph (1) of this paragraph, an individual exercising a qualified stock option or an option granted under an employee stock purchase plan must, at all times during the period beginning with the date of the granting of such option and ending at the time of such exercise or on the day 3 months before the date of such exercise, be an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. For this purpose, the employment relationship in respect of an option granted in accordance with the requirements of subparagraph (1) of this paragraph will be treated as continuing intact while the individual is on military, sick leave or other bona fide leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 90 days, or, if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation, or a corporation, or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies) is guaranteed either by statute or by contract. Where the period of leave exceeds 90 days and where the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship will be deemed to have terminated on the 91st day of such leave.

(3) For purposes of determining whether an individual meets the requirements of this paragraph, the term ''employer corporation'', as used in section 425 (e) and (f), shall be read as ''grantor corporation'' or ''corporation issuing or assuming a stock option in a transaction to which section 425(a) is applicable'', as the case may be. For purposes of the employment requirement, a corporation employing an optionee is considered a related corporation if it was a parent or subsidiary of the corporation granting or assuming the option during the entire portion of the requisite period of employment during which it was the employer of such optionee.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation granted a statutory option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1965, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises his statutory option on June 1, 1965, section 421 is not applicable to such exercise, because on June 1, 1965, A is not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within 3 months before June 1, 1965.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 425(a). If A exercises the option to purchase the share of M stock on June 1, 1965,

section 421 is applicable for A is then employed by a corporation which issued an option under section 425(a).

Example (3). E is an employee of P Corporation. On June 1, 1964, P grants E a statutory option to purchase a share of P stock. On June 1, 1965, P acquires 100 percent of the stock of S Corporation; on such date S becomes a subsidiary of P. On July 1, 1965, E ceases to be employed by P and becomes employed by S. On October 10, 1965, while still employed by S, E exercises his option to buy P stock. Since E was at all times during the requisite period of employment an employee of either P, the corporation granting the option, or S, a subsidiary of the grantor during the period in which such corporation was E's employer, section 421 is applicable to the exercise of the option.

Example (4). Assume the same facts as in example (3) except assume that at the time E became an employee of S Corporation, S assumed E's option to purchase P stock under section 425(a). Section 421 is applicable to E's exercise of his option to buy P stock.

Example (5). M Corporation grants a qualified stock option to E, an employee of such corporation. E is an officer in a reserve Air Force unit. E goes on military leave with his unit for 3 weeks. Regardless of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder during such 3-week period, E's employment relationship with M is treated as uninterrupted during the period of E's military leave.

Example (6). Assume the same facts as in example (5) and assume further that E's active duty status is extended indefinitely, but that E has an employment contract with M which provides that upon the termination of any military duty E may be required to serve, E will be entitled to reemployment with M or a parent or subsidiary of M. E exercises his M option while on active military duty. Irrespective of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder at the time of such exercise or within 3 months before such exercise, section 421 can apply to such exercise.

Example (7). X Corporation grants a qualified stock option to A, an employee of X Corporation, whose employment contract provides that in the event of illness, A's right to reemployment with X, or a parent or subsidiary of X, will continue for 1 year after the time A becomes unable to perform his duties for X. A falls ill for 90 days. For purposes of section 422(a)(2), A's employment relationship with X will be treated as uninterrupted during the 90-day period. If A's incapacity extends beyond 90 days, then, for purposes of section 422(a)(2), A's employment relationship with X will be treated as continuing uninterrupted until A's reemployment rights terminate. Under section 422(a)(2), A has 3 months in which to exercise his qualified stock option after his employment relationship with X (and its parent and subsidiary corporation) is terminated.

(i) *Related corporation.* The term ''related corporation'', used for purposes of convenience in this section and §§ 1.421–8 through 1.425–1, means a corporation which is a parent or subsidiary corporation (as defined by section 425 (e) and (f) and the regulations thereunder).

(Secs. 83 and 7805 of the Internal Rvenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6887, 31 FR 8787, June 24, 1966, as amended by T.D. 6975, 33 FR 14779, Oct. 3, 1968; T.D. 7554, 43 FR 31927, July 24, 1978]

§ 1.421–8 General rules.

(a) *Effect of qualifying transfer.* (1) If a share of stock is transferred to an individual pursuant to his exercise of a statutory option, and if the requirements of section 422(a) (relating to qualified stock options), section 423(a) (relating to employee stock purchase plans), or section 424(a) (relating to restricted stock option), whichever is applicable, are met, then—

(i) Except as provided in section 422(c)(1) (relating to exercise of option when price is less than value of stock), and paragraph (e)(2) of § 1.422–2, no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 or the regulations thereunder (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a related corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) and paragraph (a) of § 1.425–1 (relating to corporate reorganizations, liquidations, etc.) applies, with respect to the share so transferred; and

(iii) No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(2) For the purpose of this paragraph, each share of stock transferred pursuant to a statutory option is treated separately. For example, if an individual, while employed by a corporation granting him a statutory option,

exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(b) *Effect of disqualifying disposition.* (1) The disposition of a share of stock, acquired by the exercise of a statutory option before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), makes section 421 inapplicable to the transfer of such share. The income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, a deduction under section 162 attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs to the employer corporation, its parent or subsidiary corporation or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which the disposition occurs. If the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had been paid compensation at the time provided in paragraph (d) of § 1.421–6.

(2) Section 421 is not made inapplicable by a transfer before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), if such transfer is not a disposition of the stock as defined in section 425(c) and paragraph (c) of § 1.425–1, for example, a transfer from the decendent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a statutory option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (c) of this section.

(3) For special rules relating to a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, see paragraph (b) of § 1.422–1.

(c) *Exercise by estate.* (1) If a statutory option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, section 421(a) applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, except as provided by section 422(c)(1) and paragraph (e)(2) of § 1.422–2, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421(a) become inapplicable if such executor, administrator, or person disposes of the stock so acquired before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1). This special rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421(a) to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of paragraph (e) of § 1.425–1, relating to the modification, extension, or renewal of the option. Section 421(a) is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a related corporation, either when the option is exercised or at any time. However, section 421(a) is not applicable to an exercise of the option by the

estate or by such person, unless the individual to whom the option was granted met the employment requirements of section 422(a)(2), 423(a)(2), or 424(a)(2), whichever is applicable, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421(a) is not applicable to the exercise. For example, if the option is sold by the estate, section 421(a) does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421(a) is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 423(c), or 424(c)(1) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 423(c) or 424(c)(1) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If, under section 422(c)(1), 423(c), or 424(c)(1), an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 422(c)(1), 423(c), or 424(c)(1), as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 422(c)(1), 423(c), or 424(c)(1). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)–1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1964, E was granted an option under an employee stock purchase plan to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 per share. E died on February 1, 1966, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at $30. On March 1, 1966, the estate exercised the option, and on March 15, 1966, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1966, the estate is required by sections 421(c)(1)(B) and 423(c) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(c)(2), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the option in the estate of E is $10. Since $15, the amount includible in gross income by reason of sections 421(c)(1)(B) and 423(c), is less than the value for estate tax purposes of the option, only 15/30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15/30 of $10, or $5. No deduction under section 421(c)(2) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of a restricted stock option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 424(c)(1). The basis of the share shall not be increased by reason of the inclusion of the value of the restricted stock option in the estate for estate tax purposes.

(ii)*(a)* In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of an option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a statutory option to acquire 10 shares of stock has a basis of $100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10th of $100, or $10. The option acquires a basis, determined under section 1014(a), only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). To the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by *(b)* and *(c)* of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 422(c)(1), 423(c), or 424 (c)(1).

(b) If the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) had the employee exercised the option on the date of his death and held the share at the time of his death exceeds the amount which is includible in gross income under such section, the basis of the share, determined under *(a)* of this subdivision, shall be reduced by such excess. For example, if $15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only $10 is includible under section 422(c)(1), 423(c), or 424(c)(1), the basis of the share, determined under *(a)* of this subdivision, would be reduced by $5. For purposes of determining the amount which would have been includible in gross income under section 422 (c)(1), 423(c), or 424(c)(1), if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(c) If the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1), exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under *(a)* of this subdivision, shall be increased by such excess. Thus, if $15 is includible in gross income under such section, and the basis of the option with respect to the share is $10, the basis of the share, determined under *(a)* of this subdivision, will be increased by $5.

(iii) If a statutory option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1955, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date was $100 per share. On June 1, 1956, E died. The fair market value of the X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1964, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $90. The estate is required by section 424(c)(1) to include $5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is $90 (the $85 paid for the stock plus the $5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d) (as in effect with respect to taxable years ending before January 1, 1957)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1964, the X Corporation granted to E, an employee, an option under its employee stock purchase plan to purchase a share of X Corporation stock for $85. The fair market value of X Corporation stock on such date was $100 per share. On

June 1, 1966, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1966, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $120. The basis of the share is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since $15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(b)* of this subparagraph does not apply. Moreover, since the $15 includible in the gross income of the estate does not exceed the basis of the option ($35), subdivision (ii)*(c)* of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time of its sale was $90. The basis of the share, determined under subdivision (ii)*(a)* of this subparagraph, is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $90, the estate is required to include $5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of his death, $15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by $10 the amount which the estate is required to include in its gross income, subdivision (ii)*(b)* of this subparagraph applies, and the basis of the share ($120), determined under subdivision (ii)*(a)* of this subparagraph is reduced by $10. Accordingly, the basis is $110, and a capital loss of $20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was $5, and that the fair market value of X Corporation stock on the date the employee died did not exceed $100. The basis of the share, determined under subdivision (ii)*(a)* of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since such amount exceeds by $10 the basis of the option, subdivision (ii)*(c)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(a)* of this subparagraph, is increased by $10. Accordingly, the basis is $100 and a capital gain of $20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1966, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1967, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was $5. On August 1, 1967, the estate of E exercised the option and sold the share when its fair market value was $92. The basis of the share, determined under subdivision (ii)*(a)* of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $92, the estate is required to include $7 in its gross income as compensation. Since $13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(b)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(a)* of this subparagraph, is reduced by $6 to $84. Furthermore, since the $7 that the estate is required to include in its gross income when the share is sold for $92 exceeds by $2 the basis of the option, subdivision (ii)*(c)* of this subparagraph applies, and the basis of the share ($84), determined under subdivision (ii)*(a)* and (ii)*(b)* of this subparagraph, is increased by $2. Accordingly, the basis is $86 and a capital gain of $6 is realized on the disposition of the share.

(d) *Exercise by deceased employee during lifetime.* If a statutory option is exercised by an individual to whom the option was granted and the individual dies before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), section 421(a) does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding period. This rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

(e) *Incorporation by reference.* Any requirement that an option expressly contain or state a prescribed limitation or term will be considered met if such limitation or term is set forth in a statutory option plan and is incorporated by reference by the option. Thus, if a statutory option plan expressly provides that no option granted thereunder shall be exercisable after five years from the date of grant, and if an option granted thereunder expressly

provides that the option is granted subject to the terms and limitations of such plan, the option will be regarded as being, by its terms, not exercisable after the expiration of 5 years from the date such option is granted.

[T.D. 6887, 31 FR 8789, June 24, 1966]

§ 1.422–4 Qualified stock options (prior law).

Section 422 of the Code, pertaining to qualified stock options, was repealed by section 11801(a)(20) of the Omnibus Budget Reconciliation Act of 1990. In view of the savings provision of section 11821(b) of that act, the regulations under the repealed section 422, which were removed from the Code of Federal Regulations, may be of continuing interest to the public. Those regulations were set forth in 26 CFR 1.422–1 and 1.422–2 as contained in 26 CFR edition revised as of April 1, 1991.

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

§ 1.422–5 Stockholder approval of incentive stock option plans.

This section addresses the stockholder approval of incentive stock option plans required by section 422(b)(1) of the Internal Revenue Code. (Section 422 was added to the Code as section 422A by section 251 of the Economic Recovery Tax Act of 1981, and was redesignated as section 422 by section 11801 of the Omnibus Budget Reconciliation Act of 1990.) The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws, and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an incentive stock option plan must be approved:

(a) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(b) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

§ 1.423–1 Applicability of section 421(a).

(a) *General rule.* Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(2) At all times during the period beginning with the date of the granting of the option and ending on the day three months before the date of such exercise, the individual must be an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(b) *Cross-references.* For rules relating to the employment relationship, see paragraph (h) of § 1.421–7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421–8. For definition of the term ''disposition'', see section 425(c) and paragraph (c) of § 1.425–1.

[T.D. 6887, 31 FR 8798, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.423–2 Employee stock purchase plan defined.

(a) *In general.* (1) The term ''employee stock purchase plan'' means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3)

through (9) of section 423(b), such requirements may be satisfied by the terms of an offering made under such plan. However, in such a case, such requirements will be treated as satisfied only with respect to options exercised under such offering.

(2) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under such a plan, the option will not be treated as granted under an employee stock purchase plan. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4). If such an option is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, such option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the plan or the options granted under such plan or offering. For example, an option granted to an individual who is ineligible to receive an option under an employee stock purchase plan by reason of his ownership of 5 percent or more of the voting power or value of the stock of the grantor corporation (or a related corporation of such corporation), will not be treated as an option granted under an employee stock purchase plan, and the grant of such an option will not disqualify options granted under such plan from the special tax treatment of section 421. If all the options granted under an offering do not give the respective optionees the same rights and privileges, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. If, at the time an option is granted, it qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not in fact met, the option will not qualify for the special tax treatment of section 421. However, the failure of such an option to qualify for the special tax treatment of section 421, will not disqualify other options granted under the plan.

(b) *Options restricted to employees.* An employee stock purchase plan must provide that options are to be granted only to employees of the employer corporation or of its related corporations to purchase stock in any such corporation. If such a provision is not included in the terms of the plan, the plan will not be an employee stock purchase plan and options granted under such plan will not qualify for the special tax treatment of section 421. For rules relating to the employment requirement, see paragraph (h) of § 1.421–7.

(c) *Stockholder approval.* (1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an employee stock purchase plan must be approved—

(i) By a majority of the votes cast at a duly held stockholder's meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(ii) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

(2) The plan required by section 423 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and

the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees will be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The provisions relating to the aggregate number of shares to be issued under the plan and the employees (or class of employees) eligible to receive options under the plan, are the only provisions of a stock option plan which require stockholder approval for purposes of section 423(b)(1).

(4) Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring approval of the stockholders within 12 months of such adoption. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of an employee stock purchase plan may be made without such changes being considered the adoption of a new plan.

(5) A plan which otherwise meets the requirements of section 423(b) and this section may be used as an employee stock purchase plan although the adoption and approval of such plan occurred before January 1, 1964.

(d) *Options granted to certain shareholders.* (1) An employee stock purchase plan must by its terms provide that no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or its parent or subsidiary corporation. In determining whether the stock ownership of an employee equals or exceeds this 5 percent limit, the rules of section 425(d) (relating to attribution of stock ownership) shall apply, and stock which the employee may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the employee. An option is outstanding for purposes of section 423(b)(3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. If an option is granted to an individual whose stock ownership (as determined under this paragraph for purposes of section 423(b)(3)) exceeds the limitation of section 423(b)(3), no portion of such option will be treated as having been granted under an employee stock purchase plan.

(2) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not

include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant an option to E under M's employee stock purchase plan. If E's father and brother each owned 3,000 shares of M stock and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 423(b)(3) provides that stock which the employee may purchase under outstanding options shall be treated as stock owned by such employee.

Example (2). Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, E cannot receive an option from P under P's employee stock purchase plan since he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, i.e., M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 423(b)(3), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive an option under an employee stock purchase plan from any corporation in the group.

Example (3). F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 423(b)(3), R can grant an option to F under its employee stock purchase plan for 4,999 shares, since immediately after the grant of the option, F would not own 5 percent or more of the combined voting power or value of all classes of R stock actually issued and outstanding at such time. The 4,999 shares which F would be treated as owning under section 423(b)(3) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 423(b)(3).

Example (4). Assume the same facts as in example (3) and assume further that on June 1, 1965, R grants F an option, purportedly under its employee stock purchase plan, for 5,000 shares. No portion of this option will be treated as granted under an employee stock purchase plan.

(e) *Employees covered by plan.* (1) Subject to the limitations of section 423(b)(3), (5) and (8), an employee stock purchase plan must, by its terms, provide that options are to be granted to all employees of any corporation which grants options to any of its employees by reason of their employment by such corporation except that one or more of the following categories of employees may be excluded from the coverage of the plan:

(i) Employees who have been employed less than 2 years;

(ii) Employees whose customary employment is 20 hours or less per week;

(iii) Employees whose customary employment is for not more than 5 months in any calendar year;

(iv) Officers;

(v) Persons whose principal duties consist of supervising the work of other employees; and

(vi) Highly compensated employees.

No option granted under a plan or offering which excludes from participation any employees, other than those who may be excluded under section 423(b)(4) and this paragraph, and those barred from participation by reason of section 423(b) (3), (5), and (8) and paragraphs (d), (f) and (i) of this section, can be regarded as having been granted under an employee stock purchase plan. If an option is not granted to any employee who is entitled to the grant of an option under the terms of the plan or offering, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. Furthermore, no option will be considered as having been granted under an employee stock purchase plan if the option was granted in connection with an offering made after September 28, 1979 with respect to which employees, otherwise eligible, are denied participation to any extent because of their continuing participation or eligibility for participation in a prior plan or offering

(including a prior plan or offering of a related corporation). However, a plan which, by its terms, permits all eligible employees to elect to participate in an offering will not violate the requirements of this paragraph solely because eligible employees who elect not to participate in the offering are not granted options pursuant to such offering.

(2) For purposes of section 423(b)(3) the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under paragraph (h) of §1.421–7 (relating to employment relationship).

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation has a stock purchase plan which meets all the requirements of section 423(b) except that by its terms, options are not required to be granted to employees whose weekly rate of pay is less than $100. As a matter of corporate practice, M grants options under its plan to all employees, irrespective of their weekly rate of pay. M's plan is not an employee stock purchase plan.

Example (2). Assume the same facts as in example (1) and assume further that the first offering under M's plan provides by its terms that options will be granted to all employees of M Corporation. With respect to options exercised under such offering the terms of such offering will be treated as part of the terms of M's plan. Accordingly, stock transferred pursuant to options exercised under such offering will be treated as stock transferred pursuant to the exercise of options granted under an employee stock purchase plan for purposes of section 421.

(f) *Equal rights and privileges.* (1) An employee stock purchase plan must, by its terms, provide that all employees granted options under such plan shall have the same rights and privileges; however, a plan will not fail to satisfy this requirement merely because the amount of stock which may be purchased by any employee under such plan is determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation of employees, or because the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan. Thus, the provisions applying to one option under an offering (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under such offering in the same manner. If all the options granted under a plan or offering do not, by their terms, give the respective optionees the same rights and privileges, none of such options shall be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of section 423(b)(5) and this paragraph do not prevent the maximum amount of stock which an employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees. For example, if an employee stock purchase plan provides that the maximum amount of stock which each employee may purchase under the offering is one share for each $100 of annual gross pay, options granted under such offering will be treated as meeting the requirement of section 423(b)(5). However, such a provision must not exclude employees from participation under the plan or offering. For example, a plan which provides for the grant of options based on one share for each $100 of annual gross pay in excess of $10,000 will not meet the requirements of section 423(b)(5).

(3)(i) Except as provided in paragraph (f)(3)(ii) of this section, a plan permitting one or more employees to apply sums which were withheld under an earlier plan or offering towards the purchase of additional stock under the current plan or offering will be a violation of equal rights and privileges unless all employees in the current plan or offering are permitted to make payments in an amount not less than that which any employee is allowed to carry over, to be applied to the purchase of shares under the current plan or offering.

(ii) A plan will not fail to satisfy the requirements of this section merely because one or more employees are permitted to apply sums, in an amount representing a fractional share, which were withheld under an earlier plan or

offering toward the purchase of additional stock under the current plan or offering.

(4)(i) Section 423(b)(5) does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of such employee's failing to meet a minimum service requirement until such employee meets such requirement.

(ii) The provision of this paragraph (4) may be illustrated by the following example:

Example. N Corporation has an employee stock purchase plan which provides that options to purchase stock in an amount equal to ten percent of an employee's annual salary at a price equal to 85 percent of the fair market value at the time the option is granted will be granted to all employees other than those who have been employed less than 18 months. In addition, the plan provides that employees who have not yet met the minimum service requirements on the date the options are initially granted will be granted similar options on the date such employment has been attained. Such plan meets the requirements of section 423(b)(5).

(g) *Option price.* (1) An employee stock purchase plan must, by its terms, provide that the option price will not be less than the lesser of—

(i) An amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or

(ii) An amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised.

For definition of the term ''option price'', and general rules relating to such term, see paragraph (e) of §1.421–7. For rules relating to the determination of when an option is granted, see paragraph (c) of §1.421–7. Any option which does not meet the minimum pricing requirements of section 423(b)(6) and this paragraph will not be treated as granted under an employee stock purchase plan irrespective of whether the plan itself or the offering satisfies such requirements. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4).

(2) The option price may be stated either as a percentage or as a dollar amount. If the option price is stated as a dollar amount, the requirement of section 423(b)(6) and this paragraph can only be met by a plan or offering in which the price is fixed at not less than 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at grant, the option cannot meet the requirement of section 423(b)(6) even if a decline in the fair market value of the stock results in such fixed price being not less than 85 percent of the fair market value of the stock at the time the option is exercised, since such a result was not certain to occur under the terms of the option.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation has an employee stock purchase plan which provides that the option price will be 85 percent of the fair market value of the stock at grant, or 85 percent of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under M's plan, M agrees to accept an amount which is less than the minimum amount allowable under the terms of such plan. Notwithstanding that the option was issued under an employee stock purchase plan, the transfer of stock pursuant to the exercise of such option does not satisfy the requirement of section 423(b)(6) and cannot qualify for the special tax treatment of section 421.

Example (2). Assume the same facts as in example (1) and assume further that at the time of grant, the fair market value of M Corporation stock is $100 per share and that the option price is set at 85 percent of the fair market value of M stock at exercise, but not less than $80 per share. The option satisfies the requirement of section 422(b)(6), and can qualify for the special tax treatment of section 421.

Example (3). Assume the same facts as in example (2), except assume that the option price is set at 85 percent of the fair market value of M stock at exercise, but not more

than $80 per share. This option cannot satisfy the requirement of section 423(b)(6) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of M stock is $80 or less.

(h) *Option period*. An employee stock purchase plan must, by its terms, provide that options granted under such plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of the stock at the time of the exercise of the option. If the option price is to be not less than 85 percent of the fair market value of the stock at the time the option is exercised, then the option period provided under the plan must not exceed 5 years from the date of grant. If the requirement of section 423(b)(7) is not met by the terms of the plan or offering, options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether such options, by their terms, are exercisable beyond the period allowable under section 423(b)(7) and this paragraph. An option which provides that the option price is to be not less than 85 percent of the fair market value of the stock at exercise may have an option period of 5 years irrespective of whether the fair market value of the stock at exercise is more or less than the fair market value of such stock at grant. However, if the option provides that the option price is to be 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount, then irrespective of the price paid on exercise, the option period must not be more than 27 months.

(i) *Restriction on amount of optioned stock*. (1) Under section 423(b)(8), an employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of his employer corporation and its related corporations at a rate which exceeds $25,000 in fair market value of such stock (determined at the time the option is granted) for each calendar year in which any such option granted to such individual is outstanding at any time. In applying the limitation of section 423(b)(8)—

(i) The right to purchase stock under an option is deemed to accrue when the option (or any portion thereof) first becomes exercisable during the calendar year;

(ii) The right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed $25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(iii) A right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option.

If an option is granted under an employee stock purchase plan which satisfies the requirement of section 423(b)(8), but such option gives the optionee the right to buy stock in excess of the maximum rate allowable under such section and this paragraph, no portion of such option will be treated as having been granted under an employee stock purchase plan. Furthermore, if the option was granted to an employee entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 421.

(2) The limitation of section 423(b)(8) and this paragraph applies only to options granted under employee stock purchase plans and does not limit the amount of stock which an employee may purchase under qualified stock options (as defined in section 422(b)), restricted stock options (as defined in section 424(b)), or any other stock options (except those to which section 423 applies). Stock purchased under options to which section 423 does not apply will not limit the amount which an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of section 423(b)(3).

(3) Under the limitation of section 423(b)(8), an individual may purchase up to $25,000 of stock (based on the fair market value of such stock at the time the option was granted) in each calendar year during which an option granted to such individual under an employee stock purchase plan is outstanding. Alternatively, an individual may purchase more than $25,000 of stock (based on the fair market value of such stock at the time the option was granted) in a calendar year, so long as the total amount of stock which he purchases does not exceed $25,000 in fair market value of such stock (determined at the time the option was granted) for each calendar year in which the option was outstanding. If in any calendar year the individual holds two or more outstanding options granted under employee stock purchase plans of his employer corporation, or a related corporation of such corporation, his purchases of stock attributable to such year under all such options must not exceed $25,000 in fair market value of such stock (determined at the time such options were granted). Under an employee stock purchase plan, an individual may not purchase stock in anticipation that the option will be outstanding for some future year. Thus, the individual may purchase only the amount of stock which does not exceed the limitation of section 423(b)(8) for the year of the purchase and for preceding years during which the option was outstanding. Thus, the amount of stock which may be purchased under an option depends on the number of years in which the option is actually outstanding. The amount of stock which may be purchased under an employee stock purchase plan may not be increased by reason of the failure to grant an option in an earlier year under such plan, or by reason of the failure to exercise an earlier option. For example, if an option is granted to an individual and expires without having been exercised at all, the failure to exercise the option does not increase the amount of stock which such individual may be permitted to purchase under an option granted in a year following the year of such expiration. If an option granted under an employee stock purchase plan is outstanding in more than one calendar year, stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under section 423(b)(8) and this paragraph, against the $25,000 limitation for the earliest year in which such option was outstanding, then, against the $25,000 limitation for each succeeding year, in order. For example, if an individual purchases $60,000 in fair market value of stock (determined at the time the option was granted) by the exercise of an option granted under an employee stock purchase plan of his employer corporation, and if such option was outstanding in 3 calendar years, then $25,000 in fair market value of such stock (determined at the time the option was granted) will be attributed to the first calendar year in which such option was outstanding, another $25,000 in fair market value of such stock will be attributed to the second calendar year in which such option was outstanding, and the remaining $10,000 in fair market value of such stock will be attributed to the last calendar year in which such option was outstanding. Thus, the individual may receive a right under another option granted under such employee stock purchase plan (or under an employee stock purchase plan of a parent or subsidiary corporation of his employer corporation) entitling him to purchase another $15,000 in fair market value of such stock (determined as of the date such option is granted) for such last calendar year.

(4) The application of section 423(b)(8) and this paragraph may be illustrated by the following examples:

Example (1). Assume that P Corporation maintains an employee stock purchase plan and that E is employed by P. On June 1, 1964, P grants E an option under the plan to purchase a total of 750 shares of P stock at $85 per share. On such date, the fair market value of P stock is $100 per share. The option provides that it cannot be exercised after May 31, 1966. Under section 423(b)(8), the option must not permit E to purchase more than 250 shares of P stock during the calendar year 1964, since 250 shares are equal to $25,000 in fair market value of P stock determined at the time of grant. During the calendar year 1965, E may purchase under such option an amount of P stock equal to the difference between $50,000 in fair market value

of P stock (determined at the time the option was granted) and the fair market value of P stock (determined at the time of grant of the option) purchased during 1964. During the calendar year 1966, E may purchase an amount of P stock equal to the difference between $75,000 in fair market value of such stock (determined at the time of grant of the option) and the total amount of the fair market value of such stock (determined at the time of grant of the option) purchased under such option during the calendar years 1964 and 1965. E may purchase $25,000 of stock for the year 1964 and $25,000 of stock for the year 1966, although the option was outstanding for only a part of each of such years. However, E may not be granted another option under an employee stock purchase plan of P or a related corporation to purchase stock of any of such corporations during the calendar years 1964, 1965, and 1966, so long as the option granted June 1, 1964, is outstanding. If this option permitted E to purchase only $15,000 of P's stock for each year it is outstanding, then E could be granted another option by P, or by a related corporation, in 1964, permitting him to purchase an additional $10,000 of stock for each year it is outstanding.

Example (2). Assume the same facts as in example (1), and assume further that the option granted to E in 1964 is terminated in 1965 without any part of such option having been exercised, and that subsequent to such termination and during 1965, E is granted another option under P's employee stock purchase plan. Under such option, E may be permitted to purchase $25,000 of stock for 1965. On the other hand, if, in 1966, E exercised the option granted to him in 1964 and purchased 600 shares of P stock, 500 shares, the maximum amount of stock which could have been purchased in 1965 under the option, is treated as having been purchased for the years 1964 and 1965. Thus, only 100 shares of the stock are treated as having been purchased for 1966, and E may be permitted under the new option to purchase for 1966 stock having a fair market value of $15,000 at the time the new option is granted.

(j) *Restriction on transferability.* An employee stock purchase plan must, by its terms, provide that options granted under such plan are not transferable by the optionee otherwise than by will or the laws of descent and distribution, and must be exercisable, during his lifetime, only by him. For general rules relating to the restriction on transferability required by section 423(b)(9), see paragraph (b)(2) of § 1.421–7. For a limited exception to the requirement of section 423(b)(9), see section 425(h)(3).

(k) *Special rule where option price is between 85 percent and 100 percent of value of stock.* (1)(i) If all the conditions necessary for the application of section 421(a) exist, section 423(c) provides additional rules which are applicable in cases where, at the time the option is granted, the option price per share is less than 100 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) the lesser of—

(a) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

(b) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of such disposition or death.

For purposes of applying the rules of section 423(c) and this paragraph, if the option price is not fixed or determinable at the time the option is granted, the option price will be computed as if the option had been exercised at such time. The amount of compensation resulting from the application of section 423(c) and this paragraph shall be included in the individual's gross income for the taxable year in which the disposition occurs, or for the taxable year closing with his death, whichever event results in the application of section 423(c).

(ii) The application of the special rules provided in section 423(c) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 423(c), no income results to the individual at the time the stock is transferred to him,

and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If, during his lifetime, the individual exercises an option granted under an employee stock purchase plan, but such individual dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of sections 421 and 423, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 423(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 423(c). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to such employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421–8. If the special rules provided in section 423(c) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 423(c). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, an option under X's employee stock purchase plan to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporations are as follows: (i) compensation in the amount of $15 is includible in E's gross income for 1967, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includable as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of the stock. Compensation in the amount of $10 is includible in E's gross income for 1967, the year of the disposition of the share. This is determined in the following manner: The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10, the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case

$15 is includible as compensation in E's gross income for 1967. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of $150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 423(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

[T.D. 6887, 31 FR 8799, June 24, 1966 as amended by T.D. 7645, 44 FR 55836, Sept. 28, 1979; T.D 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8235, 53 FR 48641, Dec. 2, 1988]

§ 1.425–1 Definitions and special rules applicable to statutory options.

(a) *Corporate reorganizations, liquidations, etc.* (1)(i) The term ''issuing or assuming a stock option in a transaction to which section 425(a) applies'' means, for purposes of sections 421 through 425, a substitution of a new option for an old option, or an assumption of such old option, by an employer corporation, or a related corporation of such corporation, by reason of a corporate transaction (as defined by subdivision (ii) of this subparagraph), if—

(a) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(b) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

(ii) For purposes of this section, the term ''corporate transaction'' means any merger of a corporation into another corporation, any consolidation of two or more corporations into another

corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidiary relationship.

(2)(i) A change in the terms of an option attributable to the issuance or assumption of an option by reason of a corporate transaction (as defined under section 425(a) and subparagraph (1)(ii) of this paragraph) is not a modification of such option. See section 425(h)(3) and paragraph (e) of this section. Thus, section 425(a), in effect, provides rules under which a new employer, or a parent or subsidiary of a new employer, may by reason of a corporate transaction assume a statutory option granted by the former employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution being considered as a modification of the option. For example, section 425(a) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume statutory options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a statutory option to purchase its stock in place of the statutory option which they had to purchase stock of X Corporation.

(ii) Section 425(a) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a statutory option granted by the employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 425(a) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a statutory option to buy stock of X Corporation in place of a statutory option which they have to purchase the stock of Y Corporation.

(iii) Section 425(a) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 425(a) may apply where as a result of a corporate transaction a statutory option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 425(a) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 425(a). See, however, paragraph (e) of this section.

(3) For section 425(a) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 425(a) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 425(a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 425(a). For section 425(a) to apply, the assumed or substituted option must qualify as a statutory option.

(4)(i) Section 425(a) does not apply if the terms of the assumed or substituted option confer on the employee

more favorable benefits than he had under the old option. Section 425(a) can apply to a corporate transaction only if, on a share by share comparison, the ratio of the option price to the fair market value of the stock subject to the option immediately after the substitution or assumption is no more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option immediately before such substitution or assumption. The number of shares subject to an option issued or assumed may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the stock subject to the option immediately after the substitution or assumption as compared to the aggregate spread between the option price and the aggregate fair market value of the stock subject to the option immediately before such substitution or assumption. Such an adjustment will not prevent section 425(a) from applying to such substitution or assumption.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1965, P Corporation acquires 100 percent of the stock of S Corporation and on such date S becomes a subsidiary of P Corporation. Also on such date, P Corporation substitutes a qualified stock option to purchase P stock for a qualified stock option to purchase S stock held by E, an employee of S. Assume that E's S option had 3 years to run on the date of the substitution. If the P option granted to E in substitution for his S option runs for more than 3 years from the date of the substitution, section 425(a) cannot apply, since the effect of such an option would be to give E an additional benefit which he did not enjoy under his S option.

Example (2). E is an employee of S Corporation. E holds a qualified stock option which was granted to him by S to purchase 60 shares of S stock at $12 per share. On June 1, 1967, S Corporation is merged into P Corporation, and on such date P substitutes a qualified stock option to purchase P stock for E's qualified stock option to purchase S stock. Immediately before the substitution, the fair market value of S stock was $32 per share; immediately after the substitution, the fair market value of P stock is $24 per share. The new option entitles E to buy P stock at $9 per share. Since on a share by share comparison the ratio of the new option price ($9 per share) to the fair market value of P stock immediately after the substitution ($24 per share) is not more favorable to E than the ratio of the old option price ($12 per share) to the fair market value of S stock immediately before the substitution ($32 per share) ($9/24 = 12/32$) the requirement of subparagraph (4)(i) of this paragraph is met. The number of shares subject to E's option to purchase P stock is set at 80. Since the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's new option to purchase P stock, $1,200 (80×$24 minus 80×$9), is not greater than the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's old option to purchase S stock, $1,200 (60×$32 minus 60×$12), the requirement of subparagraph (1)(i)*(a)* of this paragraph is met. Thus, section 425(a) may apply to the substitution.

Example (3). Assume the same facts as in example (2), except assume that the fair market value of S stock immediately before the substitution was $8 per share and that the option price was $10 per share, and that the fair market value of P stock immediately after the substitution is $12 per share. P sets the new option price at $15 per share. Since on a share by share comparison the ratio of the new option price ($15 per share) to the fair market value of P stock immediately after the substitution ($12 per share) is not more favorable to E than the ratio of the old option price ($10 per share) to the fair market value of S stock immediately before the substitution ($8 per share) ($15/12 = 10/8$), the requirement of subparagraph (4)(i) of this paragraph is met. Assume further that the number of shares subject to E's P option is set at 20 as compared to 60 shares under E's old option to buy S stock. Immediately after the substitution, 2 shares of P stock are worth $24, which is what 3 shares of S stock were worth immediately before the substitution (2×$12=3×$8). Thus, to completely replace E's S option, E should have received an option to purchase 40 shares of P stock, *i.e.*, 2 shares of P for each 3 shares of S which E could have purchased under his old option ($2/3 = 40/60$). Since E's new option covers 20 shares of P stock, it is clear that P has replaced only ½ of E's stock option. The portion of E's stock option which was not replaced by P is an outstanding stock option to purchase stock of a predecessor corporation of P Corporation for purposes of section 422(b)(5) and (c)(2).

(5) For the purpose of applying section 425(a), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 425(a), be considered to have been granted the option which the

employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 425(a) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 425(a) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. However, if the old option was a qualified or restricted stock option, any portion of such option which is not substituted or assumed in a transaction to which section 425(a) applies will be treated as an outstanding option to purchase stock of a predecessor corporation of the new employer or grantor corporation. See section 422 (b)(5) and (c)(2) and paragraph (f) of § 1.422–2. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the statutory option which E has, entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $25 a share in substitution for his right to purchase 50 of the shares covered by the old option. However, if the option to purchase X stock was a qualified or restricted stock option, then to the extent the old option is not assumed or a new option issued in substitution therefor in a transaction to which section 425(a) applies, such old option will be treated as an outstanding option under section 422(c)(2) for purposes of section 422(b)(5). See paragraph (f) of § 1.422–2.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's-length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 425(a) and this paragraph, the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(b) *Acquisition of new stock.* (1) Section 425(b) provides that the rules provided by sections 421 through 425 which are applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies. Stock so acquired shall, for purposes of sections 421 through 425, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 425(b) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036).

(2) The application of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a statutory option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock before the expiration of the applicable holding period required with respect to the stock originally acquired pursuant to the exercise of such option, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of before the expiration of the holding period required with respect to the original stock acquired pursuant to the exercise of the option, the special tax treatment provided by section 421 is applicable to both the original shares and the shares acquired by virtue of the distribution to which section 305(a) applies.

(c) *Disposition of stock.* (1) For purposes of sections 421 through 425, the term ''disposition'' includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(i) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(ii) An exchange to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036); or

(iii) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(2) A share of stock acquired by an individual pursuant to the exercise of a statutory option is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership (other than a termination effected by the death of a joint owner) is a disposition of such share, except to the extent the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a statutory option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share. However, a termination of joint ownership resulting from the death of one of the owners is not a disposition of such share. For determination of basis in the hands of the survivor where joint ownership is terminated by the death of one of the owners, see section 1014.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, a qualified stock option to purchase 100 shares of X Corporation stock at $100 per share, the fair

market value of X Corporation stock on that date. On June 1, 1965, while employed by X Corporation, E exercises the option in full and pays X Corporation $10,000, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1968, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1965, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is $10,000.

Example (2). Assume the same facts as in example (1), except assume that on August 1, 1968, three years and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000 which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,000 ($13,000 minus E's basis of $10,000), which is treated as long-term capital gain.

Example (3). Assume the same facts as in example (2), except assume that on August 1, 1968, E makes a gift of the 100 shares of Y Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $10,000 becomes the donee's basis for determining gain or loss.

Example (4). Assume the same facts as in example (1), except assume that on May 1, 1968, two years and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within three years from the date the shares were transferred to him.

Example (5). Assume the same facts as in example (1), except assume that E dies on September 1, 1965, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1965, of the qualified stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

Example (6). Assume the same facts as in example (1), except assume that on June 1, 1965, when the option is exercised by E the 100 shares are transferred by X to E and his wife W, as joint owners with right of survivorship, and that E dies on July 1, 1965. Neither the transfer into joint ownership nor the termination of such joint ownership by E's death is a disposition. Because E has made no disqualifying disposition of the shares, section 421(a) is applicable and E realizes no income at death with respect to the shares even though he held the stock less than 3 years after the transfer of the shares to him pursuant to his exercise of a qualified stock option. See paragraph (b)(2) of § 1.421–8.

(d) *Attribution of stock ownership.* Section 425(d) provides that in determining the amount of stock owned by an individual for purposes of applying the percentage limitations of section 422(b)(7), 423(b)(3), and 424(b)(3), stock of the employer corporation or of a related corporation which is owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

(e) *Modification, extension, or renewal of option.* (1) Section 425(h) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) of an option in any taxable year of the optionee which begins after December 31, 1963, except that section 425(h)(1) and this paragraph shall not apply to any change made before January 1, 1965, in the terms of an option granted after December 31, 1963, to permit such option to meet the requirements of section 422(b) (3), (4), or (5), and the regulations thereunder. See paragraphs (d), (e), and (f), of § 1.422–2, relating to period for exercising options, option price, and prior outstanding options, respectively, in the case of qualified stock options.

(2) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(3) Except as otherwise provided in subparagraph (4) of this paragraph, in

case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for purposes of applying the rules of sections 423(b)(6), and 424(b)(1)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(4)(i) In the case of a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), the rules of subparagraph (3) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1962, a restricted stock option was granted to purchase before July 1, 1965, a share of stock for $85. The fair market value of such stock on June 1, 1962, was $100. On June 15, 1963, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1966, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1963, is as follows:

1962	
June	$100
July	90
August	80
September	70
October	$80
November	80
December	90
1963	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1963, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (3) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(5)(i) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (c) of §1.421–7. For purposes of sections 421 through 425, the term ''modification'' means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a

modification. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(ii)*(a)* A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option.

(b) A change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined by paragraph (a)(1) (ii) of this section) is not a modification of the option provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such a transaction. A reduction in the option price of an option, other than as specifically provided for in this section, is a modification of such option.

(c) The application of *(b)* of this subdivision may be illustrated by the following example:

Example. E, an employee of P Corporation, holds a qualified stock option granted to him by P to buy 90 shares of P stock at $36 per share. P Corporation is a party to a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) which results in a decline in the fair market value of P stock. Immediately before such transaction the fair market value of P stock was $64 per share. Immediately after such transaction, the fair market value of P stock is $48 per share. Two weeks after such transaction, P proposes to amend E's option in order to reflect the decline in the fair market value of P stock attributable to the transaction. At such time, the fair market value of P stock is $50 per share. However, since the change was not made at the time of the transaction, the fair market value of P stock at the time of the change is irrelevant for purposes of determining whether the change comes under the rule of *(b)* of this subdivision. P changes the terms of E's option to lower the option price to $27 per share and to increase the number of shares subject to the option to 120. No other terms of the option are changed. The aggregate fair market value (determined immediately after the corporate transaction) of the shares subject to the option immediately after the change is $5,760 ($48 × 120). The aggregate option price of the shares subject to the option immediately after the change is $3,240 ($27 × 120). Thus, the excess of such fair market value over such option price is $2,520 ($5,760 − $3,240). The aggregate fair market value of the stock subject to the option immediately before the corporate transaction is $5,760 ($64 × 90). The aggregate option price for the stock subject to the option immediately before the change is $3,240 ($36 × 90). Thus, the excess of such fair market value over such option price is $2,520 ($5,760 − $3,240). Accordingly, the excess after the change does not exceed the excess before the corporate transaction. Moreover, the ratio of the option price immediately after the change ($27 per share) to the fair market value of P stock immediately after the transaction ($48 per share) is not more favorable to E on a share by share comparison than the ratio of the old option price ($36 per share) to the fair market value of P stock immediately before the transaction ($64) ($^{27}/_{48}$ = $^{36}/_{64}$). For purposes of section 425(h), the changes made do not confer additional benefits on E which he did not have before the change. Accordingly, the changes do not constitute a modification of E's option.

(iii) Any change in the terms of an option for the purpose of qualifying the option as a statutory option grants additional benefits and, therefore, is a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b)(6), 423(b)(9), or 424(b)(2), such change is not a modification, provided that in any case where the purpose of the change is to meet the requirements of section 424(b)(2) the option is at the same time changed so that it is not exercisable after the expiration of ten years from

the date the option was granted. Where an option is not immediately exercisable in full, a change in the terms of such option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of section 425(h) and this section. A modification results where an option is revised to insert the language required by section 422(c)(6)(B).

(iv) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(6) A statutory option may, as a result of a modification, extension, or renewal, thereafter cease to be a statutory option, or any option may, by modification, extension, or renewal, thereafter become a statutory option. Moreover, a qualified option after a modification may not be exercisable in accordance with its terms because of the requirements of section 422(b)(5) and section 422(c)(6). See paragraph (f)(3)(i) of § 1.422–2 and examples (8) and (9) of paragraph (f)(4) of § 1.422–2.

(7) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1965, the fair market value of the X Corporation stock is $90 per share. Under section 425(h), the X Corporation is deemed to have granted an option to the employee on February 1, 1965. Such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee after February 1, 1965, is not the exercise of a statutory option.

Example (2). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1965, and on or before June 1, 1966. On June 1, 1964, the fair market value of X Corporation's stock is $100 per share. On February 1, 1965, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 1966. On February 1, 1965, the fair market value of X Corporation stock is $110 per share. Under section 425(h), X Corporation is deemed to have granted an option to the employee on February 1, 1965, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee is not the exercise of a statutory option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1965, before the date of the modification of the option. Any exercise of the option after February 1, 1965, the date of the modification, is not the exercise of a statutory option. See example (1) in this subparagraph. The exercise of the option on January 15, 1965, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

Example (4). On June 1, 1964, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1965, the fair market value of X Corporation stock is $80 per share. Under these facts, the X Corporation has granted two options, one option (not a statutory option) with respect to 100 shares having been granted on June 1, 1964, and the other option (a qualified stock option) with respect to the additional 150 shares having been granted on February 1, 1965. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6887, 31 FR 8808, June 24, 1966]